## Contents

1. Preface ......................................................................................................................... 1
2. Scope ............................................................................................................................. 7
3. Identifying a Business Combination ............................................................................. 16
4. The Acquisition Method ............................................................................................... 102
5. Identifying the Acquirer ............................................................................................... 103
6. Determining the Acquisition Date ................................................................................. 122
7. Recognizing and Measuring the Consideration Transferred ........................................ 127
8. Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree ................................................................. 175
9. Goodwill or a Gain from a Bargain Purchase ............................................................... 252
10. Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations .................................................................................................................. 258
11. Measurement Period ................................................................................................... 279
13. Subsequent Measurement and Accounting .................................................................. 356
14. Disclosures ................................................................................................................... 376
15. Effective Date and Transition ...................................................................................... 403

### SECTIONS 16 THROUGH 21

#### FAIR VALUE MEASUREMENTS

16. Overview of ASC Subtopic 820-10 ............................................................................ 521
17. Determining the Fair Value of Assets Acquired and Liabilities Assumed in a Business Combination .......................................................................................................................... 559
18. Determining the Fair Value of the Consideration Transferred in a Business Combination ................................................................................................................................. 619
19. Determining the Fair Value of a Noncontrolling Interest in a Business Combination ................................................................................................................................. 631
20. Determining the Fair Value of a Previously Held Equity Interest in a Business Combination ............................................................................................................................. 634
21. Determining the Fair Value of a Retained Interest in a Subsidiary When Control Is Lost ........................................................................................................................................... 637
22. Goodwill and Other Intangible Assets ........................................................................... 640
SECTIONS 23 THROUGH 25
INCOME TAX CONSIDERATIONS

23. The Tax Effects of Business Combinations ............................................. 736
   See KPMG’s Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations

24. The Tax Effects of Changes in Ownership Interests While Retaining Control ........................................... 737
   See KPMG’s Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations

25. The Tax Effects of Asset Acquisitions ................................................. 738
   See KPMG’s Accounting for Income Taxes, Section 10, Other Considerations

26. Private Company and Not-for-Profit Accounting Alternatives................. 739

27. Application of Pushdown Accounting .................................................. 758

28. Combinations of Entities Under Common Control .................................. 783

Acknowledgments ....................................................................................... 807
Preface

The purpose of KPMG’s series of Handbooks is to assist you in understanding the application of US GAAP in practice, and to explain the conclusions that we have reached on many interpretive issues.

*Business Combinations* is designed to assist you in understanding the application of:

- FASB ASC Topic 805, *Business Combinations*,
- Noncontrolling interests subsections of FASB ASC Subtopic 810-10, *Consolidation - Overall*, and
- Relevant subsections of FASB ASC Topic 350, *Intangibles--Goodwill and Other*.

We expect to update this Handbook as needed based on developments in practice. You will always be able to find the most up-to-date version of this and other KPMG publications on KPMG’s [Financial Reporting View](#).

Currently Effective Requirements

Each section of this Handbook includes excerpts from the FASB’s Accounting Standards Codification® to supplement our interpretive guidance, and illustrative examples that address the specific implementation issues we have identified.

Section 26 discusses the accounting alternatives available only to private companies and not-for-profit entities.

Pending Content

This Handbook incorporates the following Accounting Standards Updates that are effective for some or all entities for fiscal periods beginning after December 15, 2017 and certain others that allow for early adoption. This includes:

- ASU 2014-09, *Revenue from Contracts with Customers*, and related amendments
- ASU 2016-02, *Leases*, and related amendments
- ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*
- ASU 2016-10, *Identifying Performance Obligations and Licensing*
- ASU 2017-01, *Clarifying the Definition of a Business*
- ASU 2017-04, *Simplifying the Test for Goodwill Impairment*
New in 2019

In 2019, we have updated or added the following significant guidance in this Handbook.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clarification on transactions involving the formation of a joint venture</td>
<td>1.011, 15.041</td>
</tr>
<tr>
<td>Clarification on whether a combination of one or more not-for-profit entities is a merger or acquisition</td>
<td>1.018a</td>
</tr>
<tr>
<td>Examples of other areas in GAAP affected by the definition of a business</td>
<td>Table 2.2a</td>
</tr>
<tr>
<td>Clarification on what is considered a single identifiable asset when applying the screening test in the definition of a business</td>
<td>2.051</td>
</tr>
<tr>
<td>Clarification on evaluating risk factors for purposes of applying the screening test in the definition of a business</td>
<td>2.057</td>
</tr>
<tr>
<td>Example of applying the screening test for an acquisition with a property subject to a property tax abatement</td>
<td>Example 2.11b</td>
</tr>
<tr>
<td>Clarifications on transactions involving a newly formed entity</td>
<td>4.007, 4.020a</td>
</tr>
<tr>
<td>Newly formed entity in an exchange that lacks substance</td>
<td>4.020d, Example 4.3a</td>
</tr>
<tr>
<td>Special Purpose Acquisition Company (SPAC)</td>
<td>4.022a, 4.022b</td>
</tr>
<tr>
<td>Clarification of regulatory or shareholder approval in determining the acquisition date</td>
<td>5.002a</td>
</tr>
<tr>
<td>Topic</td>
<td>Page</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Clarification of an acquirer's accounting for a leveraged lease in a business combination on or after the effective date of ASC Topic 842</td>
<td>7.063</td>
</tr>
<tr>
<td>Involvement of a third-party lessor in a business combination (pre-Topic 842)</td>
<td>7.065a</td>
</tr>
<tr>
<td>Clarification on the separability criterion</td>
<td>7.071</td>
</tr>
<tr>
<td>Fair value of trade secrets not legally protected</td>
<td>7.113</td>
</tr>
<tr>
<td>Clarification on assets and liabilities arising from contingencies</td>
<td>7.158</td>
</tr>
<tr>
<td>Clarification on allocating a gain from a bargain purchase between the parent and noncontrolling interest</td>
<td>8.008</td>
</tr>
<tr>
<td>Clarification on reporting and adjustments of provisional amounts</td>
<td>10.002, 10.004, 10.008</td>
</tr>
<tr>
<td>Allocation of consideration transferred between the business combination and transactions separate from the business combination</td>
<td>11.000</td>
</tr>
<tr>
<td>Preexisting contractual relationships</td>
<td>11.009</td>
</tr>
<tr>
<td>Awards with market conditions</td>
<td>11.049a</td>
</tr>
<tr>
<td>Acquisition-related costs incurred by the acquirer</td>
<td>11.061</td>
</tr>
<tr>
<td>Payments to an acquiree that are not part of the consideration transferred</td>
<td>11.066</td>
</tr>
<tr>
<td>Preacquisition contingencies not recorded at the acquisition date</td>
<td>12.003</td>
</tr>
<tr>
<td>Subsequent accounting for assurance and service-type warranties after ASC Topic 606</td>
<td>12.005a</td>
</tr>
<tr>
<td>Reclassification of indefinite-lived assets to definite-lived</td>
<td>12.017</td>
</tr>
<tr>
<td>Changes to contingent consideration arrangements</td>
<td>12.022a</td>
</tr>
<tr>
<td>Classification and valuation of contingent consideration</td>
<td>12.023, 12.026a, 18.021</td>
</tr>
<tr>
<td>Subsequent measurement of equity-classified contingent consideration</td>
<td>12.024</td>
</tr>
<tr>
<td>Topic</td>
<td>Page</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Clarification on disclosure requirements for periods presented</td>
<td>13.002</td>
</tr>
<tr>
<td>Clarification on disclosures for public entities</td>
<td>13.006</td>
</tr>
<tr>
<td>Measurement period adjustment disclosures</td>
<td>13.031</td>
</tr>
<tr>
<td>Impact of management's intention on valuation</td>
<td>Example 16.6a</td>
</tr>
<tr>
<td>Mining assets</td>
<td>17.046a</td>
</tr>
<tr>
<td>Valuation of IPR&amp;D</td>
<td>17.079</td>
</tr>
<tr>
<td>Contracts with customers post ASC Topic 606</td>
<td>17.084a - 17.084n, Example 17.6a</td>
</tr>
<tr>
<td>ASC Topic 842 Leases (Acquiree is lessee)</td>
<td>17.095a-17.095c</td>
</tr>
<tr>
<td>Fair value of long-term debt</td>
<td>17.122, 18.016</td>
</tr>
<tr>
<td>Fair value of an asset retirement obligation</td>
<td>17.125</td>
</tr>
<tr>
<td>Clarification on determining the fair value of a noncontrolling interest</td>
<td>19.003, 19.003a, 19.004</td>
</tr>
<tr>
<td>Clarification on determining the fair value of a previously held interest</td>
<td>20.003, Example 20.1</td>
</tr>
<tr>
<td>Unit of account for impairment testing</td>
<td>Example 22.7 Scenario 4</td>
</tr>
<tr>
<td>Clarification of the effect of foreign currency guidance on goodwill</td>
<td>22.064a-e, 27.044</td>
</tr>
<tr>
<td>Evaluating events or circumstances in between annual goodwill impairment tests</td>
<td>Example 22.7a</td>
</tr>
<tr>
<td>Extending the private company accounting alternative to not-for-profit entities</td>
<td>26.001b, 26.014a</td>
</tr>
<tr>
<td>Clarification on the application of the private company alternative</td>
<td>26.002, 26.002a</td>
</tr>
<tr>
<td>Adjustment to consideration payable after common control ends</td>
<td>28.015, Example 28.2b</td>
</tr>
</tbody>
</table>
Abbreviations

The following abbreviations are used in this Handbook:

ASC  FASB’s Accounting Standards Codification®
ASU  Accounting Standards Update
BEV  Business enterprise value
CAC  Contributory asset charges
CODM Chief operating decision maker
COGS Cost of goods sold
EBITDA Earnings before interest, taxes, depreciation and amortization
EITF Emerging Issues Task Force
EPS  Earnings per share
GAAP Generally accepted accounting principles
IPO  Initial public offering
IPR&D In-process research and development
IRR  Implied rate of return
LIFO Last-in, first-out
LTCC Long-term construction-type contracts
MPEEM Multi-period excess earnings method
NCI  Noncontrolling interest(s)
NFP  Not-for-profit
NRV  Net realizable value
OCI  Other comprehensive income
OPM Option pricing method
PCS  Postcontract customer support
PFI  Projected financial information
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>R&amp;D</td>
<td>Research and development</td>
</tr>
<tr>
<td>REIT</td>
<td>Real estate investment trust</td>
</tr>
<tr>
<td>SBM</td>
<td>Scenario based method</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>VIE</td>
<td>Variable interest entity</td>
</tr>
<tr>
<td>WACC</td>
<td>Weighted-average cost of capital</td>
</tr>
<tr>
<td>WARA</td>
<td>Weighted-average return on assets</td>
</tr>
</tbody>
</table>
Section 1 - Scope

Detailed Contents

Business Combinations

Variable Interest Entities
  When a Variable Interest Entity and its Primary Beneficiary Are under Common Control

Mutual Entities

Leveraged Buyout Transactions

Transactions outside the Scope of ASC Topic 805
  The Formation of a Joint Venture
  The Acquisition of an Asset or a Group of Assets That Do Not Constitute a Business
  A Combination between Entities or Businesses under Common Control
  A Combination between Not-for-Profit Organizations or the Acquisition of a For-Profit Business by a Not-for-Profit Organization
  Financial Assets and Financial Liabilities of a Collateralized Financing Entity
1.000 ASC Topic 805, *Business Combinations*, establishes the accounting and reporting for business combinations. ASC Topic 805 defines a business combination, and requires accounting for each business combination within the scope of ASC Topic 805 by the *acquisition method*. See discussion of *The Acquisition Method* in Section 3. In addition, ASC Subtopic 805-50, *Business Combinations - Related Issues*, provides guidance on transactions that may be similar to business combinations but that do not meet the requirements to be accounted for as a business combination, such as combinations of entities under common control. See Section 28 for additional discussion of combinations of entities under common control.

1.000a Other than for limited exceptions provided in ASC Topic 805, assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination are recognized and measured at fair value at the acquisition date and, following the acquisition, are accounted for based on other applicable generally accepted accounting principles (GAAP).

**ASC Paragraph 805-10-15-3**

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

**ASC Paragraph 805-10-15-4**

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

(a) The formation of a joint venture

(b) The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity

(c) A combination between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)

(d) An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a merger of not-for-profit entities (NFPs)

(e) A transaction or other event in which an NFP obtains control of a not-for-profit entity but does not consolidate that entity, as described in ASC paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

(f) Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in [ASC] Subtopic 810-10.

1.001 ASC Topic 805 represents the codification of FASB Statement 141(R), *Business Combinations*, which replaced FASB Statement No. 141, *Business Combinations*, and
required prospective application to business combinations for which the acquisition date occurs in an annual reporting period beginning on or after December 15, 2008. Early application was prohibited.

1.001a The FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (ASU 2017-01), in January 2017. The ASU changes the framework for determining whether a set of assets and activities constitutes a business. It is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017 (i.e., January 1, 2018 for public companies with a calendar year-end). For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. An entity can early adopt the ASU and apply it to transactions that have not yet been reported in financial statements that have been issued or made available for issuance. For additional information on ASU 2017-01, see Paragraph 2.025.

BUSINESS COMBINATIONS

1.002 A business combination in ASC Topic 805 includes all transactions or events in which an acquirer obtains control of one or more businesses, regardless of how it obtains control or how the consideration is transferred. Thus, transactions in which an acquirer obtained control of a business through means other than an acquisition of net assets or equity interests are included in the scope of ASC Topic 805. For example, under ASC Topic 805, a business combination can occur on the lapse of minority veto rights that previously kept an acquirer who held a majority voting interest from controlling an acquiree. See discussion of Control in Section 2. Additionally, the acquisition of a business through a nonmonetary exchange is in the scope of ASC Topic 805. ASC paragraph 825-10-25-11

1.003 A business in ASC Topic 805 focuses on an integrated set of activities and assets that is capable of providing a return (prior to the adoption of ASU 2017-01. See Paragraph 2.025 for additional information after the adoption of ASU 2017-01). This requires that the integrated set include inputs and processes applied to those inputs which, together are or will be used to create outputs, but does not necessarily require that it currently include outputs. See discussion of Identifying a Business Combination in Section 2.

VARIABLE INTEREST ENTITIES

1.004 Under ASC Subtopic 810-10, Consolidation - Overall, the initial consolidation of a variable interest entity (VIE) that is a business by its primary beneficiary is a business combination and should be accounted for by the acquisition method.

1.005 Paragraph not used.

1.006 ASC Subtopic 810-10 requires an entity to determine whether it is the primary beneficiary of a VIE at the time it becomes involved with the VIE, and to continuously reassess whether changes in facts and circumstances result in a change in the
determination of whether the entity is the primary beneficiary of the VIE. When an entity becomes the primary beneficiary of a VIE that is a business, even if the entity was previously involved with the VIE but was not the primary beneficiary, a business combination has occurred and must be accounted for by the acquisition method at that date. See discussion of Variable Interest Entities in Section 4.

**When a Variable Interest Entity and its Primary Beneficiary Are under Common Control**

1.007 Combinations between entities or businesses under common control are outside the scope of ASC Subtopic 805-10. However, ASC Subtopic 810-10 provides guidance for situations in which an entity becomes the primary beneficiary of a VIE when the primary beneficiary and the VIE are under common control. In these situations, the primary beneficiary initially measures the assets, liabilities, and noncontrolling interests of the VIE at amounts at which they are carried in the accounts of the reporting entity (i.e., the ultimate parent) that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles). ASC paragraph 810-10-30-1

**MUTUAL ENTITIES**

1.008 Combinations of mutual entities are in the scope of ASC Topic 805.

**LEVERAGED BUYOUT TRANSACTIONS**

1.009 Under ASC Topic 805, the acquirer will account for leveraged buyout transactions resulting in a change in control by the acquisition method.

**TRANSACTIONS OUTSIDE THE SCOPE OF ASC TOPIC 805**

1.010 ASC Topic 805 does not apply to the formation of a joint venture, the acquisition of an asset or a group of assets that does not constitute a business, a combination between entities or businesses under common control, or a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

**The Formation of a Joint Venture**

1.011 The definition of a corporate joint venture in ASC Subtopic 323-10, *Investments--Equity Method and Joint Ventures - Overall*, applies in assessing whether an entity is a joint venture.

**ASC Paragraph 323-10-20: Corporate Joint Venture**

A corporation owned and operated by a small group of entities (the *joint venturers*) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The
The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

Because none of the participants in the formation of a joint venture obtains control over the entity, the formation of a joint venture does not meet the definition of a business combination under ASC Topic 805. However, control is not the only defining characteristic of a joint venture. In fact, ASC paragraph 805-10-S99-8 states that the SEC staff will object to a conclusion that joint control is the only defining characteristic of a joint venture. Rather, each of the characteristics in the definition should be met for an entity to be a joint venture, including that the purpose of the entity is consistent with that of a joint venture. ASC paragraph 805-10-S99-8 further indicates that in the stand-alone financial statements of a venture, ASC Topic 805 should be applied to transactions where businesses are contributed to a jointly controlled entity that does not meet the definition of joint venture. See Section 15, Accounting by Venture for Joint Venture Formations (New Basis or Carryover Basis).

1.012 Paragraph not used.

The Acquisition of an Asset or a Group of Assets That Do Not Constitute a Business

1.013 If an acquired asset or an asset group (including liabilities assumed, if any) does not constitute a business, the transaction is not a business combination. These transactions would be accounted for as asset acquisitions. The Acquisition of Assets Rather than a Business Subsections of ASC Subtopic 805-50 provide continuing authoritative guidance with respect to the accounting for asset acquisitions. Asset acquisitions are accounted for using a cost accumulation and allocation model rather than the ASC Topic 805 model, which requires measurement of assets acquired and liabilities assumed at fair value with limited exceptions. There may be significant differences in the accounting for the acquisition of a group of assets versus a business. Examples of these differences are provided in Table 2.3.

A Combination between Entities or Businesses under Common Control

1.014 Combinations between entities or businesses under common control involve exchanges or movements of net assets or equity interests among entities under common control, such that the same ultimate parent controls the entities both before and after the exchange or movement. These transactions do not result in an acquirer outside the control.
group obtaining control over the net assets or equity interests, but result in a shift of ownership of the net assets or equity investments within the entities or businesses under common control. Therefore, combinations between entities under common control do not meet the definition of a business combination.

1.015 Transfers or exchanges of net assets or equity instruments between entities under common control should be recorded at the carrying amount of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the ultimate parent of the entities under common control, e.g., because push-down accounting was not applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the ultimate parent of the entities under common control. The Transactions between Entities Under Common Control Subsections of ASC Subtopic 805-50 provide continuing authoritative guidance for transactions between entities under common control. See Section 28, Combinations of Entities under Common Control, for additional discussion.

1.016 If a transaction results in the acquisition of all, or part, of a noncontrolling interest in a subsidiary (i.e., an increase in the ultimate parent’s controlling interest in a subsidiary), the acquisition of the noncontrolling interest is accounted for as an equity transaction based on ASC Subtopic 810-10. If a common control transaction results in an increase in the noncontrolling interest of a subsidiary (i.e., a disposition of a portion of the ultimate parent’s interest in a subsidiary where the parent retains control after the transaction), the transaction is also accounted for as an equity transaction based on ASC Subtopic 810-10. No gain or loss is recognized in consolidated net income or comprehensive income as a result of changes in the noncontrolling interest, unless a change results in the loss of control by the ultimate parent. See Section 15, Noncontrolling Interests in Consolidated Financial Statements, for additional discussion.

A Combination between Not-for-Profit Organizations or the Acquisition of a For-Profit Business by a Not-for-Profit Organization

1.017 ASC Subtopic 958-805, Not-for-Profit Entities – Business Combinations, provides guidance on accounting by not-for-profit entities for a combination with one or more other not-for-profit entities, businesses, or not-for-profit activities. Under ASC Subtopic 958-805, which includes guidance on whether a combination is a merger or an acquisition, a not-for-profit entity applies the carryover method to account for a merger and the acquisition method to account for an acquisition.

1.018 The implementation guidance in ASC paragraphs 958-805-55-1 through 55-8 provides indicators that not-for-profit entities should consider when determining whether a combination is a merger or an acquisition. However, all of the facts and circumstances of the combination should be considered in making this determination.

1.018a ASC paragraph 958-805-55-1 states that ceding control by the prior not-for-profit entities to a new not-for-profit entity is the sole definitive criterion for identifying a merger, and one entity obtaining control over the other is the sole definitive criterion for
an acquisition. If the participating entities in a combination retain shared control of the new not-for-profit entity, they have not ceded control. To qualify as a new not-for-profit entity, the newly established combined not-for-profit entity must have a newly formed governing body and is often, but not required to be, a new legal entity. ASC paragraphs 958-805-55-3 through 55-7 include additional considerations for purposes of evaluating whether a combination is a merger or an acquisition and focus on areas such as governance, related control powers, and financial capacity. These considerations include:

- Assessing whether the governing bodies of the entities participating in the combination ceded control and understanding the process leading up to the combination and the formation of the combined entity. (ASC paragraph 958-805-55-3)

- ASC paragraph 958-805-55-4 states that one entity dominating the negotiations is an indicator of an acquisition, whereas a situation where no one party dominates or is capable of dominating the negotiations and process leading to the formation of the combined entity is an indicator of a merger.

- We believe that decisions made on a mutual basis, such as the transaction timing, strategic plan, and operating plans associated with the transaction, indicate a merger.

- ASC paragraph 958-805-55-6 states that if one entity appoints significantly more of the governing board to the newly formed entity, retains more of its key senior officials, bylaws, operating policies, and/or practices, it may be more indicative of an acquisition than a merger.

- We believe other relevant characteristics to consider include board term limits, voting rights, and future board composition. For example, the board of the new entity usually includes board members from the previous entities' governing bodies. If those board members' initial terms are long and they can continue to be reappointed, this factor would indicate that the same prior leadership is still intact, and therefore control is being shared and has not been ceded.

- Alternatively, it may be reasonable to conclude that a combination is a merger even if the new board includes some individuals who were formerly members of the recently terminated legacy boards, if the new entity implements term limits, supermajority voting requirements, or other board member transition plans that meet the requirement of ceding control.

- We believe consideration should be given to existing affiliate and joint venture ownership governance. For example, if ultimate control of all existing affiliates and joint ventures resides with the new entity (i.e., all key operating and strategic decision will be controlled by the new entity's board of directors), that would indicate a merger.
• Analyzing the financial strength and size of each of the participating entities. (ASC paragraph 958-805-55-6)
  
  ASC paragraph 958-805-55-6 indicates that if one entity is financially stronger and larger in size, that entity may be able to dominate the negotiations and transaction, which would be more indicative of an acquisition than a merger. To gauge the relative financial strength of the participating entities, we believe one can look at the credit ratings of the entities involved in the combination as part of the process. Financial strength and size, however, is just an indicator and should not be the only consideration in determining whether a combination is a merger or an acquisition.

• We believe that if one of the participating entities is experiencing financial difficulties and will depend on the other entity to provide back-office or information technology support for a below-cost fee, it could be an indicator of an acquisition.

• To gauge the relative size of the participating entities, we believe one can look at the participating entities' pre-combination total assets, total net assets, operating income, and total revenues, among other factors.

• Understanding the contributions made by the participating entities to the combination. (ASC paragraph 958-805-55-7)
  
  ASC paragraph 958-805-55-7 indicates that a merger generally is accomplished by a newly formed entity assuming all of the assets and liabilities of the participating entities without transferring cash or other assets to those entities or any of their owners, members, sponsors, or other designated beneficiaries. For example, in a merger, there are no:

  • Financial inducements for the benefit of one party, such as built-in capital or funding commitments;
  
  • Guarantees, assumptions, or payoffs of the debt of either party by the other as part of the transaction; or
  
  • Commitments for guarantees or credit support on future debt for either participating entity.

  ASC paragraph 958-805-55-7 also indicates that unlike the formation of a joint venture arrangement in which the participating entities continue to exist and usually hold a financial interest, the creators of the merged entity cease to exist as autonomous entities and no one holds a financial interest in the merged entity. The merged entity generally has a perpetual life rather than a life that is limited by the period of the venture or that allows for one or more of the participating entities to opt out of the venture or other arrangement.

• We believe that one entity making significantly more contributions than another may be indicative of an acquisition over a merger.
1.018b ASC paragraphs 958-805-55-9 through 55-31 provide illustrative examples for assessing whether a combination is a merger, an acquisition, or is neither a merger nor an acquisition.

1.018c All of the indicators and illustrative examples should be carefully considered based on the actual facts and circumstances in determining whether the combination is a merger or an acquisition. In accordance with ASC paragraph 958-805-55-2, the participating not-for-profit entities must make a decision based on the preponderance of the evidence about whether each of the governing bodies has ceded control to create a new not-for-profit, whether one entity has acquired the other, or whether another form of combination, such as the formation of a joint venture, has occurred.

**Financial Assets and Financial Liabilities of a Collateralized Financing Entity**

1.019 A collateralized financing entity (CFE) is an entity that holds financial assets such as asset-backed securities and issues beneficial interests to investors. These beneficial interests are usually debt instruments that are considered financial liabilities under U.S. GAAP. Because a CFE generally has little or no equity, it is typically a variable interest entity (VIE) under U.S. GAAP and subject to the consolidation requirements that apply to an entity not controlled through voting equity interests. Consequently, an entity may be the primary beneficiary of, and therefore required to consolidate, a CFE if it has a controlling financial interest in the CFE. Unlike the initial consolidation of a VIE that is a business, which should be accounted for under the acquisition method, the consolidation of the financial assets and financial liabilities of a VIE that is a CFE is excluded from the scope of ASC Topic 805 and should not be accounted for under the acquisition method.
Section 2 - Identifying a Business Combination

Detailed Contents

Definition of a Business Combination

Control

Control Defined
Control Does Not Exist if Minority Shareholders (or Other Interest Holders) Have Substantive Participating Rights
Determination of Control Is a Point-In-Time Evaluation

Example 2.0: Acquisition of a Franchisee

Example 2.0a: Purchase of a Business That Was Subsequently Canceled

Control Achieved Without Transferring Consideration
Transfer of Consideration Without Obtaining Control of a Business Combinations Involving Variable Interest Entities

Multiple Transactions Accounted for as a Single Transaction

Example 2.0b: Accounting for Goodwill When Multiple Transactions That Cross Reporting Periods Are Accounted for as a Single Business Combination

Business

THIS SECTION OF THE CHAPTER APPLIES TO TRANSACTIONS THAT OCCURRED PRIOR TO THE ADOPTION OF ASU 2017-01. FOR TRANSACTIONS AFTER THE ADOPTION OF ASU 2017-01, SEE PARAGRAPH 2.025.

Business Defined
Determining Whether a Set of Assets and Activities is a Business (Prior to the Adoption of ASU 2017-01)

Inputs, Processes, and Outputs
Table 2.1: Considerations in Selected Industries for the Evaluation of Whether Acquired Assets and Activities Constitute a Business (Prior to the Adoption of ASU 2017-01)

Example 2.1: Acquisition of a Group of Restaurants – Scenario 1 (Prior to the Adoption of ASU 2017-01)

Example 2.2: Acquisition of a Group of Restaurants – Scenario 2 (Prior to the Adoption of ASU 2017-01)

Example 2.3: Acquisition of a Group of Restaurants – Scenario 3 (Prior to the Adoption of ASU 2017-01)

Development Stage Enterprises
Example 2.4: Acquisition of an Integrated Set in the Development Stage – Scenario 1 (Prior to the Adoption of ASU 2017-01)
Example 2.5: Acquisition of an Integrated Set in the Development Stage – Scenario 2 (Prior to the Adoption of ASU 2017-01)

New Definition of a Business
Table 2.2: Key Changes in the Definition of a Business as a Result of ASU 2017-01
Table 2.2a: Other Areas Affected by the Definition of a Business
Table 2.3: Significant Difference in the Accounting for the Acquisition of a Group of Assets Versus a Business

Inputs, Processes, and Outputs
Example 2.6: Determining What Is a Part of the Set - Multiple Transactions with the Seller
Example 2.7: Determining What Is a Part of the Set - Contractual Arrangement with a Third Party

Step 1 – Screening Test
Example 2.8a: Applying Step 1a
Example 2.8b: Applying Step 1b
Table 2.4: Risk Factors and Examples to Consider When Identifying Similar Assets
Example 2.8c: Applying Step 1c
Example 2.8d: Applying Step 1d
Example 2.8e: Applying Step 1e
Example 2.8f: Recognizing Certain Assets of a Medical Device Company as a Single Asset for Financial Reporting Purposes
Example 2.9: Applying Step 1 When Goodwill Results from the Effects of Deferred Tax Liabilities
Example 2.9a: Applying the Step 1 Threshold (Initial Screening) Test When a Bargain Purchase Exists
Example 2.10: Acquisition of Loan Portfolio – Scenario 1
Example 2.11: Acquisition of Oil and Gas Properties – Scenario 1
Example 2.11a: Acquisition of Petroleum Storage Facilities
Example 2.11b: Acquisition of a Property Subject to a Tax Abatement

Step 2 – Evaluate Whether an Input and a Substantive Process Exist
Example 2.12: Acquisition of a Drug Candidate – Scenario 1
Example 2.13: Acquisition of Biotech – Scenario 1
Example 2.13a: Acquisition of Professional Service Employees
Example 2.13b: Intent to Restructure Workforce Post-Acquisition
Example 2.14: Acquisition of Real Estate – Scenario 2
Example 2.15: Acquisition of Loan Portfolio – Scenario 1 (continued)
Example 2.16: Acquisition of Loan Portfolio – Scenario 2
Example 2.17: Acquisition of Brands – Scenario 1
Example 2.18: Acquisition of Oil and Gas Properties – Scenario 2
Example 2.19: Acquisition of Properties That Are Simultaneously Leased to Another Party

Applying the Definition of a Business to Financial Services Companies
Example 2.20: Acquisition of a Bank Branch
Example 2.21: Acquisition of an Asset Management Firm
DEFINITION OF A BUSINESS COMBINATION

ASC Master Glossary: Business Combination

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

ASC Paragraph 805-10-25-1

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

2.000 Each transaction or event involving entities within the scope of ASC Topic 805, Business Combinations (see discussion in Section 1), that falls within the definition of a business combination is accounted for by applying the acquisition method.

2.000a The FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (ASU 2017-01), in January 2017. The ASU changes the framework for determining whether a set of assets and activities constitutes a business. It is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017 (i.e., January 1, 2018 for public companies with a calendar year-end). For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. An entity may early adopt the ASU and apply it to transactions that have not yet been reported in financial statements that have been issued or made available for issuance. For additional information on ASU 2017-01, see Paragraph 2.025.

2.001 The definition of a business combination includes all transactions or events in which an entity obtains control of a business, regardless of whether the entity obtains control through the transfer of consideration or without the transfer of consideration. Fundamental to the FASB’s definition is its belief that all transactions or events in which an entity acquires control over a business are economically similar, and that the definition of a business combination should encompass all such transactions or events.

2.002 ASC paragraph 805-10-55-3 provides examples (not intended to be an exhaustive listing) of ways a business combination may be structured for legal, taxation, or other reasons:

(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.

2.003 The structure of a transaction or event does not affect the determination of whether a business combination has occurred. Rather, the obtaining of control of one or more businesses by an acquirer is determinative. The concepts of control and what constitutes a business are discussed below. Identifying the accounting acquirer is discussed in Section 4.

CONTROL

CONTROL DEFINED

ASC Master Glossary: Control

The same as the meaning of controlling financial interest in [ASC] paragraph 810-10-15-8.

2.004 On February 18, 2015, the FASB issued ASU 2015-02, which changes the evaluation of whether an entity has a controlling financial interest in an investee. The guidance became effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015, and one year later for all other entities. Early adoption is allowed, including early adoption in an interim period. The discussion contained herein is based on the guidance in ASU 2015-02.

2.004a ASC Subtopic 810-10 indicates that majority ownership is not always determinative and that majority ownership would not constitute a controlling financial interest if control does not rest with the majority owner. Conversely, an investor could obtain control over a business in situations where the investor owns less than a majority of the voting interest of an investee (e.g., in combinations achieved by contract alone). More specifically, ASC paragraphs 810-10-15-8 and 810-10-15-8A state:

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

Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly
or indirectly, of more than 50 percent of the limited partnership’s kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

2.005 ASC paragraphs 805-10-55-10 through 55-15 provide guidance for identifying the entity that obtains control (i.e., the acquirer) in a business combination if the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer. See discussion in Section 4, Identifying the Acquirer.

2.006 ASC Subtopic 810-10, Consolidation - Overall, provides guidance on the consolidation of variable interest entities. See discussion of Variable Interest Entities beginning at Paragraph 2.014.

CONTROL DOES NOT EXIST IF MINORITY SHAREHOLDERS (OR OTHER INTEREST HOLDERS) HAVE SUBSTANTIVE PARTICIPATING RIGHTS

2.007 As noted in ASC paragraphs 810-10-15-8 and 810-10-15-8A, ownership of a majority voting interest does not constitute a controlling financial interest if control does not rest with the majority owner or, for limited partnerships, the limited partner with a majority of kick-out rights through voting interests. For example, as discussed in ASC paragraphs 810-10-25-1 through 25-14C and 55-1, a minority shareholder (or shareholders) or another limited partner (or limited partners) may have substantive participating rights such that the majority shareholder or the limited partner with a majority of kick-out rights through voting interests is unable to exercise control over an investee. ASC paragraphs 810-10-25-1 through 25-14C describe substantive participating rights as those that allow a minority shareholder or another limited partner to effectively participate in significant financial and operating decisions expected to be made in the ordinary course of business, and describe effective participation as the ability to block significant decisions proposed by the investor that has a majority voting interest. If a minority shareholder or limited partner holds substantive participating rights (whether granted by contract or law), the presumption of control by the majority owner or the limited partner with a majority of kick-out rights through voting interests is overcome (and thus, the majority owner would not control the investee for purposes of applying ASC Topic 805). Examples of substantive participating rights (whether granted by contract or law) described in ASC paragraph 810-10-25-11 include minority rights that would allow the minority shareholder to effectively participate in:

- Selecting, terminating, and setting the compensation of management responsible for implementing the investee’s policies and procedures; and
- Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

2.008 It is important to note that the likelihood that a veto right will be exercised by a minority shareholder or limited partner should not be considered in assessing whether a minority right is substantive. If the right is determined to be a substantive participating
right, such that a minority shareholder or limited partner has the ability to block significant decisions proposed by the holder of the majority voting interest or kick-out rights, control does not rest with the majority owner or the limited partner with a majority of kick-out rights through voting interests.

2.009 Not all rights granted to a minority shareholder are deemed to be substantive participating rights for purposes of determining whether control rests with the majority owner or the limited partner with a majority of kick-out rights through voting interests. ASC paragraph 810-10-25-10 describes some rights as protective. Protective rights do not allow a minority shareholder or limited partner to participate in significant decisions expected to be made in the ordinary course of business, and thus do not overcome the presumption of control by the majority owner or the limited partner with a majority of kick-out rights through voting interests. Examples of protective rights described in ASC paragraph 810-10-25-10 include:

- Amendments to articles of incorporation of the investee;
- Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions;
- Liquidation of the investee (in the context of Topic 852, Reorganizations) or a decision to cause the investee to enter bankruptcy or other receivership;
- Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances); and
- Issuance or repurchase of equity interests.

2.010 It will not always be clear whether rights granted to minority shareholders or limited partners are protective or substantive participating rights, and judgment and consideration of the available facts and circumstances, including the guidance provided in ASC paragraph 810-10-55-1, is required to make this determination. ASC paragraph 810-10-25-13 provides a discussion of factors to consider in evaluating whether minority rights are substantive participating rights that provide for effective participation in significant financial and operating decisions related to the investee’s ordinary course of operations. Additionally, ASC paragraph 810-10-55-1 includes a number of examples to facilitate an understanding of how to assess whether rights of a minority shareholder or limited partner are protective or substantive participating rights.

DETERMINATION OF CONTROL IS A POINT-IN-TIME EVALUATION

2.010a An entity can obtain control with the intention of relinquishing it in the future. Control is a point-in-time evaluation, and a business combination occurs when an acquirer obtains control of one or more businesses. Thus, when an entity obtains control
of a business, even if it is expected to be temporary, a business combination has occurred and the transaction is within the scope of ASC Topic 805. There is no concept of temporary control that allows for an exception from the scope of ASC Topic 805.

**2.010b** Careful consideration should be given to contractual terms that accompany transactions with the intention of temporary control. Such terms may include substantive participating rights, which may prevent control, or reacquisition rights granted to the seller, which may be part of the consideration transferred in the business combination.

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**Example 2.0: Acquisition of a Franchisee**

Franchisor operates a franchise with numerous stores owned by various franchisees. The franchise agreement stipulates certain conditions that the franchisee must maintain while owning and operating the franchise, including holding a business license to operate in its state or territory.

Franchisee does not maintain its business license. Franchisee applies for a new license, but regulatory approval and issuance is expected to take six months. Franchisee and Franchisor agree that Franchisor will acquire and operate the store until the business license is obtained. Control is intended to be temporary, and Franchisee holds a reacquisition right to repurchase the store at a formulaic price at any time in the next nine months, exercisable only after it obtains the business license. Franchisee will have no substantive participating rights while the store is owned by Franchisor. The store meets the definition of a business in ASC Topic 805.

**Assessment**

Franchisor concludes that the acquisition is a business combination because it has obtained control of a store that meets the definition of a business. After the transaction, Franchisee holds no rights to control the activities and decisions of the franchise during the period that it is owned by Franchisor. Additionally, Franchisor has sole rights and obligations to income or losses of the franchise during the period of ownership. The fact that control is intended to be temporary, and the fact that Franchisee holds a reacquisition right is not determinative in the analysis of control.

Franchisor should recognize the fair value of the reacquisition right (i.e., written call option) as part of the consideration transferred under ASC Topic 805 and evaluate the terms of the reacquisition right to determine whether it constitutes a derivative instrument requiring subsequent measurement at fair value under ASC Topic 815.

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**Example 2.0a: Purchase of a Business That Was Subsequently Canceled**

ABC Corp. enters into a purchase agreement to acquire a private label widget manufacturer (DEF Corp.) during April 20X0. Under the terms of the purchase agreement, ABC will pay the seller of DEF Corp. (Seller) a total of $40,000,000,
consisting of $8,000,000 on the closing date (April 30, 20X0) and two installments of $16,000,000 on August 31, 20X0 and February 28, 20X1 (deferred balance).

The purpose of the transaction is to create an exclusive business arrangement between DEF and Seller, under which DEF will sell its widgets exclusively to Seller for a period of 10 years. There is a limited guarantee agreement which limits ABC’s exposure in potential losses of DEF to $2,500,000 until the final installment payment occurs. There is also a share pledge agreement under which ABC does not have voting rights in DEF until it pays the final installment, and the DEF shares are returned to Seller if ABC does not pay the installments when due. Additionally, there is a shared services agreement under which Seller provides management, accounting, human resources, and information technology services to DEF.

Shortly after the closing date, ABC experiences turnover in several key executive management positions, and during August 20X0, ABC notifies Seller that it no longer intends to pay the $32,000,000 deferred balance. During December 20X0, ABC and Seller finalize negotiations and enter into a sales cancellation agreement.

Assessment

ABC concludes that no business combination took place because it never obtained control over DEF. ABC bases this conclusion on the fact that it did not obtain the voting rights associated with the shares, nor did it have control over management and human resource decisions, as these were outsourced to Seller under the shared services agreement. ABC accounts for the initial payment of $8,000,000 as a deposit and evaluates it for impairment.

CONTROL ACHIEVED WITHOUT TRANSFERRING CONSIDERATION

2.011 An entity can obtain control over another without transferring consideration. ASC paragraph 805-10-25-11 identifies the following circumstances under which an acquirer might obtain control over an acquiree without transferring consideration:

(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority substantive participating rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.

(c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously.

2.012 A business combination occurs when an acquirer obtains control of one or more businesses. Thus, when an entity obtains control of a business, even without the transfer
of consideration, a business combination has occurred and is within the scope of ASC Topic 805. Therefore, the acquisition method applies to these transactions, which requires, among other things, recognizing and measuring the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. ASC Topic 805 provides special guidance for these types of transactions. Applying the acquisition method to each of these types of transactions is discussed and illustrated beginning at Paragraph 9.003.

2.013 Business combinations achieved by contract alone often result from the formation of a variable interest entity that meets the definition of a business. If the variable interest entity is a business, the primary beneficiary of the variable interest entity is always the acquirer. See discussion below and the discussion of Variable Interest Entities beginning at Paragraph 4.025.

TRANSFER OF CONSIDERATION WITHOUT OBTAINING CONTROL OF A BUSINESS

2.013a In certain circumstances, an entity may transfer consideration before obtaining control of a business. In this case a business combination has not occurred as the entity has not obtained control of a business, and the entity should not apply the acquisition method. Instead, the entity should recognize the consideration transferred as an asset (e.g. a prepaid asset or deposit) given it meets the definition of an asset under Concepts Statement 6. The entity should derecognize the asset and apply the acquisition method when it obtains control of the business.

COMBINATIONS INVOLVING VARIABLE INTEREST ENTITIES

2.014 ASC Subtopic 810-10 clarifies the application of control to entities in which equity investors or limited partners lack power, through voting rights or similar rights, the obligation to absorb the expected losses or receive the expected residual returns of the entity, or lack sufficient equity at risk for the entity to operate without additional subordinated financial support from other parties. These entities are referred to as variable interest entities, or VIEs.

2.015 ASC Topic 805 specifies that the acquirer of a VIE that is a business is the primary beneficiary. Determining which party, if any, is the primary beneficiary of a VIE is made based on ASC Subtopic 810-10. The initial consolidation of a VIE that is a business is a business combination, and the primary beneficiary always is the acquirer. See discussion of Variable Interest Entities beginning at Paragraph 4.025.

MULTIPLE TRANSACTIONS ACCOUNTED FOR AS A SINGLE TRANSACTION

2.015a An entity may enter into multiple transactions to acquire a business. Examples include:
• An entity initially purchases 30 percent of a business and then shortly thereafter purchases an additional 25 percent to gain control.

• An entity negotiates the acquisition of a business in aggregate, but consummates the acquisition by entering into separate legal agreements with each business subsidiary.

• Assets and processes are acquired over time that do not meet the definition of a business on an individual basis, but would constitute a business if evaluated together.

2.015b We believe the following factors listed in ASC paragraph 810-10-40-6 (related to deconsolidation) may be considered to determine whether multiple transactions should be accounted for as a single transaction:

• They are entered into at the same time or in contemplation of one another.

• They form a single transaction designed to achieve an overall commercial effect.

• The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

• One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

2.015c If an entity determines that each transaction should be accounted for separately, assets acquired and liabilities assumed would be evaluated and accounted for separately in accordance with applicable GAAP. Alternatively, if an entity determines that multiple transactions should be accounted for as a single transaction, those transactions would be evaluated and accounted on a combined basis in accordance with applicable GAAP.

Example 2.0b: Accounting for Goodwill When Multiple Transactions That Cross Reporting Periods Are Accounted for as a Single Business Combination

On October 15, 20X1, ABC Corp. enters into a purchase agreement to acquire DEF Corp.’s fleet of merchant ships in two separate transactions, each representing the acquisition of a business. ABC will transfer consideration of $210,000,000 to obtain control of a portion of the fleet in transaction 1 on December 15, 20X1 and will transfer consideration of $210,000,000 to obtain control of the remainder of the fleet in transaction 2 on February 28, 20X2. ABC determines the two transactions should be accounted for as a single business combination, as they are in contemplation of one another and form a single transaction designed to achieve an overall commercial effect. ABC obtains a valuation of the net assets acquired for both transactions.
### BUSINESS

**THIS SECTION OF THE CHAPTER APPLIES TO TRANSACTIONS THAT OCCURRED PRIOR TO THEADOPTION OF ASU 2017-01. FOR TRANSACTIONS AFTER THE ADOPTION OF ASU 2017-01, SEE PARAGRAPH 2.025.**

#### BUSINESS DEFINED

**ASC Master Glossary: Business**

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

**2.016** For a transaction or event to be a business combination, the activities and assets over which the acquirer has obtained control must constitute a business. This is an important determination, given the different accounting treatments for acquisitions of businesses based on the ASC Topic 805 acquisition method, which requires measurements at fair value with limited exceptions, contrasted with acquisitions of assets...
that are accounted for using the cost accumulation and allocation model. Examples of these differences are provided in Table 2.3.

2.016a For guidance on accounting for asset acquisitions, see KPMG's Issues In-Depth, Asset acquisitions.

DETERMINING WHETHER A SET OF ASSETS AND ACTIVITIES IS A BUSINESS (PRIOR TO THE ADOPTION OF ASU 2017-01)

ASC paragraph 805-10-55-8

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

ASC Master Glossary: Market participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

(a) They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

(b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

(c) They are able to enter into a transaction for the asset or liability

(d) They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

2.017 The current definition of a business in ASC Topic 805 (prior to the adoption of ASU 2017-01) focuses on whether an integrated set of assets and activities is capable of being conducted and managed as a business by market participants. Thus, whether the seller operated the set as a business, or whether the acquirer intends to do so, is not relevant to determining whether the set constitutes a business. Under this definition, a transferred set need not include outputs at the acquisition date to constitute a business, but it must include inputs and processes (as discussed below). Under this definition of a business, a transferred set of activities and assets in the development stage can be a business, consistent with ASC Topic 805’s guidance that a set of activities and assets need not be self-sustaining and need not include outputs to meet the definition of a business.

2.018 The FASB issued ASU 2017-01 to address the feedback received in the post-implementation review of Statement 141(R) specific to the definition of a business. In
that review, stakeholders informed the Board that the definition was applied too broadly and was difficult to apply in practice. The guidance provided in this section is based on the definition of a business prior to the adoption of ASU 2017-01. For applying the definition of a business after the adoption of ASU 2017-01, see Paragraph 2.025.

INPUTS, PROCESSES, AND OUTPUTS

ASC paragraph 805-10-55-4

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

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

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

(c) **Output:** The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

ASC paragraph 805-10-55-5

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

ASC paragraph 805-10-55-6

The nature of the elements of a business varies by industry and by the structure of an entity’s operations (activities), including the entity’s stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and
sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

2.019 As stated in ASC paragraph 805-10-55-4, a business usually has outputs, but outputs are not required for an integrated set to qualify as a business under ASC Topic 805.

2.020 Paragraph not used.

2.021 Determining whether an integrated set of assets and activities is a business will be straightforward in some situations, but in others will require analysis of the specific facts and circumstances and the application of judgment to the fact pattern.

2.022 The following indicators should be considered as a point of reference when performing the evaluation:

(a) If the acquired assets and activities include only inputs (and thus do not include processes), the acquired set generally would be accounted for as an asset acquisition rather than as a business, as the acquisition of a business usually involves the acquisition of inputs and some processes to be applied to those inputs;

(b) The intended use of acquired assets and activities should be viewed from a market participant perspective rather than from the acquirer’s perspective (i.e., the acquirer’s intended use) or from the seller’s perspective (i.e., the seller’s previous use of the assets and activities);

(c) The acquired assets and activities do not need to include all of the inputs and processes the seller used in operating the integrated set if market participants are capable of acquiring the integrated set or integrating the acquired assets and activities with their own inputs and processes and continuing to produce outputs;

(d) If market participants are capable of producing outputs by integrating the acquired set of activities and assets with their own inputs and processes, the integrated set would most likely be a business. If a market participant could otherwise readily obtain the missing inputs and processes without significant delay or difficulty, the acquired set would usually meet the definition of a business;

(e) An investment return for investors could be in the form of future revenue and operating profits or in the form of dividends, cost reductions, or other economic benefits;

(f) Accounting, human resources, payroll, and other administrative processes would not be considered substantive processes used to create outputs for most transactions. Therefore, the lack of these activities would not typically preclude acquired assets and activities from being considered a business.
The evaluation of whether the acquired assets and activities constitute a business can be particularly challenging in certain industries. Table 2.1 provides considerations for Real Estate, Oil, Gas, and Natural Resources, and Pharmaceutical / Biotechnology industries.

Table 2.1: Considerations in Selected Industries for the Evaluation of Whether Acquired Assets and Activities Constitute a Business (Prior to the Adoption of ASU 2017-01)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Factors to Consider</th>
<th>Business Combination</th>
<th>Asset Acquisition</th>
</tr>
</thead>
</table>
| Real Estate                     | -Whether property is currently an operating property, including portion of property under lease  
                                  | -Capital requirements necessary to develop property                                  | Acquisition of property that is operating and substantially leased               | Acquisition of vacant land with intent to develop an operating property          |
|                                 | -Existence of a triple-net lease agreement                                            |                                                                                      |                                                                                  |
|                                 | -Property management requirements and availability to obtain in the marketplace      |                                                                                      |                                                                                  |
| Oil, Gas, and Natural Resources | -Feasibility study and/or reserve assessment                                        | Acquisition of producing properties or reserves for which either a market exists for the product extracted or resources necessary to take the product to market are readily obtainable | Acquisition of exploration acreage or unproven properties                       |
|                                 | -Infrastructure necessary to extract product available                               |                                                                                      |                                                                                  |
|                                 | -Capital requirements necessary to develop property                                  |                                                                                      |                                                                                  |
Example 2.1: Acquisition of a Group of Restaurants – Scenario 1 (Prior to the Adoption of ASU 2017-01)

ABC Corp., which owns and operates restaurant groups in various metropolitan areas, acquires from DEF Corp. a group of 10 restaurants located in a major city. The acquired set of assets and activities includes land, buildings, leased assets and leasehold improvements, and equipment, and the rights to the trade name used by the restaurant group. ABC also offers employment to the restaurants’ staffs, including management level employees, service staff, and chefs. ABC acquires DEF’s procurement system used to acquire the food, beverage, and other supplies necessary to operate the restaurants. ABC will integrate the 10 restaurants into its existing accounting and human resource systems.

Assessment

The integrated set includes:

Inputs

| Long-lived assets (land, buildings, leased assets and leasehold improvements, and equipment) |
| Rights to the trade name |
| Employees |
| Access to food, beverage, and other supplies which, when subjected to processes, will result in outputs |

Processes

| Management and operational processes necessary to create outputs (through retention of management and staff) |
| Procurement system |
Outputs

No outputs are acquired. The intended outputs include meals for delivery to customers.

The integrated set includes all the inputs and processes necessary to create outputs that have the capability 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 administrative systems (accounting and human resources) of DEF not acquired by ABC are not processes used to create outputs and, thus, are not missing processes for purposes of this analysis. The acquired integrated set is a business, and ABC would account for the acquisition as a business combination.

Example 2.2: Acquisition of a Group of Restaurants – Scenario 2 (Prior to the Adoption of ASU 2017-01)

Assume the same facts as in Example 2.1, except that the integrated set acquired by ABC does not include DEF’s procurement system.

Assessment

ABC concludes that the acquired set does not include all the inputs and processes necessary to create outputs, as a procurement process is essential to the production of outputs.

ABC determines that there are no missing inputs, and the only missing process is a procurement system for obtaining food, beverage, and other supplies that are essential to the creation of outputs.

ABC determines that it (and market participants) can easily replace the missing process. ABC determines it will integrate the procurement process for the restaurants from DEF into its existing procurement process, and that, for administrative reasons and to achieve economies of scale, most market participants in the restaurant industry would retain an acquired procurement system only for an interim period and, over time, replace it with, or integrate it into, its preexisting procurement system used for its other restaurant operations. ABC concludes that the acquired set is a business, and accounts for the acquisition as a business combination.

Example 2.3: Acquisition of a Group of Restaurants – Scenario 3 (Prior to the Adoption of ASU 2017-01)

Assume the same facts as in Example 2.1, except that ABC acquires only the land, buildings, leased assets and leasehold improvements, and equipment. DEF closed the restaurants comprising the acquired group a significant period of time before the
acquisition by ABC. ABC does not acquire employees, the rights to the trade name, or the processes from DEF.

Assessment

ABC determines that many of the inputs and all of the processes required to create outputs are missing in the existing set of activities. As discussed above, to meet the definition of a business, the integrated set of activities and assets must include inputs and processes applied to those inputs (although it need not include all of the inputs or processes if market participants are capable of acquiring the business and producing outputs). Therefore, ABC concludes that, even if a market participant is capable of acquiring the land, buildings, and equipment and producing outputs (through integration with its own operations and/or otherwise obtaining the missing inputs and processes without significant delay or difficulty), the acquisition of the land, buildings, leased assets and leasehold improvements, and equipment would be accounted for as an asset acquisition, rather than a business combination.

DEVELOPMENT STAGE ENTERPRISES

ASC paragraph 805-10-55-7

An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

(a) Has begun planned principal activities

(b) Has employees, intellectual property, and other inputs and processes that could be applied to those inputs

(c) Is pursuing a plan to produce outputs

(d) Will be able to obtain access to customers that will purchase the outputs.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

2.024 ASC paragraph 805-10-55-7 provides examples of factors to be considered in determining whether a set of activities and assets in the development stage is a business. Determining whether an integrated set is a business is based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Judgment is required in making this determination, including consideration of the factors listed in ASC paragraph 805-10-55-7, as well as other factors based on the specific facts and circumstances. ASC Topic 805 does not include a presumption that a transferred set of activities and assets in the development stage that has not commenced its planned principal operations cannot be a business, and does not require an acquired set of activities and assets to be self-sustaining or to have outputs for the acquired set to constitute a business.
Example 2.4: Acquisition of an Integrated Set in the Development Stage – Scenario 1 (Prior to the Adoption of ASU 2017-01)

Company A designs, develops, manufactures, and sells logic and memory semiconductor chips. Company A acquires Target, a development stage entity.

Target was formed for the purpose of developing and exploiting an early-stage semiconductor technology. Target has four employees, including three design engineers and a business unit manager. The current activities of Target include research and development, establishing supply sources (the technology is based on fabricating silicon carbide rather than silicon wafers), and developing markets for the product. Target formulated a business plan to develop the technology into a viable product, entered into a supply agreement with a producer of silicon carbide, and identified several potential customers that might purchase the semiconductors if successfully developed.

Target has not commenced its planned principal operations. The integrated set acquired from Target includes inputs and processes, but does not include outputs. The inputs and processes included in the integrated set include:

**Inputs**

- All of the facilities and equipment necessary to perform research and development activities;
- All of the intellectual property associated with the technology;
- Employees, including design engineers and a business unit manager; and
- A supply agreement with a producer of silicon carbide.

**Processes**

- The protocols and systems necessary to conduct research and development.

The intended outputs are semiconductor chips manufactured using the new technology.

**Assessment**

Company A considers the factors referenced in ASC paragraph 805-10-55-7, and determines that:

(a) The set has not begun its planned principal activities;

(b) The set has employees, intellectual property, and other inputs (a supply agreement) and processes that could be applied to those inputs (protocols and systems necessary to conduct research and development activities);

(c) A plan to produce outputs has been formulated and is being pursued; and

(d) There is a potentially large customer base for semiconductor products that
Company A believes would be receptive to semiconductor products manufactured using the new technology, if successfully developed.

Company A also considers other relevant factors in making its assessment, including:

- Target has successfully completed the research phase associated with the new technology and the development phase for a viable product. The remaining development efforts are focused on developing additional product alternatives.
- Based on the early-stage technology and the development efforts underway, Company A believes there is a high likelihood that it will be able to complete the development effort and manufacture the intended outputs using the new technology, and believes other market participants would also have this capability.
- Based on its knowledge of the semiconductor industry, Company A believes that the new products can be manufactured at a cost that will allow them to be competitively priced.
- Although there are a number of inputs and processes missing from the integrated set (e.g., manufacturing facilities, manufacturing employees, a procurement system), Company A determines that it and other market participants could readily provide the missing inputs and processes by integrating the acquired set of assets and activities into their own operations.

**Conclusion**

Although Target has not commenced its planned principal operations, the research on the new technology has been successfully completed, the development effort has been successfully completed for a number of products, and the ongoing development activities are focused on the development of additional product alternatives. Additionally, Company A has concluded that it (and other market participants) could replace the missing inputs and processes by integration of the acquired assets and activities into its own operations without undue delay or difficulty. Company A believes the products from the new technology can be manufactured and sold at prices competitive with the prices of similar products made with existing technologies. Company A is likely to conclude that the assets and activities acquired from Target constitute a business, in which case it would account for the acquisition as a business combination.

**Example 2.5: Acquisition of an Integrated Set in the Development Stage – Scenario 2 (Prior to the Adoption of ASU 2017-01)**

Assume the same facts as in Scenario 1, except that the research phase has commenced but is not yet complete, involves significant uncertainty, and will require substantial efforts, cost, and time to complete, and that the development process has therefore not commenced.
**Assessment**

In Company A’s consideration of whether the acquired set is a business, it would evaluate the inputs and processes acquired as well as the significance of the missing input (i.e., the intellectual property) and the likelihood for successful development of the missing input. In this consideration, Company A also would consider whether other market participants could acquire the set and ultimately produce outputs, either through integration with their own inputs and processes or otherwise (i.e., successfully completing the research).

Based on the information provided, it is unclear whether or not the acquired set of inputs and processes constitute a business, but the absence of a key process or input does not, in and of itself, mean that the acquired set is not a business. Each acquisition will require the evaluation of the totality of the fact pattern and consideration of market participants’ perspectives.

**NEW DEFINITION OF A BUSINESS**


ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017 (i.e., January 1, 2018 for public companies with a calendar year-end). For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. An entity may early adopt the ASU and apply it to transactions that have not yet been reported in financial statements that have been issued or made available for issuance.

The FASB issued ASU 2017-01 to address the feedback received in the post-implementation review of Statement 141(R) specific to the definition of a business. In that review, stakeholders informed the Board that the definition was applied too broadly and was difficult to apply in practice. The key changes are provided in Table 2.2.

| Table 2.2: Key Changes in the Definition of a Business as a Result of ASU 2017-01 |
|----------------------------------|----------------------------------|----------------------------------|
| **Missing Inputs or Processes**  | **Old Definition**               | **New Definition**               |
|                                  | A set is a business if a market participant could replace the missing elements | A set must include at a minimum an input and a substantive process to be a business |
This section has been revised to reflect the impact of ASU 2017-01. See the first section of this chapter for guidance prior to the adoption of ASU 2017-01.

2.026 The evaluation of whether an acquired set of assets and activities (set) qualifies as a business may have significant accounting implications beyond accounting for acquisitions under ASC Topic 805. The definition of a business affects the accounting in other areas of US GAAP including, but not limited to, the following:

### Table 2.2a: Other Areas Affected by the Definition of a Business

<table>
<thead>
<tr>
<th>Topic</th>
<th>Affected area</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill Impairment Testing</td>
<td>A component of an operating segment is a reporting unit if the component is a business for which discrete financial information is available and segment management regularly reviews the operating results of that component.</td>
<td>ASC paragraph 350-20-35-34</td>
</tr>
<tr>
<td>Discontinued Operations</td>
<td>A business that meets the held for sale criteria at the acquisition date is a discontinued operation. If the one year criterion to be classified as held for sale is met at the acquisition date, a business is a discontinued operation at the acquisition date if the other held for sale criteria are probable of being met within a short period following the acquisition (usually within three months).</td>
<td>ASC paragraph 205-20-45-1D</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Derecognition</td>
<td>The deconsolidation and derecognition guidance in ASC Topic 810 applies to businesses. Businesses are excluded from the derecognition guidance in ASC Subtopic 610-20. See Section 15, Noncontrolling Interests in Consolidated Financial Statements for additional guidance on the derecognition of assets and businesses.</td>
<td>ASC paragraphs 810-10-40-3A, 610-20-15-4, 360-10-40-3B</td>
</tr>
<tr>
<td>Consolidations</td>
<td>If an entity meets the definition of a business, it is scoped out of the VIE guidance in ASC Topic 810 unless certain conditions exist.</td>
<td>ASC paragraph 810-10-15-17(d)</td>
</tr>
<tr>
<td>Consolidation of a VIE that is Not a Business</td>
<td>In the initial consolidation of a VIE that is not a business, the primary beneficiaries measure and recognize the assets (except for goodwill) and liabilities of the VIE in accordance with the guidance on business combinations in ASC sections 805-20-25 and 805-20-30. A gain or loss is recognized.</td>
<td>ASC paragraphs 810-10-30-3 and 810-10-30-4</td>
</tr>
<tr>
<td>Spinoffs and Nonreciprocal Transfers</td>
<td>A spinoff or nonreciprocal transfer of a business is recorded based on the carrying value of the subsidiary (after reduction, if appropriate, for an indicated impairment of value).</td>
<td>ASC paragraphs 505-60-25-2, 845-10-30-10</td>
</tr>
<tr>
<td>Gain or Loss on Disposal</td>
<td>When a business is disposed of, goodwill associated with that business shall be included in the carrying amount of the business to determine a gain or loss on disposal.</td>
<td>ASC paragraphs 350-20-40-2, 350-20-40-9, 360-10-35-39</td>
</tr>
<tr>
<td>Intangible Asset Impairment Testing</td>
<td>The unit of accounting to test indefinite-lived intangible assets for impairment cannot represent a group of indefinite-lived intangible assets that collectively are a business.</td>
<td>ASC paragraph 350-30-35-26</td>
</tr>
</tbody>
</table>
Eligibility for cash flow hedging

A business combination cannot be designated as the hedged item in a cash flow hedge. However, the guidance does not preclude a forecasted asset acquisition from being designated as the hedged item in a cash flow hedge, assuming all other criteria are met.

ASC paragraph 815-20-25-15(g)

2.026a For a transaction or event to be a business combination, the set that the acquirer has obtained control over must constitute a business. This is an important determination, given the different accounting models for the acquisition of a group of assets versus a business. Business combinations are accounted for using the ASC Topic 805 acquisition method that requires measurement of assets and liabilities at fair value with limited exceptions. Acquisitions of assets are accounted for using the cost accumulation and allocation model. Examples of these differences are provided in Table 2.3.

| Table 2.3: Significant Difference in the Accounting for the Acquisition of a Group of Assets Versus a Business |
|---------------------------------------------------------------|---------------------------------------------------------------|
| **Initial Measurement**       | **Asset Acquisition**                  | **Business Combination**                  |
|                               | The acquirer measures the assets acquired based on their cost, which is generally allocated to the assets on a relative fair value basis. | The acquirer measures identifiable assets and liabilities generally at fair value. |
| **Direct Acquisition-Related Costs** | The acquirer includes direct acquisition-related costs in the cost of the acquired assets. | The acquirer expenses direct acquisition-related costs as incurred. |
| **Contingent Consideration**  | If the arrangement is a derivative, the acquirer initially measures contingent consideration at fair value with changes in fair value reported currently in earnings. | The acquirer recognizes contingent consideration at the acquisition date and measures it at fair value. Subsequent changes to the fair value of liability-classified contingent consideration are reported currently in earnings. |

Otherwise, the acquirer generally recognizes contingent consideration when it is probable and estimable. Subsequent changes are generally recorded as adjustments to the carrying amount of the assets.
| Settlement of Preexisting Relationships | There is no explicit guidance. We believe acquirers should apply ASC Topic 805 by analogy. | The acquirer recognizes a gain or loss for the effective settlement of a preexisting relationship. The acquirer measures the gain or loss either:  
(1) for a noncontractual relationship, at fair value, or  
(2) for a contractual relationship, at the lesser of:  
   (a) the amount by which the contract is favorable or unfavorable to the acquirer, or  
   (b) the amount of stated settlement provisions in the contract available to the party to whom the contract is unfavorable. |
| Measurement Period | No concept of a measurement period exists in an asset acquisition. The acquirer must finalize all valuations of assets acquired and liabilities assumed before the next reporting date. | The acquirer may record provisional amounts for the assets acquired and liabilities assumed and adjust them during the measurement period, which ends the earlier of (1) one year from the acquisition date, and (2) when the acquirer has obtained all relevant information about facts that existed at the acquisition date or learns that more information is not obtainable. |
| Intangible Assets | Intangible assets are recognized if they meet the recognition criteria in FASB Concepts Statement No.5, Recognition and Measurement in Financial Statements of Business Enterprises, which is a lower recognition threshold than the criteria for intangible assets acquired in a business combination. | Intangible assets are recognized at fair value if they meet the contractual-legal criterion or the separability criterion.  
Private companies and not-for-profit entities may elect an accounting policy to subsume into goodwill non-compete agreements and customer-related |
<table>
<thead>
<tr>
<th>Intangible Asset Type</th>
<th>Description</th>
<th>Specific Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-process Research and Development (IPR&amp;D)</td>
<td>The portion of the purchase price allocated to IPR&amp;D at the acquisition date is expensed immediately unless it has an alternative future use.</td>
<td>IPR&amp;D is recognized and accounted for as an indefinite-lived intangible asset until the acquirer completes or abandons the project.</td>
</tr>
<tr>
<td>Assembled Workforce</td>
<td>Assembled workforce is recognized as an intangible asset.</td>
<td>Assembled workforce is recognized as a part of goodwill.</td>
</tr>
<tr>
<td>Reacquired Rights</td>
<td>There is no explicit guidance. The acquirer may determine the measurement basis of reacquired rights either (1) using a measurement based solely on the remaining contractual terms (by analogy to ASC Topic 805) or (2) based on fair value.</td>
<td>The acquirer measures reacquired rights based solely on the remaining contractual terms.</td>
</tr>
<tr>
<td>Acquired Contingencies</td>
<td>Acquired contingencies are accounted for under ASC Topic 450, <em>Contingencies</em>. Acquired loss contingencies are recognized if they are both probable and reasonably estimable. Gain contingencies are not recognized until realized.</td>
<td>Acquired contingencies are recognized and measured at fair value if determinable at the acquisition date or during the measurement period. Otherwise, they are accounted for in a manner consistent with ASC Topic 450. The acquirer is required to develop a systematic and rational approach to subsequent measurement, depending on the nature of the contingency.</td>
</tr>
<tr>
<td>Indemnification Assets</td>
<td>There is no explicit guidance. Acquirers sometimes apply ASC Topic 805 by analogy.</td>
<td>The acquirer records an indemnification asset at the same time and on the same basis as the indemnified item, subject to any contractual limitations and collectibility.</td>
</tr>
</tbody>
</table>
Goodwill

Goodwill is not recognized. Generally, the acquirer allocates any excess cost over the fair value of the net assets acquired on a relative fair value basis only to certain nonfinancial assets acquired. Any excess consideration transferred over the fair value of the net assets acquired is goodwill and is recognized as a separate asset.

Bargain Purchase Amount

Similar to goodwill, the acquirer should allocate a bargain purchase amount only to certain nonfinancial assets on a relative fair value basis. The acquirer recognizes a bargain purchase gain immediately in earnings.

Deferred Taxes

Because neither goodwill nor a bargain purchase gain are recognized, if the cost differs from the tax bases of the assets acquired and liabilities assumed, the simultaneous equations method is used to calculate the deferred tax assets and liabilities and the resulting adjustments to the related assets’ and liabilities’ carrying amounts. (See KPMG’s Accounting for Income Taxes Section 10 - Other Considerations)

Recognizing deferred tax assets and liabilities results in increases or decreases to goodwill or a bargain purchase gain. (See KPMG's Accounting for Income Taxes Section 6 - The Tax Effects of Business Combinations)

2.026b For additional guidance on accounting for asset acquisitions, see KPMG’s Issues In-Depth, Asset acquisitions.

INPUTS, PROCESSES, AND OUTPUTS

ASC paragraph 805-10-55-3A

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

ASC paragraph 805-10-55-4

A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:
(a) **Input:** Any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

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

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

**ASC paragraph 805-10-55-5**

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

**ASC paragraph 805-10-55-6**

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

2.027 The three elements of a business are inputs, processes, and outputs. While a business typically has outputs, they are not required for a set to qualify as a business.

2.028 Inputs are resources that contribute to the creation of outputs when processes are applied to the inputs. Generally, inputs are the assets in the set and include long-lived
tangible assets (e.g., real estate and equipment), intangible assets (e.g., intellectual property, customer lists, trade names, patents, and recipes), materials, contracts that provide the ability to obtain access to necessary materials or rights (e.g., distribution rights, mineral interests, broadcast rights, supply contracts, and some service contracts), and employees.

2.029 Processes are systems, standards, protocols, conventions, and rules that, when applied to inputs, create or have the ability to contribute to the creation of outputs. Processes typically include:

- Strategic management processes (e.g., the overall vision and direction of the set that contribute to the creation of outputs and obtaining customers),
- Operational processes (e.g., the fulfillment, production, development, or customer acquisition processes that contribute to creating outputs), and
- Resource management processes (e.g., processes involved in deploying resources such as raw materials and employees to produce outputs).

Accounting, billing, payroll, and other administrative systems are typically not processes used to create outputs in most industries.

2.030 An entity could acquire a process even if it is not documented. While employees are an input, when they form an organized workforce, the capacity (e.g., knowledge, skills, or experience) of that workforce to perform a process is acquired even if the process is not documented. In other words, the workforce itself is an input but the knowledge of the activities the workforce performs can be a process. However, as noted in Paragraph 2.073, if the acquired set includes a workforce, other inputs must also be present to conclude that the set is a business.

2.031 Outputs are the result of processes applied to inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues. In general, outputs give rise to the revenue of the set. As discussed in paragraph BC59 of the Basis for Conclusions of ASU 2017-01, the FASB decided to align the definition of outputs with how that term is used in ASC Topic 606, Revenue from Contracts with Customers. However, a set does not need to have contracts in the scope of ASC Topic 606 to have outputs because the definition includes investment income and other revenues. For example, a set could generate outputs as a result of leasing property in the scope of ASC Topic 840, Leases, or ASC Topic 842, Leases, once adopted.

2.032 An integrated set does not need to include all of the inputs and processes that the seller used in operating that set. For example, a set could qualify as a business if it is a division, product line, or subsidiary of another entity. However, a set is a business only if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The evaluation requires an entity to consider the substance of what was acquired regardless of whether the missing elements (e.g., missing inputs and processes) could be replaced by a market participant.
ASC Topic 805 includes two steps to determine if the minimum requirements to be a business are met. Step 1 is a screening test that, if met, results in the conclusion that the set is not a business. If Step 1 is not met, the entity evaluates whether the set includes an input and a substantive process (Step 2). However, before performing these steps an entity needs to identify the inputs, processes, and outputs included in the set.

**Determining What Is a Part of the Set**

In most cases, evaluating what is a part of the set will not be difficult, because the items included in the set will be explicitly identified in the contract between the acquirer and the seller. However, in other situations this analysis may not be straightforward and significant judgment will be required.

**Employees**

In some transactions, the acquirer will not acquire a legal entity of the seller (for tax or legal purposes this is often referred to as an *asset acquisition* instead of a *stock acquisition*). For the acquirer to acquire employees of the seller, the employees are terminated by the seller and hired by the acquirer. We believe the employees would be a part of the acquired set and the form of the transaction would not be relevant in these circumstances. However, all facts and circumstances need to be considered in determining whether employees are part of the acquired set.

**Multiple Transactions with the Acquirer and Seller**

When an entity enters into multiple transactions at or near the same time with the same counterparty to acquire assets or activities, it evaluates whether the substance is a single transaction or multiple transactions. Entities should consider the factors in Paragraph 2.015b to determine whether multiple transactions should be accounted for as a single transaction.

In addition to the factors in Paragraph 2.015b, the guidance in ASC paragraphs 805-10-25-20 through 25-22 and 55-18 may be helpful in identifying whether a separate contract entered into between the acquirer and seller to provide future goods or services should be included in the set. That guidance indicates that some arrangements should be accounted for separately as a settlement of a pre-existing relationship, a transaction that compensates employees or former owners of the acquiree for future services, or a transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs.

When re-deliberating ASU 2017-01, the FASB observed that many entities used the guidance in ASC paragraphs 805-10-25-20 to 25-22 and 55-18 to determine whether contractual arrangements were a part of the set; and in paragraph BC49 of the Basis for Conclusions of ASU 2017-01, the FASB noted that entities should continue to use judgment. As a result, that guidance remains relevant for determining whether contracts between the acquirer and seller for future goods or services are a part of the acquired set (see Section 11 for further details on this guidance).
Other indicators that a contract that compensates the seller for future goods or services is *not* a part of the acquired set include when the future goods or services provided by the seller are:

- Readily available in the marketplace; and
- An output of the seller's ordinary activities.

In addition, because the definition of a business is also relevant to the scope of derecognition guidance (i.e., ASC Topic 810 and ASC Subtopic 610-20), we believe it is also relevant to understand whether the seller disposed of an input or process. For example, if a contract between the acquirer and seller does not involve the seller transferring inputs or processes (e.g., it is a revenue contract from the perspective of the seller), then that transaction is not considered a disposal of an input or process by the seller, nor the acquisition of an input or process by the acquirer.

**Example 2.6: Determining What Is a Part of the Set - Multiple Transactions with the Seller**

Entity A enters into a contract to sell a building to Entity B. At the same time, Entity A and Entity B enter into a contract whereby Entity A will provide property management services and Entity B will compensate Entity A for those services. The services are:

- Readily available in the marketplace; and
- A part of Entity A's ordinary activities.

Entity B evaluates whether the property management contract is a part of the set. Consistent with the guidance in ASC paragraph 805-10-55-21, because the transaction compensates the former owners for future services, the transaction would be considered separate from the set. That is because acquirer is compensating the seller for future property management services and the services are:

- Readily available in the marketplace; and
- A part of the seller's ordinary activities.

Furthermore, in the property management contract, Entity A does not dispose of an input or process.

As a result, Entity B concludes that the property management contract is not a part of the acquired set.
Contractual Arrangements

2.040 A contract that is separately negotiated and entered into with an independent third party by the acquirer is typically not a part of the set even if it was entered into at or near the same time or relates directly to the acquirer's operation of the set. However, when the seller and third party previously had a contractual relationship that transfers to the acquirer the determination may not be as clear.

2.041 When evaluating whether a third party contract is a part of the set, the objective is to determine if the acquirer and third party entered into a separately negotiated contract or if the seller transferred the contract to the acquirer. In many cases, this will be a legal distinction because a contract is either acquired through a legal entity or assigned by the seller to the acquirer. However, entities should also evaluate the substance of the arrangement when the acquirer and third party enter into a contract directly.

2.041a To make this evaluation, entities should consider the following factors (not exhaustive):

- **Whether the acquirer and third party entered into substantive negotiations to continue the relationship.** If the contract between the acquirer and third party was the result of a bona fide negotiation, it may indicate the contract is not a part of the set. In contrast, if the contract was not the result of a bona fide negotiation, it may indicate the contract is a part of the set.

- **Whether it is feasible to change vendors.** If changing vendors is not feasible (even if available in the marketplace) because of a significant cost of changing or disruption caused by the change, it might indicate that the negotiations between the acquirer and third party are not substantive and the contract is a part of the set. In contrast, the fact that it is convenient to maintain the same vendor would not necessarily indicate the change was not feasible.

- **Whether the goods or services are readily available in the marketplace.** If the services are unique or scarce such that the acquirer would not be able to obtain the goods or services elsewhere, it might indicate that the seller transferred the contractual relationship to the acquirer. If the goods or services can be obtained in the marketplace, it might indicate that the contract is a separately negotiated contract and not a part of the set.

- **Whether the transaction can be closed without the contract transferring.** For example, if the contract between the acquirer and seller includes a contingency that requires the contract between the acquirer and a third party to be entered into, it would indicate the contract is a part of the set.
Example 2.7: Determining What Is a Part of the Set - Contractual Arrangement with a Third Party

Entity A owns a hotel property and has an at-market in-place contract with Manager X to manage that property. Entity B acquires the hotel from Entity A. Consider the following scenarios:

Scenario 1

The contract between Entity A and Manager X has a change-in-control provision that automatically terminates the contract on sale of the property. Entity B and Manager X must enter into a new contract and neither party is required to continue the relationship. Entity B and Manager X enter into a new contract with substantially similar terms.

The contract is not a part of the set because Entity B and Manager X had substantive negotiations to enter into the new contract, the services are readily available in the marketplace, the entity could reasonably replace the vendor with another party without a significant disruption in operations and the consummation of the transaction was not dependent upon entering into the new agreement.

Scenario 2

The contract between Entity A and Manager X does not terminate on sale of the property and Entity A can assign the contract to other parties. Entity A assigns the management contract to Entity B as a part of the transaction.

The contract is a part of the set. The contract transferred from Entity A to Entity B. While the services are readily available in the marketplace, there were no substantive negotiations between Entity B and Manager X.

Scenario 3

The contract between Entity A and Manager X does not terminate on sale of the property and is assignable to other parties. At Entity B's request, Entity A terminates the contract with Manager X before the close of the transaction. Entity B and Manager X enter into a new contract with terms that are substantially the same as the contract between Entity A and Manager X; however, the transaction could not close until Entity B and Manager X had a new contract in place.

The contract is a part of the set. In substance, the contract transferred from Entity A to Entity B. While Entity B and Manager X entered into a new contract, it was not a result of a separate negotiation but rather the transaction was dependent on Entity B and Manager X entering into the same contract. Furthermore, Entity A and Manager X only terminated the contract to help facilitate the transaction closing.
STEP 1 – SCREENING TEST

ASC paragraph 805-10-55-5A

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

ASC paragraph 805-10-55-5B

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

(a) A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)

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

ASC paragraph 805-10-55-5C

A group of similar assets includes multiple assets identified in accordance with [ASC] paragraph 805-10-55-5B. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics). However, the following should not be considered similar assets:

(a) A tangible asset and an intangible asset

(b) Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)

(c) A financial asset and a nonfinancial asset

(d) Different major classes of financial assets (for example, accounts receivable and marketable securities)

(e) Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

(f) Identifiable assets within the same major asset class that have significantly different risk characteristics.
2.042 Step 1 is an initial screen to determine when a set is not a business. Step 1 requires that when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. However, if Step 1 is not met, the entity will still need to evaluate Step 2 to determine if the set is a business. While Step 1 is required, an entity could choose to go directly to Step 2 if it concludes under Step 2 that the set is not a business. That is because Step 1 could not contradict that conclusion. However, an entity will need to appropriately evaluate Step 1 before concluding that a set is a business, because Step 1 is determinative that a set is not a business regardless of an entity's interpretation of Step 2.

2.043 There may be circumstances when Step 1 could be completed solely on a qualitative basis. Paragraph BC19 in the Basis for Conclusions of ASU 2017-01 states:

The assessment could be qualitative if, for example, an entity concludes that all of the fair value will be assigned to one element of the acquisition. For example, if the acquisition includes a license for a drug candidate and an at-market contract and the entity concludes that the at-market contract has at the date of assessment little or no fair value assigned to it or the fair value of a single identifiable asset or group of similar identifiable assets is so significant that it is very clear that the threshold will be met, the entity may conclude that the threshold has been met. If there are multiple assets that the entity concludes will have more than an insignificant value assigned, the entity may be able to qualitatively conclude that there is clearly significant value in assets that are not similar and that the threshold is not met and go on to the rest of the framework. However, an entity must determine the fair value of each asset to allocate the consideration to assets recognized in both an asset acquisition and a business combination...if the set is not a business, an entity could choose to document its conclusion in the most cost-effective manner depending on its situation.

We would expect an entity to document its qualitative analysis and its considerations to conclude the screening test is met without a quantitative analysis.
The following flowchart illustrates the steps that may be useful when applying Step 1:

Step 1a: Determine all identifiable assets in the set

2.044 In Step 1a, an entity would determine all identifiable assets in the set. Paragraph BC24 in the Basis for Conclusions of ASU 2017-01 states, "For ease of application, the Board decided that an entity should use the same unit of account when assessing the threshold that it would use for identifying assets recognized in a business combination even if it results in some tangible assets and intangible assets being combined into a single asset."

2.044a As a result, the starting point is to determine what assets would be recognized under ASC Topic 805 if the set were considered a business rather than a group of assets.

2.045 For example, in a business combination an entity would recognize and measure an in-process research and development (IPR&D) asset, but it typically would not recognize IPR&D as an asset in an asset acquisition (see Paragraph 22.018). Because the unit of account is the same as in a business combination, a single IPR&D asset would be considered a single identifiable asset for purposes of applying Step 1.
In contrast, an assembled workforce (or goodwill) is not an identifiable asset that could be recognized in a business combination, but an assembled workforce intangible asset could be recognized in an asset acquisition. Because the unit of account is the same as in a business combination, an assembled workforce intangible asset would not be considered a single identifiable asset for purposes of applying Step 1.

A single identifiable asset could also include certain complementary intangible assets that are recognized and measured as a single asset in a business combination. For example, ASC paragraph 805-20-55-18 states, "The terms brand and brand name, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Subtopic does not preclude an entity from recognizing, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives."

Similarly, some tangible assets and intangible assets (e.g., a nuclear power plant and a license to operate it in ASC paragraph 805-20-55-2(b)) that are combined for financial reporting purposes in a business combination would also be considered a single identifiable asset for purposes of Step 1.

Example 2.8a: Applying Step 1a

Entity X acquires five separate apartment complexes. Each complex includes land, building, property improvements, and at-market in-place tenant leases. Entity X first determines the identifiable assets that could be recognized separately in a business combination.

The land, building, property improvements, and in-place leases would be recorded as separately identifiable tangible and intangible assets. Entity X also identifies an intangible asset for the trade name associated with the apartment complexes.

As a result, the identifiable assets in the set include five parcels of land, five buildings, various property improvements, the in-place lease intangible assets at each complex, and the trade name intangible asset.

Step 1b: Combine any identifiable assets that meet exceptions in ASC paragraph 805-10-55-5B

ASC paragraph 805-10-55-5B provides two exceptions to the general rule discussed in Step 1a. These exceptions require an entity to combine assets that would be considered separately identifiable in a business combination as a single asset only for purposes of applying Step 1.
2.048a Those exceptions are to consider as a single identifiable asset:

(1) 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 (e.g., land and building); and

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

2.048b While identifiable assets that meet these exceptions are combined as a part of Step 1b, they generally would be recorded separately regardless of whether the set is a group of assets or a business. For example, a building and an in-place lease should be measured and recorded separately regardless of whether the acquired set meets the definition of a business.

2.049 The FASB included the exceptions in Step 1b to allow practical application of Step 1 in certain transactions. For example, in real estate transactions, land and buildings are often transferred together but are considered separate assets for accounting purposes. Without the first exception that allows the combination of tangible assets, these transactions would rarely meet Step 1. The second exception was included to promote consistency between real estate transactions in Step 1 so that an entity would not get a different outcome for similar transactions solely because the value of the leases was different or because the lease had above or below market rents.

2.050 We believe the exception for lease intangibles should be interpreted narrowly (i.e., it should be applied only when the contract meets the definition of a lease in ASC Topic 840, Leases, or ASC Topic 842, Leases, once adopted); entities should not make analogies to combine other contracts and assets.

2.051 Additionally, we believe the reference to "an intangible asset representing the right to use a tangible asset" in ASC paragraph 805-10-55-5B(a) is limited only to intangible assets that represent a right to use a tangible asset that is physically attached to and cannot be physically removed and used separately from another tangible asset without incurring significant cost or significant diminution in utility or fair value of either asset. Paragraph BC25 of ASU 2017-01 cites two examples that would qualify: (1) a building and a related ground lease, and (2) a pipeline and the use rights for the land in which the pipeline is laid. By contrast, we believe that intangible assets associated with a product would not be combined with the related inventory, because they do not represent a right to use a tangible asset that is physically attached to the inventory. The analysis in Case G in ASC paragraphs 805-10-55-85 through 55-87 (see Example 2.17) appears to support this view. In that example, the entity acquires the intellectual property rights to a yogurt brand and the related equipment and inventory but does not combine those rights with the tangible assets for the screening test.
Example 2.8b: Applying Step 1b

The following is a continuation of Example 2.8a.

Entity X evaluates whether any of the exceptions in ASC paragraph 805-10-55-5B (Step 1b) apply. Entity X concludes that the land, building, property improvements, and in-place leases at each property (apartment complex) are a single asset for the following reasons:

1. The building and property improvements are attached to and cannot be physically removed from and used separately from the land without incurring significant costs or reducing their fair value; and
2. The in-place lease intangibles for each apartment are required to be combined with the leased asset.

After applying the exceptions, the set has six single identifiable assets (i.e., the combined land, building, property improvements, and leases at each of the five properties are one asset and the trade name intangible asset). The exceptions in Step 1b do not apply to the trade name intangible asset.

Step 1c: Evaluate whether the remaining assets from Step 1b are similar assets

2.052 In Step 1c, an entity evaluates whether the assets identified in Step 1b are similar. However, an entity that acquires a combined single asset (e.g., the combined land, building, property improvements, and leases in Example 2.8b) does not need to evaluate components of that combined single asset for similarity. For example, it is not necessary to consider whether the commercial and retail space in a single real estate asset are different or similar. The analysis of significantly different risks is only about comparing an individual or combined asset identified in Step 1b with another individual or combined asset identified in Step 1b.

2.053 ASC paragraph 805-10-55-5C states, "When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics)."

2.053a In addition, that paragraph identifies types of assets that should not be considered similar, including:

(a) a tangible asset and an intangible asset,
(b) identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development),
(c) a financial asset and a nonfinancial asset,
(d) different major classes of financial assets (for example, accounts receivable and marketable securities),

(e) different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles), and

(f) identifiable assets within the same major asset class that have significantly different risk characteristics.

2.054 ASC subparagraph 805-10-55-5C(a) states that a tangible asset and an intangible asset should not be considered similar. This factor is applied only after assets are combined in accordance with ASC paragraph 805-10-55-5B in Step 1b. Accordingly, an entity does not need to separate a tangible and an intangible asset (e.g., real estate asset and related lease intangible) in Step 1c when applying the above factors.

2.054a Furthermore, the individual combined assets (e.g., real estate asset and related lease intangible) could be considered similar to other assets that are identified in Step 1b. For example, a combined apartment complex and related leases would be compared to other assets to determine if they are similar assets and may be grouped with other similar combined assets (e.g., other combined apartment complexes and related leases) if the other criteria to be a similar asset are met. Also, an apartment complex that is combined with lease intangibles in Step 1b may be combined with a similar apartment complex without leases if there are similar risks associated with managing and creating outputs from the assets.

2.055 Significant judgment will be required to determine if single assets within a major asset class have significantly different risk characteristics (factor (f)). Paragraph BC31 in the Basis for Conclusions of ASU 2017-01 states, “The Board clarified that the risks to be evaluated should be linked to the risks associated with the management of the assets and creation of outputs because this assessment may be instructive on whether an integrated set of assets and activities has been acquired. That is, when the risks associated with managing and creating outputs from the assets are significantly different, the set would need more sophisticated processes to manage and create outputs.” As a result, the relevant analysis is whether the risks associated with creating outputs are significantly different.

2.056 Consistent with ASC paragraph 805-10-55-8, we believe an entity should consider the risks associated with the management of the assets and the creation of outputs from the perspective of a market participant (see discussion of the market participant perspective in Paragraph 2.093). It is not necessarily relevant how the acquirer intends to operate the set, or how the seller operated the set, when determining the risks associated with the assets.

2.057 An entity should consider different risk factors depending on the nature of the asset. In paragraph BC32 of ASU 2017-01, the Board indicated its expectation that different types of risks would be important to the analysis of different types of transactions. For example, real estate and intellectual property have different risk characteristics to analyze. Additionally, we believe that intellectual property under
development usually would have different risks to analyze from intellectual property embedded in a mature product. Entities may also need to consider different types of risks for assets within a particular industry.

2.058 Table 2.4 summarizes risk factors and examples associated with operating and managing the assets to create outputs that may be relevant based on the nature of the asset (not exhaustive). These risks will need to be significant to affect the conclusion of whether assets are similar, and while these factors may be present in a particular transaction, they may not be determinative and all facts and circumstances should be evaluated.

<table>
<thead>
<tr>
<th>Type of Assets</th>
<th>Risk Factors</th>
<th>Examples of Assets That May Have Significantly Different Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>Geographic location</td>
<td>Property in a developing or volatile economy versus a stable and low volatility economy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Properties in jurisdictions or countries with significantly different regulations</td>
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<td></td>
<td></td>
<td>Single-family home in a large metropolitan area (population &gt; 2 million) versus single-family home in a small town (population &lt; 10,000)</td>
</tr>
<tr>
<td>Class of customers</td>
<td></td>
<td>Four-star hotel versus a two-star hotel</td>
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<tr>
<td></td>
<td></td>
<td>Commercial office building versus residential property</td>
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<tr>
<td></td>
<td></td>
<td>Tenants with a high risk of default versus tenants with a low risk of default</td>
</tr>
<tr>
<td>Size of the properties</td>
<td></td>
<td>Office building with two floors versus an office building with 30 floors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Shopping center (e.g., with five tenants) and a shopping mall (with many tenants)</td>
</tr>
<tr>
<td>Market risk</td>
<td></td>
<td>Property in a high growth area versus a property in a low growth area</td>
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<tr>
<td></td>
<td></td>
<td>Significant cost to obtain tenants versus property with a waiting list to become a tenant</td>
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<tr>
<td>Types of assets</td>
<td>Residential versus commercial real estate</td>
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<tr>
<td></td>
<td>Hotel versus commercial real estate</td>
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<td></td>
<td>Apartment building versus a single-family home</td>
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<tr>
<td>Life Sciences Development risk</td>
<td>Drug compounds in different phases of clinical trials (e.g., Phase 2 versus Phase 3)</td>
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<tr>
<td></td>
<td>Commercialized drug versus development stage compound</td>
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<tr>
<td>Class of customers</td>
<td>Drug compounds that treat (or are intended to treat) different diseases (i.e., the patients have different demographics)</td>
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<tr>
<td>Market risks</td>
<td>Generic brand versus premium brand</td>
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<td></td>
<td>Commercialized product with generic competition versus product with patent protection</td>
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<tr>
<td>Financial Assets Credit risk</td>
<td>High quality bond versus junk bond</td>
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<tr>
<td></td>
<td>Loan to a large multinational company with a high credit rating versus a loan to a start-up company with a low credit rating</td>
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<tr>
<td>Term</td>
<td>Three-year loan versus a 20-year loan</td>
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<tr>
<td>Type</td>
<td>Mortgage loan versus commercial loan</td>
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<tr>
<td>Oil and Gas Assets Development risks</td>
<td>Property in shallow water versus property in ultra-deep water</td>
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<td></td>
<td>Property in location with known adverse weather conditions versus property with moderate weather conditions</td>
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<td></td>
<td>Offshore properties versus onshore properties</td>
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<tr>
<td>Jurisdiction (laws and regulations)</td>
<td>Property in a highly regulated country versus property in less regulated country</td>
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<td>------------------------------------------------------------------------</td>
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<td>Property in country with unstable government versus property in country with stable government</td>
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<td></td>
<td>Property in area with access to a workforce (e.g., local workforce available) and property in area with no workforce (e.g., workforce must be transported to site)</td>
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<tr>
<td>Transportation Assets</td>
<td>Type of asset</td>
<td></td>
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<tr>
<td></td>
<td>Assets that perform different functions (e.g., cargo aircraft versus a passenger aircraft)</td>
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<tr>
<td></td>
<td>Oil tanker and cargo ship</td>
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<tr>
<td>Market risks</td>
<td>Assets designed to operate in locations with known adverse weather conditions versus assets designed to operate in moderate weather conditions</td>
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<tr>
<td></td>
<td>Assets (e.g., newer models, better technology, or unique functions) that demand higher rates from customers such as a boat with a day rate of $30,000 versus a boat with a day rate of $10,000</td>
<td></td>
</tr>
</tbody>
</table>

**Example 2.8c: Applying Step 1c**

The following is a continuation of Examples 2.8a and 2.8b.

The acquired apartment complexes are all in the same metropolitan area and have a similar class of customers. There are differences in prices charged for apartments on lower floors and apartments with a view. However, the ratio of price differences between apartments on lower floors and apartments with views is reasonably consistent at each apartment complex. The trade name intangible asset is not a similar asset to the apartment complexes (i.e., tangible assets) as a tangible asset and an intangible asset (except for lease intangibles and leased assets) are not similar per ASC paragraph 805-10-55-5C(a).

In applying ASC paragraph 805-10-55-5C, Entity X concludes that the five apartment complexes are similar assets because the risks of operating the assets and creating outputs from these assets are not significantly different.

As noted in the factors presented in Table 2.4, geographic location should be considered when determining whether real estate assets are similar assets. Apartment complexes in different parts of the United States or different parts of the same metropolitan area may not be similar assets if the risks associated with producing outputs (e.g., lease income) in
different geographical locations are significantly different. Also, if there were another type of asset acquired in the transaction such as an office building or hotel, it would not be similar to apartment complexes.

**Step 1d: Determine fair value of gross assets acquired**

2.059 In Step 1d, the entity determines the fair value of gross assets acquired (i.e., the denominator). The gross assets acquired generally include all assets that are recognized in a business combination including goodwill. The denominator also includes consideration transferred (plus the fair value of noncontrolling interests and previously held interests, if any) in excess of the fair value of net identifiable assets acquired. The consideration transferred would also include contingent consideration determined under ASC Topic 805 because contingent consideration may affect the value of goodwill, which is included in gross assets. However, transaction costs are excluded from both the numerator and denominator, because they are expensed in a business combination. Additionally, an assembled workforce, which is not a recognized intangible asset in a business combination, would be included in the denominator by virtue of its inclusion in goodwill.

2.060 The FASB specifically excluded items from the numerator and denominator such as cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. Cash and cash equivalents are excluded to prevent entities from increasing the purchase price with no economic substance (e.g., by choosing to include a greater amount of cash or cash equivalents in the acquired set) to avoid a conclusion that substantially all of the fair value is concentrated in a single asset (or group of similar assets).

2.060a The deferred tax items are excluded because those items are a reflection of the legal or tax form of the transaction rather than the substance of what was acquired.

2.060b Except for unfavorable lease intangible liabilities, which are combined with the related leased asset (see further discussion of leases in Paragraph 2.048), the numerator and denominator exclude all debt or other liabilities because the assumption of those liabilities may simply be a financing mechanism for the transaction. The Board indicated in paragraph BC20 of ASU 2017-01 that it decided to exclude liabilities from the screening test to avoid “a group of assets that would otherwise be subject to further evaluation under the model bypassing such evaluation solely because a transaction includes liabilities in addition to assets.” Following this rationale, we believe that a gain from a bargain purchase also should be excluded from (i.e., it does not reduce) the denominator. ASC paragraph 805-10-55-5A states that gross assets should include any consideration transferred in excess of the fair value of net identifiable assets acquired. ASC paragraph 805-10-55-5A does not specifically state that gross amounts should include any deficit (i.e., bargain purchase amount). Including a bargain purchase amount in the numerator and denominator would distort the screening test in a manner similar to including liabilities. See Example 2.9a.
We believe that the exclusion of all liabilities (except for unfavorable lease intangible liabilities) from the numerator and denominator of the screening test also applies to asset retirement obligations related to assets included in the set. That is, an asset retirement obligation should not be netted against (should not reduce) the fair value of the assets included in the numerator and denominator. For example, assume an entity acquires a set that includes a manufacturing facility with an associated asset retirement obligation. The entity determines the fair value of the manufacturing facility to be $100 million (net of an asset retirement obligation of $20 million). In accounting for the acquisition, the entity would record the manufacturing facility at $120 million and a liability for the asset retirement obligation at $20 million. In applying the screening test, the entity would include the manufacturing facility with a value of $120 million in both the numerator and denominator. However, the presence of an asset retirement obligation may be a relevant qualitative factor to consider (see factors discussed in Paragraph 2.063).

Example 2.8d: Applying Step 1d

The following is a continuation of Examples 2.8a, 2.8b, and 2.8c.

For this example, Entity X also assumes debt associated with building the apartment complexes of $2,500,000 and cash on hand of $50,000. Company X paid a purchase price of $25,600,000.

Entity X determines the fair value of the gross assets acquired to determine the denominator.

<table>
<thead>
<tr>
<th>Items Acquired / Assumed</th>
<th>Estimated Fair Value</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apartment complex 1</td>
<td>$5,100,000</td>
<td>$5,100,000</td>
</tr>
<tr>
<td>Apartment complex 2</td>
<td>$4,850,000</td>
<td>$4,850,000</td>
</tr>
<tr>
<td>Apartment complex 3</td>
<td>$5,650,000</td>
<td>$5,650,000</td>
</tr>
<tr>
<td>Apartment complex 4</td>
<td>$5,400,000</td>
<td>$5,400,000</td>
</tr>
<tr>
<td>Apartment complex 5</td>
<td>$5,200,000</td>
<td>$5,200,000</td>
</tr>
<tr>
<td>Assumed debt</td>
<td>($2,500,000)</td>
<td>Not included</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>$50,000</td>
<td>Not included</td>
</tr>
<tr>
<td>Trade names</td>
<td>$1,850,000</td>
<td>$1,850,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,600,000</strong></td>
<td><strong>$28,050,000</strong></td>
</tr>
</tbody>
</table>

The fair value of gross assets acquired is $28,050,000 in this example. Cash, debt assumed, deferred taxes (if any), and goodwill resulting from the effects of deferred tax liabilities (if any) are not included in gross assets acquired.
Step 1e: Compare the single identifiable asset or group of similar identifiable assets to the fair value of gross assets acquired

2.061 In Step 1e, an entity compares the fair value of the single identifiable asset (or group of similar assets) to the fair value of the gross assets acquired. To do that, an entity would identify the individual identifiable asset with the greatest fair value or group of similar identifiable assets with the greatest fair value (whichever is greater). Next the entity compares that amount to the fair value of the gross assets acquired as determined in Step 1d. If the fair value of that single identifiable asset or group of similar identifiable assets represents substantially all of the fair value of the gross assets, then the screening test is met and the set is not a business.

2.062 The FASB decided to use the term *substantially all* because it is commonly used throughout U.S. GAAP. However, the FASB did not specify a quantitative threshold for what *substantially all* means in Step 1. In other U.S. GAAP, substantially all is generally interpreted to mean approximately 90 percent or greater; however, for purposes of the definition of a business, substantially all is not necessarily meant to be a bright-line quantitative threshold.

2.063 When there is uncertainty about whether the *substantially all* test is met (e.g., because the ratio is close to the quantitative threshold or the valuation of assets acquired is based on unobservable (Level 3) fair value measurement inputs subject to significant measurement uncertainty), we believe qualitative factors may also be considered. The purpose of a qualitative assessment is to evaluate whether the other assets in the set have substance, in which case Step 2 should be performed. We believe relevant qualitative factors include but are not limited to the following:

- **The composition of other assets.**
  - If the other assets are equipment or materials that can be easily replaced at a cost that is insignificant in relation to the fair value of the set, that may qualitatively indicate that the substantially all threshold is met because the other assets are not substantive.
  - If the other tangible or intangible assets complement the primary asset (e.g., a customer list accompanying a significant developed technology intangible asset), that may qualitatively indicate that the other assets are substantive and an entity should move to Step 2.

- **The set includes employees and goodwill.** The presence of goodwill is an indicator of a substantive process in the set. If the set includes employees and a more than insignificant amount of goodwill, that may indicate that an entity should move to Step 2 to evaluate whether the employees represent an organized workforce, in which case a substantive process would be present and the set likely would be a business.

- **The set is self-sustaining.** If the set is self-sustaining (i.e. the set was a stand-alone entity or a largely independent division, subsidiary or product line of a larger entity), that may qualitatively indicate that in substance an entity is
acquiring more than just a single asset and the other elements are substantive; therefore the entity should move on to Step 2.

- **An asset retirement obligation is included in the set.** Asset retirement obligations, although excluded from the substantially all quantitative test, generally are associated with the normal operation of long-lived assets. If exclusion of an asset retirement obligation associated with an asset in the set is the reason a quantitative threshold has been met, that may qualitatively indicate that in substance an entity acquired more than just a single asset and the other elements are substantive depending on the nature and composition of the other assets.

2.064 We would expect entities to apply the quantitative and qualitative factors consistently to similar transactions. In general, we would place greater emphasis on the quantitative assessment when there is a higher concentration of fair value in a single asset (or group of similar assets) or the fair value measurements of the assets are not subject to significant measurement uncertainty. As a result, qualitative factors ordinarily would not overcome the quantitative assessment when the fair value of a single asset (or group of assets) is well above 90 percent of the fair value of the gross assets even if employees are included in the set. In contrast, we believe it would be rare for an entity to conclude that Step 1 is met when the concentration of fair value is more than just a few percentage points less than 90 percent of the fair value of the gross assets.

---

**Example 2.8e: Applying Step 1e**

The following is a continuation of Examples 2.8a, 2.8b, 2.8c, and 2.8d.

Entity X evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $28,050,000. The apartment complexes were found to be similar and are grouped together for Step 1. In Step 1e, their combined value of $26,200,000 is compared to the gross assets acquired of $28,050,000.

This results in 93 percent of the value of the gross assets acquired being associated with a group of similar assets. Entity X also considers qualitatively whether in substance it acquired a group of similar assets and whether the other elements are substantive. Entity X determines the other elements (e.g., trade names) acquired are not substantive because the other elements are not a result of goodwill and an organized workforce, and the set was not a stand-alone self-sustaining operation.

The quantitative and qualitative factors indicate that, in substance, the entity acquired a group of similar assets and the set is not a business.
Example 2.8f: Recognizing Certain Assets of a Medical Device Company as a Single Asset for Financial Reporting Purposes

Entity B acquires Medical Device Corp. on December 15, 20X7. Medical Device has a monopoly on a certain medical device product. The product has been on the market and generating revenue for 20 years.

Entity B acquires all of the existing product technology, manufacturing equipment, employees and supply contracts of the product line. The identifiable intangible assets include technology, trade name, FDA approval and customer (doctor) relationships. The trade name and customer relationship were determined to have nominal value. As Entity B has a monopoly on the product, if it is medically necessary, doctors are compelled to prescribe it as there are no alternatives. The technology and FDA approval are recognized as a single asset (the "technology asset") by analogy to ASC subparagraph 805-20-55-2(b), which indicates that a power plant and a license to operate that plant may be recognized as a single asset if their useful lives are similar. The fair value of the technology asset, goodwill, and other tangible assets represent 94%, 2%, and 4%, respectively, of the fair value of the gross assets acquired.

Because the fair value of the technology asset is 94% of the fair value of the gross assets acquired, Medical Device Corp concludes that substantially all of the fair value of the gross assets is concentrated in a single identifiable asset. Step 1 is met and Step 2 is unnecessary. The set is not a business.

Example 2.9: Applying Step 1 When Goodwill Results from the Effects of Deferred Tax Liabilities

Entity A acquires 100% of Biotech Corp. on January 1, 20X9 for $10,000,000. Biotech's operations include IPR&D activities on a single development stage drug compound. No employees are included in the set. The enacted tax rate is 25% for 20X9 and all future years.

The identifiable assets acquired and liabilities assumed have the following fair values and tax bases.

<table>
<thead>
<tr>
<th></th>
<th>Estimated Fair Value</th>
<th>Tax Basis</th>
<th>Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>$9,450,000</td>
<td>$0</td>
<td>$9,450,000</td>
</tr>
<tr>
<td>Research lab</td>
<td>$400,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Current liabilities,</td>
<td>($200,000)</td>
<td>($200,000)</td>
<td>$0</td>
</tr>
<tr>
<td>excluding deferred</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Identifiable net assets</td>
<td>$9,700,000</td>
<td>$50,000</td>
<td>$9,650,000</td>
</tr>
</tbody>
</table>
The assets acquired and liabilities assumed would be recognized (under ASC Topic 805) as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>$9,450,000</td>
</tr>
<tr>
<td>Research lab</td>
<td>$400,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>($2,412,500)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$2,712,500</td>
</tr>
<tr>
<td>Consideration paid</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>

**Step 1a**

Entity A determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, IPR&D, and the research lab.

**Step 1b**

Entity A evaluates whether any of the exceptions in ASC paragraph 805-10-55-5B (Step 1b) apply. Entity A concludes that none of the assets meet the exceptions and none of the acquired assets are combined.

**Step 1c**

In applying ASC paragraph 805-10-55-5C, Entity A concludes that none of the acquired identifiable assets (e.g., cash, IPR&D, and the research lab) are similar assets.

**Step 1d**

In applying Step 1d, the gross assets acquired would not include the goodwill associated with the deferred tax liabilities acquired in this transaction. The deferred tax liabilities acquired in this example generated $2,412,500 of goodwill, which is excluded for purposes of applying Step 1, leaving $300,000 of goodwill.

The gross assets acquired in this example for purposes of Step 1 are as follows:
<table>
<thead>
<tr>
<th>Items Acquired / Assumed</th>
<th>Value under ASC Topic 805</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
<td>Not included</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>$9,450,000</td>
<td>$9,450,000</td>
</tr>
<tr>
<td>Research lab</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>($200,000)</td>
<td>Not included</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>($2,412,500)</td>
<td>Not included</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$2,712,500</td>
<td>$300,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,000,000</strong></td>
<td><strong>$10,150,000</strong></td>
</tr>
</tbody>
</table>

The fair value of gross assets acquired is $10,150,000.

**Step 1e**

Entity A evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $10,150,000. As previously discussed, none of the acquired assets were found to be similar and none are grouped together for Step 1c. In Step 1e, the largest acquired asset had a value of $9,450,000 and is compared to the gross assets acquired of $10,150,000.

This results in 93 percent of the value of the gross assets acquired being associated with a single identifiable asset (e.g., IPR&D). Entity A also considers qualitatively whether in substance the other elements (e.g., research lab, goodwill) of the transaction are substantive. While the set includes goodwill, the value associated with the goodwill is de minimis (below 3 percent) and is not attributable to an organized workforce because there are no employees acquired. As a result, the quantitative and qualitative factors indicate that substantially all the fair value is concentrated in a single asset and the set is not a business.
Example 2.9a: Applying the Step 1 Threshold (Initial Screening) Test When a Bargain Purchase Exists

ABC Corp. enters into a purchase agreement to acquire a small software company (Target) for $9,000,000. Target has five employees that are all software developers, earns some revenue, but is not profitable. Target’s owners believe its software alone is worth more than the purchase price. However, Target is running out of money, and its owners are willing to sell to ABC at a significant discount.

Target’s software has a fair value of $10,000,000 and it has a customer-related intangible with a fair value of $500,000.

ABC’s senior management and IT department believe Target’s five software developer employees can be replaced after consummation of the transaction without significant time, effort or delay in the ability to continue producing outputs, as they are not considered essential (e.g., the software is already developed).

ABC determines that it should exclude the bargain purchase amount from the numerator and denominator in Step 1 (see Paragraph 2.060b). Because an assembled workforce is not a recognized identifiable asset in a business combination (and because there is no goodwill in this example), ABC will exclude the assembled workforce from Step 1.

ABC performs Step 1 to evaluate whether the fair value is concentrated in a single asset or group of similar assets.

<table>
<thead>
<tr>
<th>Items Acquired</th>
<th>Value Under ASC Topic 805</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Customer-related intangible</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Bargain purchase</td>
<td>$(1,500,000)</td>
<td>Not included</td>
</tr>
<tr>
<td>Total</td>
<td>$9,000,000</td>
<td>$10,500,000</td>
</tr>
</tbody>
</table>

ABC compares the largest acquired asset (software) valued at $10,000,000 to the fair value of gross assets acquired of $10,500,000.

This results in 95% of the value of the gross assets acquired being associated with a single identifiable asset. ABC also evaluates whether qualitatively, the other elements (customer-related intangible and employees) are substantive. There is no goodwill associated with the set (i.e., there is no value in the assembled workforce because the employees can easily be replaced) and the value of a single asset is well above 90%. ABC concludes that substantially all the fair value is concentrated in a single asset and the set is not a business.

2.065 Paragraph not used.
Example 2.10: Acquisition of Loan Portfolio – Scenario 1

Facts

- Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- Bank A does not acquire the employees that managed the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions, or systems.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (Screening Test):

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

See Example 2.15 for the analysis of Step 2.

Conclusion

The acquired set does not meet the screening test (Step 1); therefore, Step 2 is required.

Alternatively, because no employees, protocols, conventions or systems were acquired, it is clear that the set does not include an organized workforce or an acquired process. Bank A could have elected to bypass the screening test (and the necessary assessment of similarity of risk characteristics) and gone directly to Step 2 to conclude the set is not a business. This alternative analysis applies only when it is clear that the set would not be a business under Step 2. An entity may not skip Step 1 if it's clear that there is an input and a substantive process, because the screening test could still lead to a conclusion that the set is not a business.
Example 2.11: Acquisition of Oil and Gas Properties – Scenario 1

Facts

- XYZ Co. acquires the mineral rights (i.e., lease agreements to develop and produce the underlying mineral reserves) in certain properties in the southwest shale.
- The acquisition provides XYZ Co. with an average 50% working interest in the properties.
- The properties are proved and unproved properties. The proved properties are currently producing oil and gas. The properties classified as unproved have known reserves (they have been *proved up*) but are classified as unproved because of the requirement to classify properties as unproved if an entity does not expect to produce from those properties within the next five years.
- XYZ Co. also assumes customer contracts in the acquisition, which are at market rates. No employees are in the set.

Analysis

*Step 1 (Screening test)*

The oil and gas properties are found to be two single identifiable assets that would be recognized in a business combination under Topic 805. The two assets are proved and unproved properties. Even though they have different disclosure requirements, we believe that proved and unproved oil and gas properties can be considered to be within the same major asset class and therefore could be considered similar assets if they do not have significantly different risks. When evaluating whether those assets are similar, an entity should consider the nature of proved and unproved properties and the risks associated with managing and creating outputs from the proved and unproved properties (i.e., the risk characteristics).

In this example, the two identified assets do not have significantly different risks associated with creating outputs and therefore are similar assets. They are similar assets because they are in the same geographic area (e.g., southwest shale) and are expected to have similar outputs (e.g., mix of hydrocarbons) from both assets. The unproved properties, while not meeting the proved definition because XYZ Co. does not expect to produce from those properties over the next five years, are considered to have the same risk profile as the proved properties because they have known reserves.

If the unproved properties had not already been proved up, XYZ Co. may have concluded that the proved and unproved properties have significantly different risks.

Additionally, oil and gas properties in different regions of the United States, in different jurisdictions, and those that have different characteristics such as offshore and onshore could result in different conclusions about whether they are similar and would require analysis of the specific facts and circumstances.
There is no fair value associated with the customer contracts because the contracts are at market rates and are readily available in the market place, and there were no other assets acquired. Accordingly, XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (the proved and unproved oil and gas properties). Step 1 is met and the set is not a business.

Example 2.11a: Acquisition of Petroleum Storage Facilities

Facts

- ABC Co. (ABC) enters into an asset purchase agreement with DEF Co. (DEF) for total consideration of $500 million.
- DEF will transfer to ABC the following:
  - Two petroleum storage and distribution terminal facilities located along the Oregon coastline; and
  - Customer relationships and fixed assets comprised of automobiles, equipment, tools and IP equipment.
- The set has revenues from both facilities that will continue after the acquisition.
- The type and class of customers are similar for the facilities.

Analysis

*Step 1 (threshold test)*

The land, buildings, storage tanks, and interconnecting pipes at each facility are attached to each other and cannot be physically removed from and used separately from one another without incurring significant cost or reducing their fair value. As such, they are considered to be a single asset for the screening test.

The next step is to determine if the two petroleum storage and distribution terminal facilities are similar assets. The two identified facilities do not have significantly different risks associated with creating outputs. They are in the same geographic area (e.g., Oregon coastline), both on-shore properties, both expected to have similar outputs (e.g., crude oil and refined petroleum products) from both assets and the type and class of customers are similar for the assets. As such, they are similar assets and grouped together for the screening test.

ABC next compares the largest acquired group of similar assets (petroleum storage and distribution facilities) valued at $483,000,000 to the fair value of gross assets acquired of $500,000,000.
<table>
<thead>
<tr>
<th>Items Acquired</th>
<th>Estimated Fair Value</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum storage and distribution facilities</td>
<td>$483,000,000</td>
<td>$483,000,000</td>
</tr>
<tr>
<td>Customer-related intangibles and fixed assets</td>
<td>$17,000,000</td>
<td>$17,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$500,000,000</strong></td>
<td><strong>$500,000,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Items Acquired</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum storage and distribution facilities</td>
<td>96.6%</td>
</tr>
<tr>
<td>Customer-related intangibles and fixed assets</td>
<td>3.4%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Because 96.6% of the fair value of the gross assets acquired is concentrated in the group of similar assets, ABC concludes that the *substantially all* test (step 1) is met and the set is not a business.

**Step 2 (input and substantive process)**

Step 2 is not necessary in this scenario.

**Conclusion**

ABC concludes the transaction is an asset acquisition rather than a business combination because substantially all the fair value is concentrated in a group of similar assets.

---

**Example 2.11b: Acquisition of a Property Subject to a Tax Abatement**

**Facts**

- ABC Co. (ABC) constructed a new facility and entered into a property tax abatement agreement with the local government.
- The term of the property tax abatement is 30 years.
- ABC enters into an asset purchase agreement with DEF Co. (DEF) where DEF acquires the facility (land and building) and the related property tax abatement.
- There is no goodwill or other assets in the set.
The FV of the facility is $10,000,000 and the FV of the property tax abatement is $2,500,000.

Analysis

To apply Step 1, DEF evaluates whether the set includes a single identifiable asset or a group of similar assets.

Step 1a

DEF concludes that the identifiable assets in the set include the land, building and property tax abatement. The abatement is an identifiable intangible asset under ASC Topic 805 because it meets the contractual-legal criterion.

Step 1b

The land and building are combined under ASC paragraph 805-10-55-5B for the screening test because they are attached to and cannot be physically removed and used separately from each other without incurring significant costs or reducing their fair value. However, the property tax abatement does not meet one of the exceptions in ASC paragraph 805-10-55-5B and is not combined with the land and building into a single identifiable asset. Although the property tax abatement was derived from the construction of the facility and is an intangible asset related to the property, it does not represent the right to use the land or building and is not a lease.

Step 1c

The facility (combined land and building) is a tangible asset and the property tax abatement is an intangible asset. Therefore, the two assets cannot be considered similar.

Step 1d

The fair value of the gross assets acquired is $12,500,000.

Step 1e

DEF compares each of the single identified assets to the gross assets acquired. The fair value of the facility compared to the gross assets acquired is 80% ($10,000,000/$12,500,000) and the fair value of the property tax abatement is 20% of the gross assets acquired. DEF concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single asset or group of similar assets.

Conclusion

The acquired set does not meet the screening test (Step 1); therefore, Step 2 is required.
STEP 2 – EVALUATE WHETHER AN INPUT AND A SUBSTANTIVE PROCESS EXIST

Framework – Inputs, Substantive Processes, and Other Considerations

ASC paragraph 805-10-55-5D

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

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

(b) Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

(1) Intellectual property that could be used to develop a good or service

(2) Resources that could be developed to create outputs

(3) Access to necessary materials or rights that enable the creation of future outputs.

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

ASC paragraph 805-10-55-5E

When the set has outputs (that is, there is a continuation of revenue before and after the transaction), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

(a) Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

(b) An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired
an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).

(c) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

(d) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

**ASC paragraph 805-10-55-5F**

If a set has outputs, continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis in [ASC] paragraph 805-10-55-5E of whether a process has been acquired.

**ASC paragraph 805-10-55-6**

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

**ASC paragraph 805-10-55-8**

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

**ASC paragraph 805-10-55-9**

When evaluating whether a set meets the criteria in [ASC] paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill.

2.066 In Step 2, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The guidance provides a framework to assist entities in evaluating whether both an input and a substantive process are present and gives examples about applying the implementation guidance.
2.067 The first decision point is to determine if the set has outputs. The guidance has a different set of criteria depending on whether the set has outputs. Outputs are the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (e.g. dividends, interest), or other revenues. Although outputs are not required for a set to be a business, outputs are one of the three elements of a business. The FASB created a more stringent set of criteria when outputs are not present.

2.067a Based on informal discussions, we understand that the FASB staff believes it is acceptable for an acquirer to evaluate a set of assets and activities with only inconsequential outputs as a set without outputs. Judgment is required and an acquirer may also need to consider qualitative aspects. For example, we believe it generally would be appropriate to evaluate a start-up with only minimal outputs that is ramping up central activities as a set with outputs. Conversely, we believe it generally would be appropriate
to evaluate a set with only minimal outputs that is winding down activities as a set without outputs.

2.067b Determining whether one or more inputs exist is usually straightforward. Accordingly, the discussion below focuses primarily on determining whether a substantive process exists.

Acquired Set with No Outputs (ASC paragraph 805-10-55-5D)

2.068 For a set with no outputs (e.g., an entity in the development stage that has not generated revenues) to have both an input and substantive process, it must include:

(a) Employees that form an organized workforce; and
(b) An input that the workforce could develop or convert into outputs.

2.069 The employees that form the organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

Organized Workforce

2.070 The organized workforce must consist of employees. An acquired contract that performs a process would not on its own be considered an organized workforce when a set does not have outputs. However, if the set includes both employees and service contracts, the processes performed by the vendor may be considered a critical process. For example, paragraph BC48 of the Basis for Conclusions of ASU 2017-01 states, "The Board also noted that a critical process performed by employees could include the management of service providers. The Board stated that, as an example, an entity should come to consistent conclusions when evaluating a set that has 100 employees and a set that has 20 employees with the equivalent of 80 employees replaced by outsourced service providers because the 20 employees would be responsible for the management and performance of the outsourced employees."

2.071 ASC paragraph 805-10-55-5D(a) states that a process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs. However, the FASB did not provide additional guidance and as a result, determining whether the acquired workforce is performing a critical process will require significant judgment.

2.072 We believe the analysis of whether the process is critical should focus on the nature of the process being performed by the workforce. To evaluate whether the process is critical or minor, entities may compare the process being performed by the workforce to the missing processes from the set. If the acquired process (or group of processes) is considered qualitatively and quantitatively minor compared to all of the processes required to produce outputs, the process would not be critical. The following factors may
indicate that the employees are performing a process that is critical to developing or converting inputs into outputs (none of which individually would be determinative):

- **Size of the workforce.** The greater the number of employees, the more likely the process is substantive. However, the number of employees is not determinative as a few employees might have significant knowledge, experience, or skills that are critical to developing the acquired inputs into outputs.

- **Stage of activities.** If the organized workforce has not yet commenced activities to develop or convert inputs into outputs, it could call into question whether the processes acquired are in fact substantive or could be used to develop or convert the inputs into outputs. In contrast, if the organized workforce has commenced key activities to develop or convert inputs into outputs, the processes being performed would likely be critical.

- **Research and development activities.** The process may be substantive if the organized workforce has employees with necessary skills, knowledge, or experience in performing research and development processes that are significant to converting inputs into outputs. In an entity without outputs, research and development activities are likely to be one of an entity's most significant processes in the development stage. Example 2.13 below illustrates an example where research and development processes performed by acquired scientists are critical to the development of intellectual property.

- **How close the set is to generating revenues.** If the entity is close to generating revenues, the processes the employees are performing are more likely to be critical to developing or converting the inputs into outputs. The workforce may not be critical if there is significant uncertainty about its knowledge, skills, experience, or ability to complete the required steps to turn the inputs into outputs. For example, the need to hire a significant number of employees after the acquisition with the necessary knowledge, skills, or experience to continue the activities required to develop or convert the acquired inputs into outputs could indicate that the processes performed by the acquired workforce are not critical.

- **Whether the set is self-sustaining and operated on a stand-alone basis.** If the set includes an organized workforce that was operating the set on a stand-alone basis (i.e., it was not a division, subsidiary, product line, or portion of a larger entity), the organized workforce may be performing critical processes to manage and operate the set. This factor does not refer to the entity's financing needs or ability to access capital.

- **Presence of goodwill.** The presence of goodwill in a set with no outputs may indicate that the organized workforce is performing a critical process.

- **Process of integrating multiple assets.** If the employees are performing resource allocation, strategic management, or operational processes that manage different risks to integrate multiple different assets to develop inputs into outputs, the process is likely critical.
Inputs That the Entity Could Convert into Outputs

2.073 Acquiring employees is not enough to conclude that a set with no outputs is a business. That acquired workforce must be able to develop or convert another acquired input or inputs into outputs. As a result, the set also must include an input or inputs that could be developed or converted (or are being developed or converted) into outputs. These inputs include but are not limited to items such as technology, drug compounds, real estate, oil and gas properties, and distribution or production rights.

2.074 These types of assets form the foundation of what would ultimately be the goods or platform for the services to be provided to customers. Assets such as equipment that could be used to convert other inputs (e.g., a piece of machinery used to manufacture a good) may not be sufficient on their own because those inputs generally are not developed or converted into outputs and are used only to convert another input into outputs.

Example 2.12: Acquisition of a Drug Candidate – Scenario 1²

Facts

- Pharma Co. acquired two development stage drug compounds from Biotech that treat different illnesses.
- The two drug compounds each have significant value and significantly different risks (e.g., they treat different illnesses, have different patient subsets, and have different expected lives).
- Pharma Co. also assumes from Biotech their (1) clinical research organization (CRO) contract and (2) clinical manufacturing organization (CMO) contract.
- Pharma Co. does not acquire the scientists and long-lived tangible assets.
- Biotech is not currently generating revenues.

Analysis

Step 1 (Screening Test):

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

Pharma Co. also concludes that there is no fair value associated with the CRO and CMO contracts because the services are provided at market rates and could be provided by multiple vendors. Therefore, all of the consideration in the transaction will be allocated to the IPR&D activities.
The fair value of the gross assets is spread across the two identifiable IPR&D assets because these assets are not similar for the purposes of applying the screening test. Step 1 is not met.

**Step 2 (Input and Substantive Process):**

When there are no outputs, there must be inputs and employees (an acquired contract that represents an organized workforce is not sufficient). Accordingly, the acquired CRO and CMO contracts are not relevant to the Step 2 analysis because there are no outputs in the set. Pharma Co. concludes that the criteria in ASC paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process are not met because the set does not have employees.

**Conclusion**

The acquired set is not a business because the set does not include employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

**Example 2.13: Acquisition of Biotech – Scenario 1**

**Facts**

- Pharma Co. acquires the outstanding shares of Biotech, whose operations include IPR&D activities on several development stage drug compounds. The compounds target different illnesses and patient subsets.
- Pharma Co. also acquires long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment.
- Pharma Co. concludes there is significant fair value in the acquired workforce, the different IPR&D projects, and tangible assets.
- The set includes the scientists with the necessary skills, knowledge, or experience to continue to perform R&D activities.
- There is also a more-than-insignificant amount of goodwill.
- Biotech has not generated revenues.

**Analysis**

**Step 1 (Screening Test):**

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes
that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

In addition, there is significant fair value in different asset classes: intangible (IPR&D assets) and tangible (the headquarters, the research lab, and testing equipment). Step 1 is not met.

**Step 2 (Input and Substantive Process):**

When there are no outputs, there must be inputs and employees. Pharma Co. concludes that the scientists make up an organized workforce with the necessary skills, knowledge, or experience to perform R&D processes. Those processes, when applied to the IPR&D inputs, are critical to the ability to develop the inputs into outputs.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process.

**Conclusion**

The acquired set is a business because the set includes employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process that when applied to acquired inputs (IPR&D) is critical to the ability to develop those inputs into outputs.

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**Example 2.13a: Acquisition of Professional Service Employees**

**Facts**

ABC Co. acquires 100% of the outstanding shares of Sub Co. from DEF Co. for consideration of $2 million in cash. Sub has 35 employees from a service line that DEF is discontinuing and holds no assets. ABC will retain the employees to integrate into its operations.

**Analysis**

**Step 1 (Screening Test):**

ABC concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single asset or a group of similar assets. The employees represent an assembled workforce, but an assembled workforce would not be recognized as a separate asset in a business combination. Rather, it would be subsumed into goodwill, and goodwill is excluded from the numerator of the screening test.
Step 2 (Input and Substantive Process):

ABC evaluates Sub as a set that does not have outputs, because there is no continuation of revenues. The set includes an assembled workforce; however, there are no inputs in the set for the employees to turn into outputs.

Conclusion

The acquired set is not a business because the set does not include inputs. ABC recognizes an intangible asset for the assembled workforce it acquires.

Example 2.13b: Intent to Restructure Workforce Post-Acquisition

Facts

- Widget Co. acquires the outstanding shares of Acme Co., an early stage competitor of Widget that also plans to manufacture and sell widgets.
- Acme has not started manufacturing widgets or generated any revenues.
- Widget also acquires long-lived tangible assets such as a corporate headquarters, manufacturing facilities, equipment and raw materials.
- Widget's intent of the acquisition is to acquire the manufacturing facilities, equipment and raw materials to expand its production capacity.
- The set includes employees with the necessary skills, knowledge, or experience to manufacture and sell widgets, however Widget already has an established workforce to manufacture and sell widgets.
- Widget intends to implement a significant restructuring plan after the acquisition to eliminate the redundancies between the two companies that includes terminating substantially all of the Acme workforce.
- Widget concludes there is significant fair value in the acquired workforce (although it has plans to terminate substantially all of the workforce) and tangible assets.
- There is also a more-than-insignificant amount of goodwill.

Analysis

Step 1 (Screening Test):

Widget concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single asset or a group of similar identifiable assets, because it acquires a variety of assets in different classes, all with substantial fair value. Step 1 is not met.
Step 2 (Input and Substantive Process):

When an acquired set has no outputs, there must be inputs and employees that constitute an organized workforce to conclude the set is a business. Although Widget decided before the acquisition to terminate all of Acme's employees, the restructuring is for the benefit of Widget and not executed until after the acquisition. Therefore, Widget considers terminating the employees to be a separate transaction rather than part of the acquisition and the employees are considered part of the set.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is capable of performing a critical process.

Conclusion

The acquired set is a business because the set includes employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform widget manufacturing and selling processes that, when applied to the acquired inputs (manufacturing facilities, equipment and raw materials), are critical to the ability to develop those inputs into outputs.

Acquired Set with Outputs (ASC paragraph 805-10-55-5E)

2.075 When the set has outputs, only one of the factors in ASC paragraph 805-10-55-5E needs to be present for a set to have a substantive process. The set will have both an input and a substantive process when any of the following are present:

(a) Employees that form an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

(b) An acquired contract that provides access to an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

(c) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs; or

(d) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

2.076 ASC paragraph 805-10-55-5E does not specifically state types of inputs that must be acquired because by definition a set that has outputs would have an input (or inputs) that could be converted into outputs. However, the process acquired must relate to an
acquired input because all of the factors require that the process acquired be applied to an
input in the acquired set.

Organized Workforce Consisting of Employees

2.077 Similar to sets with no outputs, a set that has outputs is a business when it includes
an organized workforce that consists of employees that have the necessary skills,
knowledge, or experience to perform an acquired process (or group of processes) that
when applied to an acquired input or inputs is critical to the ability to continue producing
outputs. While employees are an input, they can also provide a process (see Paragraph
2.030) if they constitute an organized workforce. However, to be a business, we believe
the workforce must perform a process on another acquired input. That is, the employees
cannot be the only input in the set.

2.078 An entity would perform a similar evaluation of whether the acquired process
(employees that make up an organized workforce) is critical as it would if the set did not
have outputs (see Paragraph 2.072). However, the focus of the analysis is on whether that
process is critical to the continuation of outputs. The following factors may indicate that
the acquired process is considered critical:

- **Involvement in fulfillment activities.** If the workforce is directly involved in
  fulfillment of providing goods or services or obtaining customers, that would
  indicate that the acquired process is critical to continuing to produce outputs.
  For example, an entity acquires a set with a workforce that is directly involved
  in generating new customers, producing goods sold (manufacturing
  employees), or fulfilling a service to the customers (customer-facing
  employees providing the service).

- **Skillset of the workforce.** If the workforce has specialized skills or
  knowledge required to perform operational processes needed to continue
  producing outputs, that would be an indicator that the workforce is critical.
  The specific skills of the workforce must be considered in light of the set's
  activities. For example, a group of cleaning employees might be very skilled
  at cleaning; however, if the business activities of the set are not cleaning
  services, they usually would not be performing a process that is critical to
  continuing to produce outputs.

- **Size of the workforce.** The greater the number of employees the more likely
  the process is to be substantive. However, the number of employees is not
  determinative because a few employees might have significant knowledge,
  experience, or skills that are critical to continuing to produce outputs.

- **Ability to operate on a stand-alone basis.** If the set includes an organized
  workforce that was operating the set on a stand-alone basis (i.e., it was not a
  division, subsidiary, product line, or portion of a larger entity), the organized
  workforce may be performing processes critical to continuing to produce
  outputs. This factor does not refer to the entity's financing needs or ability to
  access capital.
• **Presence of goodwill.** The presence of goodwill may indicate that the organized workforce is performing a critical process.

• **Strategic management process.** If the processes performed are strategic management processes that involve determining the strategy for creating outputs, setting the price with customers, or determining the types of goods or services to sell to customers, that may indicate that the acquired processes are critical.

• **Resource allocation process.** If the organized workforce is performing resource allocation processes to facilitate the delivery of goods or services to customers, these processes may be critical to continue producing outputs.

• **The number of processes acquired.** While only a single substantive process is required for a set to be a business, the more processes the organized workforce is performing, the more likely the group of processes together would be considered critical.

• **Process of integrating multiple assets.** If the process acquired includes resource allocation, strategic management, or operational processes that manage different risks to integrate multiple different assets to continue producing outputs, those processes would likely be considered critical.

### Acquired Contracts

**2.079** In contrast to sets that do not have outputs, entities must evaluate acquired contracts (when the set is receiving goods or services) to determine if the entity in effect acquired an input or an organized workforce performing a substantive process. Paragraph BC46 in the Basis for Conclusions of ASU 2017-01 states:

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

**2.080** Based on the Basis for Conclusions and as illustrated in Case F of ASU 2017-01 (ASC paragraphs 805-10-55-82 through 55-84), a typical supply agreement is an input. However, when the vendor provides a service, the vendor could be applying a process to an input for the set. For example, the service provider in an asset management contract typically applies processes to the investment portfolio and customer contracts to raise and
deploy capital to create outputs. As a result, similar to employees, an acquired service contract could be both an input and a process.

2.081 When the set includes a service contract, entities will need to make an evaluation similar to evaluating an employee workforce to identify the processes that are performed in the contract and whether that process (or group of processes) is critical to continue producing outputs. However, we believe there should be more scrutiny applied to conclude that an acquired service contract represents a substantive process when a set does not include employees.

2.082 The inherent limitations of what may be performed by an acquired contract requires an entity to analyze the substance of the acquired contract to determine if in effect it has acquired an organized workforce. As a result, the guidance requires that entities should also consider the duration and renewal terms of the acquired contract when making this determination. The FASB did not provide additional guidance on how to evaluate the duration or renewal options; however, we believe the objective is to determine whether the entity acquired a substantive process (through the contract) or whether the contract is in substance an input.

2.083 The nature of an acquired organized workforce is such that an entity obtains the employees’ knowledge and skills and therefore acquires a process that can be passed along to other employees. As a result, the entity controls the process and can sustain it even after termination of an individual employee. In contrast, if a service contract is not renewed or was cancelled, the process may be terminated or need to be replaced. As a result, if a contract has a long duration, the substance of the acquisition may be more akin to acquiring an organized workforce and process that the entity effectively controls.

2.084 We believe that if the services contract is for a short duration (e.g., less than one year with no explicit or implicit renewal options), generally the contract would not provide an organized workforce performing a critical process. In contrast, a service contract with a term greater than one year should be evaluated to determine whether the process being performed is critical, similar to the evaluation for an employee workforce (see Paragraphs 2.077 and 2.078). However, one year should not be viewed as a bright line.

2.085 When considering short-term contracts with a renewal option (or long-term contracts with termination provisions akin to a renewal), further consideration is needed. The following factors may indicate that a service contract with renewal periods that extend beyond one year is akin to acquiring an organized workforce:

- The services are proprietary or not easily accessible in the marketplace. If the services are not readily available in the marketplace, it may indicate that the acquired contract is a substantive process that is critical to continue producing outputs; or
- Replacing the service provider would result in a significant cost, effort, or delay in the ability to continue producing outputs.
2.086 However, if the services are provided only on a temporary basis, or if the services are merely meant to help the acquirer transition on a temporary basis, that would indicate that in substance the entity did not acquire an organized workforce that is critical to continuing to produce outputs. This is different from acquiring an organized workforce that has a going concern element (even if the entity planned to terminate the employees).

2.086a Because the assessment of whether the set is a business is made from the perspective of a market participant, it is not relevant whether the acquirer plans on terminating the contract.

**Acquired Process Cannot Be Replaced without Significant Cost, Effort, or Delay or Is Considered Unique or Scarce**

2.087 An organized workforce is not required when outputs are present. The FASB decided that an organized workforce might not be required if the set includes automated processes (e.g., through acquired technology, infrastructure, or specialized equipment) or other significant processes that significantly contribute to the ability to continue producing outputs. As such, criteria (c) and (d) of ASC paragraph 805-10-55-5E address the scenarios when a set would have a substantive process but no workforce. A substantive process could also be present when the process would significantly contribute to the ability to create outputs and either:

- The acquired process (or group of processes) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs; or
- Is considered unique or scarce.

Examples include:

- A manufacturing process included in an assembly line that is highly automated;
- A process embedded in the setup of the infrastructure that requires minimal involvement from employees to complete;
- Proprietary production techniques; and
- Technology that performs processes to fulfill contracts with customers.

**Revenue or Lease Contracts**

2.088 While service contracts might provide access to an organized workforce performing a substantive process, a revenue contract, lease arrangement (the acquiree is the lessor), or other similar contracts should be excluded from the evaluation. ASC paragraph 805-10-55-5F specifically requires an entity to exclude those contracts from the evaluation of whether a substantive process is present. As a result, an entity would not be able to conclude that it acquired a process solely because a revenue or lease contract was present.
Presence of Goodwill

2.089 The presence of more than an insignificant amount of goodwill indicates that an acquired process is substantive. However, the presence of goodwill does not always mean a process is present. The entity should not assume that a process was acquired because the set includes goodwill. Rather, the entity would first need to identify the acquired process (and the organized workforce performing that process if the set does not have outputs) and then it could use the presence of goodwill to help evaluate whether the process is substantive.

2.090 One of the components of goodwill is usually the value of the assembled workforce. As a result, fair value associated with a workforce may indicate that an organized workforce is performing a critical process. Similarly, the excess of fair value over the net assets acquired could also indicate that there is value in an acquired process that would typically not be an identifiable asset.

2.091 Whether an entity records goodwill depends on the transaction being a business combination. As a result, for purposes of this analysis (i.e., to determine if a transaction is a business combination), the evaluation would focus on whether the consideration transferred was in excess of the fair value of the identifiable net assets acquired.

Market Participant Concept

2.092 The evaluation of whether the acquired assets and activities constitute a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. It does not matter how the seller used, or acquirer plans to use, the set when evaluating whether the set is a business.

2.092a For example, an entity may acquire a division from a seller of a vertically integrated business. Because that set was operated by the seller, the division did not have external customers; it only transferred goods to other divisions of the seller — e.g., intercompany transfers. After the transaction, the former division would transfer the same goods to its former parent although those sales would be recorded as revenue. When viewing this set from the standpoint of a market participant, that set would have outputs and the acquirer would need to evaluate whether both an input and substantive process was acquired in accordance with ASC paragraph 805-10-55-5E.

2.093 Similarly, an entity might acquire a supplier even though the entity was that supplier's only customer to more effectively manage its supply chain. It would not be relevant how the acquirer intended to use the set when viewing the set from the standpoint of a market participant. From the standpoint of a market participant, that set would have outputs (even if post-transaction the goods or services are provided only to internal divisions of the acquirer) and the acquirer would need to evaluate whether both an input and substantive process was acquired in accordance with ASC paragraph 805-10-55-5E.
2.094 The evaluation of whether ASC paragraphs 805-10-55-5D and 805-10-55-5E are met should occur from a market participant's perspective. This may affect the conclusion on whether a process is critical to the creation of outputs. A process that is not critical to a specific acquiree that already has the same process in place may nevertheless be critical to a market participant as that term is defined in ASC Topic 805.

2.094a For example, Company A acquires a set that includes processes to produce a unique type of computer monitor that Company A already produces. Company A acquired the set to take its competitor out of the market, because Company A and the competitor are the only ones that currently produce the item. While the process to create the unique computer monitor is not critical (or unique) to Company A, the process to produce this item may be critical (or unique) to a market participant and must be evaluated from that perspective when evaluating whether a business was acquired.

Example 2.14: Acquisition of Real Estate – Scenario 2

Facts

- REIT acquires 10 single-family homes, which have significant value in the aggregate, in the Washington, D.C. metro area. The acquisition includes the land, building, property improvements, and in-place leases.
- Each single-family home has a different layout (e.g., floor plan, square footage, and design). The lessees are a similar class of customers.
- REIT also acquires an office park with six 10-story office buildings leased to maximum occupancy, which have significant value in the aggregate.
- REIT acquires the vendor contracts for outsourced cleaning, security, and maintenance.
- Seller’s employees that perform leasing (sales, underwriting, etc.), tenant management, financing, and other strategic management processes are not included in the set.
- No other assets are acquired in the transaction.

Analysis

Step 1 (Screening Test):

REIT chooses to perform the screening test qualitatively because it is clear that substantially all of the fair value of the gross assets is not concentrated in a single asset or group of similar assets. There is significant value in the 10 single-family homes and six 10-story office buildings.

The single-family homes and office buildings are in a different class of tangible assets, and managing those assets (and producing outputs) has significantly different risks. Step 1 is not met.
Step 2 (Input and Substantive Process):

The set has outputs as a result of the continuing lease income from in-place leases on the properties acquired. Accordingly, REIT considers the criteria in ASC paragraph 805-10-55-5E.

The set does not include employees but does include acquired service contracts (e.g., contracts for outsourced cleaning, security, and maintenance). The acquired service contracts are not substantive as the processes performed are not critical to continue producing outputs (lease income). The functions of cleaning, security, and maintenance do not generate substantive income in the real estate industry. These functions may be substantive in other industries, but are not in the real estate industry.

In accordance with ASC paragraph 805-10-55-5F, the leases are excluded from the analysis of whether a process was acquired. There is no substantive process acquired in the set and Step 2 is not met.

Conclusion

The set does not include a substantive process and is therefore not a business.

Example 2.15: Acquisition of Loan Portfolio – Scenario 1 (continued)\(^5\)

Facts

- Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- Bank A does not acquire the employees that managed the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions, or systems.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (Screening Test):

As described in Example 2.10, the fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

Step 2 (Input and Substantive Process):

The set has outputs as a result of the continuing interest income from the loans acquired. Bank A evaluates the criteria in ASC paragraph 80-10-55-5E.
In accordance with ASC paragraph 805-10-55-5F, the loans are excluded from the analysis of whether a process was acquired. The set does not include an organized workforce or an acquired process. Step 2 is not met.

**Conclusion**

The set does not include a substantive process and is therefore not a business.

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**Example 2.16: Acquisition of Loan Portfolio – Scenario 2**

**Facts**

- Bank A acquires from Bank Z a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- The set includes the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers).
- There is a more-than-insignificant amount of goodwill.
- The loan portfolios currently produce outputs (interest income).

**Analysis**

**Step 1 (Screening Test):**

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios) because these assets are not similar for the purposes of applying the screening test. Bank A also concludes that there is a more-than-insignificant amount of goodwill associated with the acquired workforce, which affects the gross assets acquired (e.g., the denominator). Step 1 is not met.

**Step 2 (Input and Substantive Process):**

The set has outputs as a result of the continuing interest income from the loans acquired. Accordingly, Bank A evaluates the criteria in ASC paragraph 805-10-55-5E.

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 fact that there is a more-than-insignificant amount of goodwill acquired indicates the acquired workforce is performing a substantive process critical to continue producing outputs. Step 2 is met.
Conclusion

The acquired set is a business because the set includes both an input and a substantive process that together significantly contribute to the ability to continue producing outputs.

Example 2.17: Acquisition of Brands – Scenario 1

Facts

MSZ Corp. acquires

- The rights to Yogurt Brand F, including all related intellectual property;
- All customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, and raw material supply contracts; and
- The specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F.

MSZ Corp. does not acquire employees, manufacturing facilities, non-specialized manufacturing equipment, and processes required to produce the product, and distribution facilities (and related distribution processes).

There is a more-than-insignificant amount of goodwill.

The set currently produces outputs (Yogurt Brand F).

Analysis

Step 1 (Screening Test):

The gross assets include intellectual property (trademark, related trade name, and recipes) associated with Yogurt Brand F, customer contracts and related relationships, equipment, finished goods inventory, and the excess of the consideration transferred over the fair value of the net assets acquired.

There is significant fair value in both tangible and intangible assets. MSZ Corp. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. Step 1 is not met.

Step 2 (Input and Substantive Process):

As a part of Step 2, MSZ Corp. notes that the set has outputs through the continuation of...
revenues. MSZ Corp. considers the criteria in ASC paragraph 805-10-55-5E. The set does not include an organized workforce or an acquired contract that is in effect an organized workforce. However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property, raw material supply contracts, and the equipment, they significantly contribute to the ability to continue producing outputs. The set includes both inputs and substantive processes. Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to continue producing outputs.

Example 2.18: Acquisition of Oil and Gas Properties – Scenario 2

Facts

- XYZ Co. buys all the outstanding shares of Entity A, which owns and operates a number of diverse oil and gas properties (both proved and unproved properties).
- XYZ Co. acquires the employees and all of the assets including the long-lived tangible assets of Entity A.
- There is significant fair value in the acquired workforce, production processes, the oil and gas properties and other tangible assets.
- Entity A is currently generating revenues.

Analysis

Step 1 (Screening Test):

XYZ Co. first needs to determine whether Step 1 is met. XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets.

This is because there is significant fair value in many different asset classes, including intangible assets such as the acquired workforce and production processes (both of which are included in goodwill for the screening test), and tangible assets including the oil and gas properties (both proved and unproved properties), and other tangible assets. Step 1 is not met.

Step 2 (Input and Substantive Process):

XYZ Co. notes that the acquired set has outputs and concludes that the employees make up an organized workforce that has the necessary skills, knowledge or experience to
perform oil and gas processes. The oil and gas production processes cannot be replaced without significant cost, effort or delay. Those processes are applied to the oil and gas properties inputs and are critical to the ability to continue converting the inputs into outputs.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process. XYZ Co. concludes the set includes inputs and substantive processes and is therefore a business. Step 2 is met.

Conclusion

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

Example 2.19: Acquisition of Properties That Are Simultaneously Leased to Another Party

Facts

- Company A acquires 15 movie theater properties from Company B, an independent third party.
- Company A simultaneously leases these theaters to Company C, also an independent third party, under a triple-net master lease with a 20-year term.
- Company A will not operate the theaters. Company C acquires the operations (theater management and other employees, ticketing systems, vendor contracts, etc.) from Company B at the same time that it enters into the lease with Company A and will operate the theaters.
- The 15 movie theaters vary in location, with different economic conditions, market risks and local regulations. In addition, Company C will continue the seller's practice of allowing the local management of each theater to select the types of films to show based on the class of customer at each location. Films range from new releases, classics, independent, documentary, etc.
- The fair values of the individual theaters vary; however, they are all within a reasonable range with no significant outliers.

Analysis

Step 1 (Screening Test):

Company A concludes that substantially all of the fair value of the gross assets acquired are not concentrated in a single or a group of similar identifiable assets. Company A notes that the nature of the theaters' activities is similar. However, Company A concludes that each theater property has significantly different risks associated with creating outputs.
because of the different locations and classes of customers, and therefore they are not a
group of similar assets. The fair value of the gross assets acquired is spread across the
individual theaters.

Step 2 (Input and Substantive Process):

Company A concludes the set does not include a substantive process and is therefore not
a business. Company A notes that the acquired set has outputs and evaluates whether
there is an input and a substantive process using the criteria in paragraph 805-10-55-5E.
Company A acquired inputs (the 15 theater properties); however Company A did not
acquire processes. Rather, Company C acquired the theaters' processes directly from
Company B and will operate the theaters. Company A is not a party to that contract, and
therefore the processes transferred to Company C are not part of Company A's acquired
set.

Step 2 is not met.

Conclusion

The acquired set is not a business because the set does not include both an input and a
substantive process that together significantly contribute to the ability to create outputs.

APPLYING THE DEFINITION OF A BUSINESS TO FINANCIAL SERVICES
COMPANIES

2.095 Although the new framework applies equally across all industries, there are unique
aspects to applying the definition of a business to transactions involving financial
services companies due to the nature of their operations, which are often heavily cash
dependent and contain significant financial assets and liabilities. Transactions occurring
between financial services companies might also include few, if any, tangible assets.
Because cash and liabilities (such as customer deposits) are excluded from the screening
test, whether that test is met often will depend on the significance of loan or other
financial asset portfolios included in the set.

2.096 The guidance in ASU 2017-01 may change the accounting for common
transactions between financial services companies. For instance, bank branch acquisitions
that historically may have been treated as business combinations now may be accounted
for as asset acquisitions because the acquired set does not meet the new definition of a
business. The new definition also affects whether disposal transactions are in the scope of
Topic 860 or Topic 810, which could have meaningful implications for financial services
companies.
Example 2.20: Acquisition of a Bank Branch

Facts

Bank A acquires a bank branch from Bank B. The branch consists primarily of savings accounts, checking accounts, certificates of deposit, cash, and a small portfolio of homogeneous consumer loans, as well as the physical premises (land, building, furniture, and equipment). In the transaction, Bank A receives net cash from Bank B of $27,030,000, consisting of $29,300,000 at the branch, less $2,270,000 consideration paid.

The bank branch serves as a location for customers to make deposits and loan payments in-person and initiate new banking services.

Bank A identifies a core deposit intangible asset as part of the acquisition.

There is no goodwill associated with the set.

There are no marketing, strategic operations, loan or different product origination or other back office operations within the bank branch as these functions were being performed centrally at Bank B.

The branch managers and tellers become employees of Bank A on acquisition. The employees could be replaced easily within the labor market.

The assets acquired and liabilities assumed would be recognized (under Topic 805) as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$29,300,000</td>
</tr>
<tr>
<td>Loans</td>
<td>$1,550,000</td>
</tr>
<tr>
<td>Furniture</td>
<td>$30,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$80,000</td>
</tr>
<tr>
<td>Building</td>
<td>$200,000</td>
</tr>
<tr>
<td>Land</td>
<td>$600,000</td>
</tr>
<tr>
<td>Core deposit intangible</td>
<td>$350,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>$(40,000)</td>
</tr>
<tr>
<td>Deposit liabilities</td>
<td>$(29,800,000)</td>
</tr>
<tr>
<td>Consideration paid</td>
<td>$2,270,000</td>
</tr>
</tbody>
</table>

Analysis

Step 1 (Screening Test):

Bank A concludes that substantially all of the fair value is not concentrated in a single or group of similar identifiable assets. The cash and liabilities are excluded from the analysis in Step 1d under Topic 805. The analysis is as follows.
Step 1a

Bank A determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, loans, furniture, equipment, building, land and the core deposit intangible.

Step 1b

Bank A evaluates whether any of the exceptions in paragraph 805-10-55-5B apply. Bank A concludes that the building and land are a single asset because they are attached to and cannot be physically removed from and used separately from each other without incurring significant costs or reducing the fair value.

Step 1c

In applying paragraph 805-10-55-5C, Bank A notes that assets in different asset classes are not similar assets. However, Bank A concludes that the loan portfolio consists of loans that are similar assets. Additionally, Bank A concludes that all of the furniture are similar assets, and all of the equipment are similar assets.

Step 1d

The gross assets acquired are as follows:

<table>
<thead>
<tr>
<th>Items Acquired / Assumed</th>
<th>Value under Topic 805</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$29,300,000</td>
<td>Not included</td>
</tr>
<tr>
<td>Loans</td>
<td>$1,550,000</td>
<td>$1,550,000</td>
</tr>
<tr>
<td>Furniture</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$80,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Building and land</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Core deposit intangible</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>$(40,000)</td>
<td>Not included</td>
</tr>
<tr>
<td>Deposit liabilities</td>
<td>$(29,800,000)</td>
<td>Not included</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,270,000</strong></td>
<td><strong>$2,810,000</strong></td>
</tr>
</tbody>
</table>

The fair value of gross assets acquired is $2,810,000 as the cash and liabilities are excluded.

Step 1e

Bank A evaluates whether substantially all of the fair value is concentrated in a single asset or group of similar assets.

The acquired asset with the greatest fair value is the loan portfolio. Its fair value of $1,550,000 is compared to the gross assets acquired of $2,810,000, yielding 55%.
Step 1 is not met.

**Step 2 (Input and Substantive Process):**

The bank branch produces deposit fee revenue and interest income on loans, which are considered outputs. Accordingly, Bank A considers the criteria in paragraph 805-10-55-5E.

The set does not include an organized workforce that is critical to developing or converting inputs into outputs, because:

- While the branch is dependent on its employees to conduct daily business, the bank tellers and managers do not have specialized skills or knowledge required to perform operational processes needed to continue producing outputs based on the commonality in operating procedures across bank branches and the fact that they can be easily replaced within the labor market.
- The branch employees help customers who want to take out a loan complete a loan application, but they are not otherwise involved in the underwriting or origination decision process.
- The employees do not perform strategic management or resource allocation processes.

There are no acquired contracts that provide access to an organized workforce. The set also does not include a process that cannot be replaced without significant cost, effort or delay, or that is considered unique and scarce. Bank A could easily move the branch servicing of the loan and deposit accounts acquired to other branches. The in-person collection of customer deposits and loan payments is not proprietary or highly automated.

**Conclusion**

The acquired set is not a business because the set does not contain a substantive process.

**Additional considerations**

If substantially all of the fair value of the gross assets acquired had been concentrated in a single or group of identifiable assets, e.g., the loan portfolio, Step 1 would have been met and the set would not be a business. Step 2 would not have been required.

While the above example concludes that the acquired bank branch is not a business, there may be circumstances in which acquired bank branches would be considered businesses. These may include:

- If the set includes autonomous banking operations with employees who possess specialized skills or knowledge and who perform the strategic functions necessary to generate outputs, which might be the case when multiple bank branches are acquired, rather than one (e.g., a set that includes all bank branches within a particular region that function independently from
other bank branches).

- If the bank branch includes loan or other product origination operations and relationship managers tasked with generating new business.
- If there are strategic or marketing decisions made at the branch level.
- If the acquired branch includes proprietary customer service operations (e.g., virtual teller technology) that are unique.

If there is a more than insignificant amount of goodwill in the set, that may indicate that one or more substantive processes, such as the ones listed above, are present.

The assessment of these factors would require additional analysis and judgment assessing the individual facts and circumstances to determine whether the acquired branch(es) meet the definition of a business.

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Example 2.21: Acquisition of an Asset Management Firm

Facts

ABC Corp., a diversified financial company, acquires an asset management entity that provides investment advisory services to individuals in a stock deal valued at $11,830,000.

The acquired set includes several asset managers and cash, land, building, furniture, and equipment.

The acquired set also includes a contract with a third party for investment research services priced at a market rate.

ABC identifies a large customer relationship intangible asset.

There is a more-than-insignificant amount of goodwill.

The acquisition is structured as a nontaxable stock acquisition and therefore the tax bases of the asset management entity’s assets and liabilities carry over to ABC.

The set currently produces outputs (i.e., it provides asset management services and earns fees).
The assets acquired and liabilities assumed would be recognized (under Topic 805) as follows:

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$60,000</td>
</tr>
<tr>
<td>Furniture</td>
<td>$20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$50,000</td>
</tr>
<tr>
<td>Acquired contract</td>
<td>$0</td>
</tr>
<tr>
<td>Building</td>
<td>$750,000</td>
</tr>
<tr>
<td>Land</td>
<td>$250,000</td>
</tr>
<tr>
<td>Customer relationship intangible</td>
<td>$5,700,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$6,400,000</td>
</tr>
<tr>
<td>Deferred income tax liabilities</td>
<td>$(1,400,000)</td>
</tr>
<tr>
<td>Consideration paid</td>
<td>$11,830,000</td>
</tr>
</tbody>
</table>

**Analysis**

*Step 1 (Screening Test):*

ABC concludes that substantially all of the fair value is not concentrated in a single or group of similar identifiable assets. The analysis is as follows.

**Step 1a**

ABC determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, furniture, equipment, an acquired contract, a building, land, a customer relationship intangible, and goodwill. The acquired contract is priced at the current market rate and therefore has an immaterial fair value (assumed to be $0 for this example).

**Step 1b**

ABC evaluates whether any of the exceptions in paragraph 805-10-55-5B apply. ABC concludes that the building and land are a single asset because they are attached to and cannot be physically removed from and used separately from each other without incurring significant costs or reducing the fair value.

**Step 1c**

In applying paragraph 805-10-55-5C, ABC notes that assets in different asset classes are not similar assets. ABC concludes that all of the furniture are similar assets, and all of the equipment are similar assets.

**Step 1d**

In applying Step 1d, the gross assets acquired would not include the goodwill associated with the deferred tax liabilities acquired in this transaction. The deferred tax liabilities generate $1,400,000 of goodwill, which is excluded for purposes of applying Step 1, leaving $5,000,000 of goodwill.
The gross assets acquired are as follows:

<table>
<thead>
<tr>
<th>Items Acquired / Assumed</th>
<th>Value under Topic 805</th>
<th>Included in Gross Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$60,000</td>
<td>Not included</td>
</tr>
<tr>
<td>Furniture</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Acquired contract</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Building and land</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Customer relationship intangible</td>
<td>$5,700,000</td>
<td>$5,700,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$6,400,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Deferred income tax liabilities</td>
<td>$(1,400,000)</td>
<td>Not included</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$11,830,000</strong></td>
<td><strong>$11,770,000</strong></td>
</tr>
</tbody>
</table>

The fair value of gross assets acquired is $11,770,000.

**Step 1e**

ABC evaluates whether substantially all of the fair value is concentrated in a single asset or group of similar assets. The asset with the greatest fair value is the customer relationship intangible asset. Its fair value of $5,700,000 is compared to the gross assets acquired of $11,770,000, yielding 48%.

Step 1 is not met.

**Step 2 (Input and Substantive Process):**

The set has outputs as a result of the continued management fee income. Accordingly, ABC evaluates the factors when a set has outputs.

The acquired set includes furniture, equipment, an acquired contract, land and building, and a customer relationship intangible as inputs.

The set also includes an organized workforce that performs processes (investment management) critical to the ability to continue producing outputs. ABC determined that the asset managers included in the set have specialized skills and knowledge in providing investment advice to clients. The asset managers are also directly involved in generating new customers and producing revenue from existing clients. Therefore, ABC concludes that the employees represent an organized workforce and Step 2 is met.

**Conclusion**

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to continue producing outputs.
Note that this fact pattern may be similar to other common financial services transactions, such as the acquisition of an insurance agency or other service organizations.

1 Based, in part, on Case H, Scenario 2, in ASU 2017-01.
2 Based, in part, on Case B, Scenario 2, in ASU 2017-01.
3 Based, in part, on Case C in ASU 2017-01.
4 Based, in part, on Case A, Scenario 2, in ASU 2017-01.
5 Based, in part, on Case H, Scenario 2, in ASU 2017-01.
6 Based, in part, on Case H, Scenario 3, in ASU 2017-01.
7 Based, in part, on Case G in ASU 2017-01.
Section 3 - The Acquisition Method

OVERVIEW OF THE ACQUISITION METHOD

ASC paragraph 805-10-25-1

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

3.000 The definition of a business combination in the ASC Master Glossary includes events and transactions in which an acquirer obtains control of one or more businesses, regardless of how it obtains control. See the discussion of Business Combinations Achieved without the Transfer of Consideration in Section 4.

3.001 Each transaction or other event that falls within the scope of ASC paragraphs 805-10-15-3 and 15-4, as discussed in Section 1, is accounted for using the acquisition method. If a transaction or event is outside the scope of ASC Topic 805, it is accounted for based on other applicable GAAP. Note: The FASB issued ASU 2017-01 in January 2017. The ASU changes the framework for determining whether a set of assets and activities constitutes a business. For additional information on ASU 2017-01, see Paragraph 2.025.

ASC Topic 805

ASC paragraph 805-10-05-4

…The acquisition method requires all of the following steps:

a. Identifying the acquirer
b. Determining the acquisition date

c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
d. Recognizing and measuring goodwill or a gain from a bargain purchase.

3.002 See the guidance in the following Sections for applying the acquisition method:

a. Identifying the Acquirer Section 4
b. Determining the Acquisition Date Section 5
c. Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree Section 7
d. Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase Section 8
Section 4 - Identifying the Acquirer

Detailed Contents

Acquirer (and Acquiree) Defined
Application of ASC Subtopic 810-10 Guidance to Identify the Acquirer
Consideration of Other Factors to Determine the Acquirer When Application of ASC Subtopic 810-10 Guidance Does Not Clearly Identify the Acquirer

Combinations Effected Primarily by the Transfer of Cash or Other Assets, or Incurring Liabilities
  - Capital Transactions versus Business Combinations

Combinations Effected Primarily by Exchanging Equity Interests
  - Example 4.0: Composition of Senior Management of the Combined Entity
  - Example 4.1: Voting Rights, Board of Directors, and Senior Management
  - Example 4.2: Voting Rights, Large Minority Interest, Board of Directors, and Senior Management
  - Example 4.3: Voting Rights, Board of Directors, Senior Management, and Payment of a Premium

Relative Size of the Combining Entities

Combinations Involving More Than Two Entities

Transactions Involving a Newly Formed Entity
  - Transactions Involving a Non-Substantive Newco
  - Newly Formed Entity in an Exchange that Lacks Substance
  - Example 4.3a: Use of a NewCo in an Up-C Structure

Roll-Up Or Put-Together Transactions
  - Example 4.4: Roll-Up or Put-Together Transaction Involving Two Entities
  - Example 4.5: Roll-Up or Put-Together Transaction Involving More Than Two Entities

Transactions Involving a Substantive Newco
  - Example 4.6: Newly Formed Entity Controlled by a Venture Capital Company
  - Example 4.6a: Newly Formed Entity Controlled by a Venture Capital Company

Special Purpose Acquisition Company (SPAC)

Business Combinations Achieved Without the Transfer of Consideration

Variable Interest Entities
  - Example 4.7: Initial Consolidation of a Variable Interest Entity

Business Combinations Achieved by Contract Alone Often Result in the Formation of Variable Interest Entities

Reverse Acquisitions
ACQUIRER (AND ACQUIREE) DEFINED

ASC Master Glossary: Acquirer

The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

ASC Master Glossary: Acquiree

The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

ASC paragraph 805-10-25-4

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

ASC paragraph 805-10-25-5

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

(See discussions of Control and Business in Section 2.)

4.000 The acquirer in a business combination in which a variable interest entity is acquired is always the primary beneficiary of the variable interest entity. See the discussion of Variable Interest Entities beginning at Paragraph 4.025.

4.001 There is only one acquirer in every business combination, including combinations of three or more entities. The acquirer is the entity that obtains control of a business (or businesses). In business combinations involving more than two entities, determining the acquirer includes consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities. See discussion of Combinations Involving More Than Two Entities beginning at Paragraph 4.018.
APPLICATION OF ASC SUBTOPIC 810-10 GUIDANCE TO IDENTIFY THE ACQUIRER

4.002 ASC Topic 805, Business Combinations, specifies that the guidance in ASC Subtopic 810-10, Consolidation - Overall, should be used to determine the acquirer (i.e., the entity that obtains control of one or more businesses in a business combination), and if applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in ASC paragraphs 805-10-55-11 through 55-15 should be considered in making the determination.

4.003 ASC paragraph 810-10-15-8 specifies that the usual condition for obtaining control is the ownership of more than 50% of the outstanding voting interest of another entity. However, such ownership does not constitute control if it does not give the holder control of the majority-owned entity. For example, as discussed in ASC paragraphs 810-10-25-1 through 25-14C, a minority shareholder or limited partner may have substantive participating rights that prevent the majority holder from exercising control over the investee. Conversely, an investor could obtain control over a business in situations where the investor owns less than a majority (and perhaps none) of the voting interests in the investee (e.g., in a situation where control is achieved by contract alone). See discussion of Control beginning at Paragraph 2.004.

CONSIDERATION OF OTHER FACTORS TO DETERMINE THE ACQUIRER WHEN APPLICATION OF ASC SUBTOPIC 810-10 GUIDANCE DOES NOT CLEARLY IDENTIFY THE ACQUIRER

4.004 If applying the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer, ASC Topic 805 requires that other facts and circumstances be considered in making the determination, including the factors described in ASC paragraphs 805-10-55-11 through 55-15, discussed below. No individual factor is necessarily determinative. Rather, all pertinent facts and circumstances should be considered in determining which of the combining entities is the acquirer.

COMBINATIONS EFFECTED PRIMARILY BY THE TRANSFER OF CASH OR OTHER ASSETS, OR INCURRING LIABILITIES

ASC paragraph 805-10-55-11

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

4.005 In business combinations effected primarily by the transfer of cash, other assets, or by incurring liabilities, the entity that transfers the cash or other assets, or incurs the liabilities, is usually the acquirer. Regardless of the form of the transaction, if the acquirer retains control of the transferred assets or liabilities (including an equity interest in a subsidiary) after the business combination, it measures the transferred assets and liabilities at their carrying amounts immediately before the acquisition date and does not
recognize a gain or loss on the transfer. See discussion and examples of *Assets or Liabilities Transferred by the Acquirer* in Section 6.

**Capital Transactions versus Business Combinations**

4.006 The guidance in ASC paragraph 805-10-55-11 does not apply to a transaction that in substance is a capital transaction rather than a business combination. In these instances, the entity that distributes cash or assets is the acquiree and not the acquirer for accounting purposes. The SEC staff, in the Division of Corporation Finance, *Financial Reporting Manual*, par. 12100, states that the acquisition of a private operating company by a nonoperating public *shell company* typically results in the owners and management of the private company having actual or effective voting and operating control of the combined company. This transaction is equivalent to the issuance of shares by the private company for the net monetary assets of the shell company, accompanied by a recapitalization (i.e., a reverse recapitalization). The accounting is similar to that for a reverse acquisition; that is, the private company is the accounting acquirer (see *Reverse Acquisitions* beginning at Paragraph 9.012), except that it recognizes no goodwill or other intangible asset because the transaction does not constitute the acquisition of a business. Instead, the private company would account for this transaction as the acquisition of an asset or a group of assets that does not constitute a business.

4.007 Special considerations apply to transactions involving a newly formed entity. See discussion at Paragraph 4.020a.

**COMBINATIONS EFFECTED PRIMARILY BY EXCHANGING EQUITY INTERESTS**

4.008 In most business combinations effected primarily through the exchange of equity interests, the acquirer is the entity that issues the new equity interests. However, ASC paragraphs 805-10-55-10 through 55-15 consider other pertinent facts and circumstances in identifying the acquirer in such business combinations, including the factors described in ASC paragraph 805-10-55-12. See discussion of *Reverse Acquisitions* beginning at Paragraph 9.012, in which the issuing entity is the acquiree.

**ASC paragraph 805-10-55-12**

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

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

4.009 The existence of equity interests, other than common shares, with voting rights (e.g., voting preferred shares) may lead to identifying an acquirer other than the entity that would have been identified in the absence of such equity interests. Options, warrants, and convertible securities that are in-the-money and that are vested and exercisable or convertible into shares with voting rights at the date of acquisition, including exercisability or convertibility triggered by the terms of the acquisition, should also be considered when determining relative voting rights.

4.010 In some transactions, voting rights of one or more classes of shares automatically change at a future date or on the occurrence of specified events. For example, a class of shares may be designated as nonvoting for the first year following the business combination. All of the facts and circumstances of the transaction should be evaluated to determine how this affects the identification of the acquirer. The factors described in Paragraph 4.012 may be helpful in evaluating whether the period of time the shares are nonvoting is substantive.

ASC subparagraph 805-10-55-12(b)

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

4.011 This may be a significant factor in determining the acquirer for a put-together or roll-up transaction. The application of this guidance is demonstrated in Examples 4.4, 4.5, and 4.6.

ASC subparagraph 805-10-55-12(c)

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

4.012 ASC Topic 805 is silent as to whether the owner election rights need to exist only at the acquisition date, or for a period of time thereafter. However, if control of the board by a shareholder group is temporary, the control may not be substantive. In evaluating this factor, consideration should be given not only to the board’s current composition, but also to the period of time each board member is entitled to hold his or her board position, taking into account scheduled board member retirements and scheduled elections after the acquisition date. While there is no minimum duration required for a shareholder group to be in control of the board for it to be deemed substantive, we believe that control generally should extend for a sufficient duration to allow the board to consider and act on significant substantive matters arising from the acquisition, such as those related to
corporate governance; the appointment and compensation of senior management; the issuance of debt or equity securities; and substantive business integration, exit, and disposal activities. Judgment is required in determining whether control of a shareholder group following an acquisition is substantive. Although control for a period of two years or more is generally sufficient to conclude that the control is substantive, an assessment based on all the facts and circumstances should be made. In some cases, a period exceeding two years might be required and, in other cases, a period of less than two years may be substantive.

ASC subparagraph 805-10-55-12(d)

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

4.013 Senior management generally consists of the executive chairman of the board, the chief executive officer, the chief operating officer, the chief financial officer, divisional heads, and members of the executive committee, if one exists. This description of senior management is meant to identify functions, not necessarily managers with a specific title. These functions should comprise the highest level of operating decision makers within the combined entity. If the senior management of the combined entity is not dominated by individuals from one of the combining entities, we believe that more weight should be given to those executive positions that are most closely aligned with the core business activities of the combined entity.

Example 4.0: Composition of Senior Management of the Combined Entity

ABC Corp. and DEF Corp. agree to merge their similarly sized pharmaceutical businesses. ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. The shareholders of DEF will receive 50.01% of the voting interests of the combined company.

The board of directors of the combined company will have four former ABC and four former DEF directors. Staggered board elections will begin two years after consummation of the business combination, and there are no scheduled board member retirements before that time. Removal of board members requires a vote of at least two-thirds of the shareholders. Management will consist of:

<table>
<thead>
<tr>
<th>ABC</th>
<th>DEF</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>President of Human Resources</td>
</tr>
<tr>
<td>COO</td>
<td>General Counsel</td>
</tr>
<tr>
<td>Chief Medical Officer</td>
<td>CFO</td>
</tr>
</tbody>
</table>

No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, etc.
Assessment

ABC will have the most influence in the combined company and is the acquirer. Although the owners of DEF will receive a marginally larger portion of the voting rights of the combined company, the senior management of ABC will assume the role of CEO and other executive positions that are most closely aligned with the core business activities of the combined entity (that is, development and marketing of pharmaceutical products).

Considering the neutral status of the board of directors, the absence of board elections for two years, the absence of significant blocks of voting rights, and the similar size of the combining entities, the small voting majority of the owners of DEF does not represent a decisive element of continuing control for DEF.

ASC subparagraph 805-10-55-12(e)

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

4.014 The FASB did not provide any hierarchy for these factors. Some factors may be more relevant to identifying the acquirer in one combination and less relevant in others. Judgment is required in instances where the various factors individually point to different entities as the acquirer.

4.015 Factors (a) through (d) relate to persons involved in controlling the operations of an entity. These functions are sometimes collectively referred to as the *governance system* of an entity. The premium mentioned in factor (e), referred to as a *control premium*, can be presumed to be paid because the members of the governance system of the paying entity can extend their control to the acquirer.

4.016 The following examples assume that neither the guidance in ASC Subtopic 810-10, nor any other factors clearly indicate which entity is the acquirer and, thus, the determination of the acquirer is appropriately being made based on an analysis of the factors in ASC paragraph 805-10-55-12.

Example 4.1: Voting Rights, Board of Directors, and Senior Management

ABC Corp. and DEF Corp. agree to merge their similar-sized businesses. ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. The shareholders of DEF will receive 50.01% of the voting interests of the combined company.

The board of directors of the combined company will have five former ABC and four former DEF directors. Staggered board elections will begin two years after consummation of the business combination, and there are no scheduled board member
retirements before that time. Removal of board members requires a vote of at least two-thirds of the shareholders. Management will consist of:

**ABC**
- Chairman/CEO
- Co-COO*
- CFO

**DEF**
- President
- Co-COO*

*ABC and DEF each have the right to appoint an individual that shares the COO position with the Co-COO appointed by the other company.

No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, management, etc.

**Assessment**

ABC is the acquirer. Although the owners of DEF will receive the larger portion of the voting rights of the combined company, the members of the board of directors and senior management of ABC will dominate the respective bodies of the combined company. Considering the absence of significant blocks of voting rights, the absence of board elections for two years, and the similar size of the combining entities, the small voting majority of the owners of DEF does not represent a decisive element of continuing control for DEF. Thus, ABC will have the most influence in the combined company for at least two years after the business combination.

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**Example 4.2: Voting Rights, Large Minority Interest, Board of Directors, and Senior Management**

Bank A and Bank B agree to enter into a business combination. On consummation, Bank A’s former shareholders will own 55% and Bank B’s former shareholders will own 45% (30% of which will be owned by shareholder X) of the outstanding voting shares of the combined entity. The largest former shareholder of Bank A will own 7% of the combined entity.

As a condition of closing, shareholder X will be granted the right to appoint a majority of the combined entity’s first board of directors (board members serve a three-year term). The acquisition agreement also provides for the carryover of the CEO, CFO, and COO of Bank B into comparable positions in the combined entity. The board of directors will have the authority to appoint and remove the senior officers of the combined entity. No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, or management.

**Assessment**

Bank B is the acquirer. Despite the voting majority of the former shareholders of Bank A, the significant minority interest of shareholder X and his or her right to appoint a
majority of the combined entity’s first board of directors (which will serve for three years), together with the carryover of the senior management of Bank B indicate that Bank B has the most influence in the combined entity.

Example 4.3: Voting Rights, Board of Directors, Senior Management, and Payment of a Premium

ABC Corp. acquires 15% of the outstanding shares of a public company, DEF Corp., for cash, paying a premium of 10% above the market price, and acquires the remaining outstanding shares of DEF in exchange for shares of ABC. After the acquisition, the former shareholders of DEF own 58% of the outstanding shares of the combined entity. If exercised, warrants and convertible debentures held by former shareholders of DEF would increase the interest of former shareholders of DEF to 71%; however, the warrants and convertible debentures cannot be exercised for three years from the closing date.

The board of directors of the combined entity consists of five nominees of ABC and four nominees of DEF for a two-year term. Removal of board members requires a vote of at least two-thirds of the shareholders. The chairman and the CEO of ABC retain their positions in the combined entity. No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, or management.

Assessment

ABC has the most influence in the combined entity and is the acquirer. ABC paid partly in cash, including a premium above market price, and dominates the board of directors and senior management of the combined entity. DEF’s former shareholders will own the majority of shares in the combined entity, but they will not own two thirds of the shares for at least three years following the business combination.

RELATIVE SIZE OF THE COMBINING ENTITIES

ASC paragraph 805-10-55-13

The acquirer usually is the combining entity whose relative size (measured in, for example, assets, revenues, or earnings) is significantly larger than that of the other combining entity or entities.

4.017 Judgment is required when comparing the combining entities based on their relative size. When each combining entity is involved in similar activities and lines of business, a comparison of relative size may be straightforward. For example, reported revenues and total assets might be an appropriate comparison in these circumstances.

4.017a However, in circumstances where the combining entities are involved in disparate activities and businesses, a comparison of relative size based on reported amounts might not be appropriate, and information other than the reported amounts of assets, earnings,
and revenues may require consideration. Comparing the amount of reported revenues without considering the nature and source of those revenues may not be meaningful. For example, comparing revenues generated by an entity with high volume, high turnover, and low gross margins (e.g., a grocery store chain) with revenues generated by an entity with low volume, high value-added, and high gross margins (e.g., a custom designer and manufacturer of specialized equipment) might not be meaningful.

4.017b Likewise, comparing the reported amount of total assets or net assets of an entity whose principal revenue-generating assets are internally developed intangible assets (and thus not reflected in the entity’s reported amounts) to the reported amount of total assets or net assets of an entity whose principal revenue-generating assets are similar long-lived intangible assets that were acquired in a series of business combinations (and thus are reflected in the entity’s reported amounts) may not be particularly meaningful.

4.017c A comparison of operating cash flows might, in certain instances, be helpful in identifying whether one of the combining entities is significantly larger than the other combining entities. In certain instances, we believe that market capitalization may also be an appropriate factor to consider in assessing the relative size of the combining entities.

COMBINATIONS INVOLVING MORE THAN TWO ENTITIES

ASC paragraph 805-10-55-14

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

4.018 The definition of control could be viewed to exclude certain transactions in which no former shareholder group obtains control of the combined entity, such as combinations involving more than two entities, including roll-up and put-together transactions. However, those transactions are business combinations under ASC Topic 805.

4.019 All of the factors in ASC paragraphs 805-10-55-11 through 55-15 require consideration in identifying the acquirer if application of the guidance in ASC Subtopic 810-10 does not clearly identify the acquirer. The guidance in ASC paragraph 805-10-55-12(b), which indicates that in combinations involving the exchange of equity interests, the acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity, may be particularly helpful in identifying the acquirer in some combinations involving more than two entities.

4.020 Example 4.5 illustrates an example of a business combination of more than two entities.
TRANSACTIONS INVOLVING A NEWLY FORMED ENTITY

4.020a Special considerations apply when a new entity (NewCo) is formed to effect a transaction. A newly formed entity with precombination activities deemed to be significant (i.e., NewCo is substantive), but which do not constitute a business, can be the acquirer in a business combination. That is, the accounting acquiree must be a business for the transaction to be a business combination, but it is not necessary that the accounting acquirer be a business. A nonsubstantive NewCo could indicate the transaction is not a business combination or that another entity (e.g., one of the combining entities) is the acquirer.

ASC paragraph 805-10-55-15

A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in [ASC] paragraphs 805-10-55-10 through 55-14. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

4.020b Factors to consider in determining whether the newly formed entity is substantive include, but are not limited to:

- Whether the newly formed entity has assets other than cash related to the initial equity investment made by its founder;
- Whether the newly formed entity survives the transaction;
- The precombination activities of the newly formed entity (e.g., raising capital, issuing debt, identifying a target, negotiating, and promoting the business combination);
- How long the newly formed entity has been in existence; and
- Whether the elements of the transaction are integrated or preconditioned on each other.

Transactions Involving a Non-Substantive Newco

4.020c A transaction involving a newly formed entity with no significant precombination activities may or may not be a business combination, depending on the facts and circumstances.

Newly Formed Entity in an Exchange that Lacks Substance

4.020d If a newly formed entity with no significant precombination activities obtains a controlling financial interest in an operating entity in a legal entity reorganization or an exchange that lacks substance, the transaction would not be a business combination. Paragraph 6 of FASB Technical Bulletin No. 85-5, Issues Relating to Accounting for Business Combinations, stated, “if the exchange lacks substance, it is not a purchase
event and should be accounted for based on existing carrying amounts.” Although FASB Technical Bulletin No. 85-5 was superseded by Statement 141(R), we believe this guidance remains relevant for transactions that lack economic substance (see also *Combinations Between Entities or Business with a High Degree of Common Ownership* beginning at Paragraph 28.009).

**Example 4.3a: Use of a NewCo in an Up-C Structure**

OpCo is an operating entity in the legal form of an LLC (a limited liability corporation) with four Investors, one of whom holds a 40% interest (Investor A), and the remainder of whom each holds a 20% interest (Investors B, C, and D). None of the Investors individually controls OpCo. To effect an initial public offering of OpCo, Investor A forms a corporation (NewCo) that will acquire OpCo and file a registration statement. This is an example of a transaction commonly referred to as an "Up-C" structure.

Two steps are required to arrive at the desired structure. In Step 1, Investor A creates NewCo and transfers all of its 40% interest in OpCo to NewCo. NewCo has no other substantive assets or activities. After this step, the entities are organized as follows.
In Step 2, Investors B, C, and D each exchange their 20% interest in OpCo for a 20% interest in NewCo. After the reorganization, the entities are structured as follows:

Assessment

NewCo's acquisition of OpCo is not a business combination. NewCo did not engage in any significant precombination activities and did not raise any capital, identify acquisition targets or negotiate transactions. Each Investor holds the same percentage interest in NewCo as they held in OldCo before Step 1. Both Step 1 and Step 2 lack economic substance and merely represent a change in the legal form to effect the IPO. NewCo consolidates OpCo at the carryover basis of OpCo's assets and liabilities.

Roll-Up Or Put-Together Transactions

4.021 A transaction in which two or more entities transfer net assets that constitute a business, or the owners of those entities transfer their equity interests to a newly formed entity, is sometimes referred to as a *roll-up* or *put-together* transaction. These transactions are business combinations and should be accounted for using the acquisition method. If a new entity with no significant precombination activities is formed to issue equity interests to effect a business combination, the newly formed entity should be looked through, with one of the existing combining entities determined to be the acquirer.
Example 4.4: Roll-Up or Put-Together Transaction Involving Two Entities

ABC Corp. contributes its wholly owned subsidiary, Sub A, and DEF Corp. contributes its wholly owned subsidiary, Sub D, to the newly formed XYZ Corp. In exchange, ABC receives a 52% equity interest in XYZ and as a result has the ability to appoint a voting majority of the board of directors of XYZ. DEF receives the remaining 48% equity interest in XYZ. There are no other factors that indicate which of the combining entities is the acquirer.

**Assessment**

At the XYZ level, Sub A is the acquirer. Newly formed XYZ had no significant precombination activities and, thus, one of the combining entities must be identified as the acquirer. Sub A’s parent (ABC) received a 52% equity interest in XYZ, and there are no other factors that indicate which of the combining entities is the acquirer. XYZ should account for this transaction using the acquisition method. Because Sub A is the acquirer, its assets and liabilities should be recognized at their carryover basis, and the assets and liabilities of Sub D should be recognized and measured under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles of ASC Topic 805).

At the ABC consolidated level, it has effectively acquired a controlling financial interest in Sub D (by acquiring a 52% equity interest in XYZ) in exchange for a noncontrolling interest in Sub A (through the 48% noncontrolling interest in XYZ acquired by DEF). Thus, in its consolidated financial statements, ABC should continue to recognize the assets and liabilities of Sub A at their carryover basis, and account for the acquisition of Sub D using the acquisition method. Therefore, ABC should recognize and measure the assets and liabilities of Sub D under ASC Topic 805 (i.e., same basis as recognized and measured in the consolidated financial statements of XYZ), and recognize the noncontrolling interest in XYZ held by DEF at its acquisition-date fair value. ABC recognizes no gain or loss on this transaction (unless there is a bargain purchase gain).

Example 4.5: Roll-Up or Put-Together Transaction Involving More Than Two Entities

Companies A, B, C, and D each operate independent florist shops in suburbs of Metro City (Metro). Company E operates four florist shops in Metro City. To capitalize on economies of scale and other synergies, the owners agree to form a single entity (Metro Florists, a voting interest entity) through a roll-up transaction. The ownership of Metro Florists will be as follows: Companies A, B, and C shareholders – 15% each; Company D shareholders – 20%; and Company E shareholders – 35%. There are no other factors that indicate which entity is the acquirer.
**Assessment**

Newly formed Metro Florists had no significant precombination activities and, thus, one of the combining entities must be identified as the acquirer. At the Metro Florists level, Company E is the acquirer. Company E’s shareholders receive a greater interest in Metro Florists (35%) than the shareholders of any of the other combining companies, and no other factors indicate to the contrary. Metro Florists’ consolidated financial statements will include the assets and liabilities of Company E at their carryover basis, and will include the assets and liabilities of Companies A, B, C, and D, which are recognized and measured under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles prescribed by ASC Topic 805).

**Transactions Involving a Substantive Newco**

4.022 Although a new entity formed to effect a business combination is not necessarily the acquirer, a newly formed entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer. See Paragraph 4.020b for factors to consider in determining whether the newly formed entity is substantive. If a newly formed entity is substantive, further analysis of ASC Subtopic 810-10 and ASC paragraphs 805-10-55-11 through 55-15 (as discussed in 4.002 through 4.020a) will need to be performed to determine if the newly formed entity is the acquirer. This situation could arise, for example, in a roll-up transaction in which the number of shares in the combined entity issued to new management and a sponsoring venture capital company exceeds the number of shares issued to the former owners of the numerous combining companies (refer to Example 4.6 for further discussion).

**Example 4.6: Newly Formed Entity Controlled by a Venture Capital Company**

Assume the same facts as in Example 4.4, except that newly formed XYZ was formed by a venture capital company, which transferred cash to XYZ in exchange for a 52% equity interest in XYZ. ABC transferred Sub A to XYZ in exchange for a 25% interest in XYZ, and DEF transferred Sub D to XYZ in exchange for a 23% interest in XYZ. Through its 52% equity interest, the venture capital company has the ability to appoint a voting majority of the board of directors of XYZ. All other facts remain the same (i.e., there are no other factors that indicate which of the combining entities is the acquirer).

**Assessment**

XYZ is the acquirer of Sub A and Sub D. Although XYZ is newly formed, a venture capital company transferred cash to XYZ in exchange for a 52% equity interest in XYZ, and has the ability to appoint a voting majority of the board of directors of Company XYZ. XYZ should account for this transaction using the acquisition method, resulting in the recognition and measurement of the assets and liabilities of both Sub A and Sub D.
under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles prescribed by ASC Topic 805).

ABC, in its consolidated financial statements, will recognize a gain or loss on the disposition of its controlling interest in Sub A equal to the difference between the carrying value of that interest before the transaction and the fair value of the 25% interest in XYZ received in the exchange. In the absence of evidence to the contrary, ABC and DEF would be presumed to have the ability to exercise significant influence over XYZ and would account for their respective investments in XYZ using the equity method of accounting in accordance with ASC Topic 323, Investments—Equity Method and Joint Ventures.

Example 4.6a: Newly Formed Entity Controlled by a Venture Capital Company

A venture capital company forms a new company (XYZ) and transfers cash to XYZ in exchange for a 100% equity interest in XYZ. Additionally, XYZ raises funds through a debt offering and uses the proceeds and the cash received from the venture capital company to acquire a controlling financial interest in ABC. XYZ survives the transaction as the parent of ABC.

Assessment

XYZ is the acquirer. Although XYZ is newly formed, it raised funds independently through the debt offering in addition to the cash contributions from the parent to consummate the acquisition. As such, XYZ is considered to be substantive.

Special Purpose Acquisition Company (SPAC)

4.022a A SPAC is generally structured as a legal entity and often is funded through the issuance of equity securities based on an agreement with its investors that the proceeds will be used to acquire companies and/or assets within a predetermined period of time or the unused proceeds will be returned to the investors. Management of the acquired company is often retained to operate the business post-acquisition. SPACs' precombination activities are to raise capital through an IPO, identify potential targets, perform due diligence, and acquire one or more operating companies, usually within a 24-month period.

4.022b A SPAC generally has significant precombination activities associated with executing its investment strategy. If the SPAC is the accounting acquirer and the operating company is a business, the transaction would be accounted for as a business combination. If the operating company is the accounting acquirer, the transaction generally would be accounted for as a recapitalization consistent with the discussion in Paragraph 4.006 because the SPAC likely would not meet the definition of a business, assuming its primary asset is cash or marketable securities.
**BUSINESS COMBINATIONS ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION**

4.023 Business combinations may occur without the transfer of consideration. For example, an acquiree might repurchase a sufficient number of its own shares for an existing investor to obtain control, minority veto rights that previously kept the holder of a majority voting interest from controlling an investee might lapse, or control might be achieved by contract alone. These transactions are business combinations, and the entity that acquires control as a result is the acquirer.

4.024 Many business combinations achieved by contract alone result in the formation of a variable interest entity (VIE). In these situations, the primary beneficiary of the VIE is always the acquirer, because the acquiree’s equity-at-risk investors lack the power to direct the activities that most significantly impact the VIE’s economic performance (as described in ASC Subtopic 810-10). See the guidance immediately following, and *Business Combinations Achieved without the Transfer of Consideration*, beginning at Paragraph 9.003.

**VARIABLE INTEREST ENTITIES**

ASC paragraph 805-10-25-5

… However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of [ASC] Subtopic 810-10 not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in [ASC] paragraphs 805-10-55-11 through 55-15.

4.025 As noted in ASC paragraph 810-10-15-14(b), if interests other than the equity investment at risk provide the holders of those interests with the three characteristics in ASC paragraph 810-10-15-14(b) or if interests other than the equity investment at risk prevent the equity holders from having the characteristics in ASC paragraph 810-10-15-14(b), the entity is a variable interest entity. In such situations, the primary beneficiary of the VIE is always the acquirer. ASC Subtopic 810-10 requires a reporting entity to determine whether it is the primary beneficiary of a VIE at the time the reporting entity becomes involved with the VIE, and to reconsider that determination on a continuous basis. ASC Subtopic 810-10 also includes guidance about when to reconsider whether an entity in which a reporting entity holds a variable interest has become, or ceased to be, a VIE.

4.026 ASC Subtopic 810-10 specifies that the initial consolidation of a variable interest entity that is a business (as defined in the ASC Master Glossary) is a business combination. Except for common control situations, as described below, and circumstances where a new entity is formed and acquires an interest in a VIE in an exchange that lacks substance (see Paragraph 4.022c), whenever a reporting entity becomes the primary beneficiary of a VIE that is a business, even if the reporting entity...
was previously involved with the VIE but was not the primary beneficiary, a business combination has occurred and the acquisition method of accounting must be applied. Upon initial consolidation by the primary beneficiary, the assets, liabilities, and noncontrolling interests of a variable interest entity are recognized and measured at their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles of ASC Topic 805. For situations in which a variable interest entity and its primary beneficiary are under common control, see discussion in Paragraph 1.007. For guidance on determining whether entities are under common control or have a high degree of common ownership, see Section 28.

Example 4.7: Initial Consolidation of a Variable Interest Entity

Company A is involved with Entity B, a variable interest entity. Entity B is a business, as defined in ASC Topic 805. In 20X7, at the time of Company A’s initial involvement with Entity B, Company A determined that it was not the primary beneficiary of Entity B and, accordingly, has not consolidated Entity B. However, on July 1, 20X9, the governing documents and contractual arrangements among the parties involved with Entity B are revised, such that the power to direct the activities that most significantly impact Entity B’s economic performance is changed. As required by ASC Subtopic 810-10, Company A continuously reassesses whether changes in facts and circumstances result in a change in the determination of the primary beneficiary. As a result of the changes to the governing documents and contractual arrangements, Company A determines that it is now the primary beneficiary of Entity B.

This event is a business combination under ASC Topic 805 and, accordingly, at the acquisition date (July 1, 20X9), Company A must apply the acquisition method to its investment in Entity B, and include Entity B in its consolidated financial statements from that date forward. Thus, as of July 1, 20X9, Company A:

1. Remeasures its previously held interest in Entity B (using appropriate valuation techniques – see Business Combinations Achieved without the Transfer of Consideration in Section 9) at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings;
2. Recognizes and measures the full amount of the identified assets acquired, the liabilities assumed, and the noncontrolling interest in Entity B under the recognition and measurement principles of ASC Topic 805; and
3. Recognizes and measures goodwill or a gain from a bargain purchase.

BUSINESS COMBINATIONS ACHIEVED BY CONTRACT ALONE OFTEN RESULT IN THE FORMATION OF VARIABLE INTEREST ENTITIES

4.027 On February 18, 2015, the FASB issued ASU 2015-02, which changes the evaluation of whether an entity has a controlling financial interest in an investee. The guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015, and one year later for all other entities. Early
adoption is allowed, including early adoption in an interim period. The discussion contained herein is based on the guidance in ASU 2015-02. In many business combinations achieved by contract alone, the acquiree’s equity-at-risk investors would lack at least one of the three characteristics in ASC paragraph 810-10-15-14(b) and the acquiree would be a variable interest entity. Those characteristics include:

1. The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance.
   (i) For legal entities other than limited partnerships, if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly affect the entity’s economic performance, kick-out rights or participating rights held by the holders of the equity investment at risk will not prevent interests other than the equity investment from having this characteristic unless a single party, or its related parties and de facto agents, has the unilateral ability to exercise such rights.
   (ii) For limited partnerships and similar entities, partners lack the power if a simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is not able to exercise substantive kick out rights or participating rights through voting interests over the general partner.

2. The obligation to absorb the expected losses of the entity.

3. The right to receive the expected residual returns of the entity.

4.028 In these situations, the primary beneficiary of the variable interest entity is always the acquirer. See the discussion of *A Business Combination Achieved by Contract Alone* beginning at Paragraph 9.008.

**REVERSE ACQUISITIONS**

4.029 In most business combinations effected through an exchange of equity interests, the entity that issues the equity interests is usually the acquirer. However, in some business combinations, referred to as *reverse acquisitions*, application of the guidance in ASC paragraph 805-10-55-12 results in the identification of the legal acquirer (i.e., the entity that issues the securities) as the accounting acquiree. In these situations, the transaction is accounted for as a business combination only if the accounting acquiree meets the definition of a business. See the discussion of *Reverse Acquisitions* beginning at Paragraph 9.012.

1 Control premium may also be referred to as a Market Participant Acquisition Premium (MPAP).
Section 5 - Determining the Acquisition Date

Detailed Contents

Acquisition Date Defined
Acquisition Occurs when Control Is Obtained
   Designation of an Effective Acquisition Date Other Than the Actual Acquisition Date Is Not Permitted by ASC Topic 805
Step Acquisitions
   Acquisitions of Noncontrolling Interests after Control Is Obtained
Acquisition Date Documentation
ACQUISITION DATE DEFINED

ASC Paragraph 805-10-25-6
The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

ASC Paragraph 805-10-25-7
The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree – the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

ACQUISITION OCCURS WHEN CONTROL IS OBTAINED

5.000 The acquisition date is the date on which the acquirer obtains control of the acquiree, and the obtaining of control results in a business combination. Thus, on the acquisition date, the acquirer accounts for the business combination by applying the acquisition method.

5.001 The FASB concluded that to faithfully represent an acquirer’s financial position and results of operations, the acquirer’s financial position should reflect the assets acquired and liabilities assumed at the acquisition date – and not before or after they are obtained or assumed, and that the acquirer’s financial statements should include only the cash inflows and outflows, revenues and expenses, and other effects of the acquiree’s operations after the acquisition date.

5.002 ASC Topic 805, Business Combinations, provides for the possibility that an acquirer might obtain control of an acquiree on a date either earlier or later than the closing date, indicating, for example, that the acquisition date precedes the closing date if a written agreement enables the acquirer to control the acquiree on a date before the closing date. However, situations where an acquirer obtains control of an acquiree on a date before the closing date will be unusual, because control for this purpose means control as defined and used in ASC Topic 810. See discussion of Control beginning at Paragraph 2.004.

5.002a In certain instances, shareholder or regulatory approval is required to consummate the business combination. Generally, the acquisition date does not precede the approval date because the acquirer does not obtain control before approval. However, when the only remaining contingency is shareholder approval, the acquisition date could precede that approval if it is considered perfunctory and the acquirer controls the acquiree through written agreement before the approval date. Shareholder approval would be perfunctory
only if management and the board of directors control enough shareholder votes to approve the transaction.

**DESIGNATION OF AN EFFECTIVE ACQUISITION DATE OTHER THAN THE ACTUAL ACQUISITION DATE IS NOT PERMITTED BY ASC TOPIC 805**

5.003 Statement 141(R) (as codified by ASC Topic 805) eliminated the previous provision in Statement 141 (the *convenience exception*) that allowed the acquirer in a business combination, under certain circumstances, to designate an effective acquisition date (i.e., the end of an accounting period between the dates a business combination was initiated and consummated). Statement 141(R) also eliminated the previous provisions that permitted an acquirer to include a subsidiary that was purchased during the year in the acquirer’s consolidated financial statements as though the subsidiary had been acquired at the beginning of the year and to deduct the preacquisition earnings of the subsidiary at the bottom of the consolidated income statement.

5.004 The FASB noted that the financial statement effects of eliminating the convenience exception are rarely likely to be material and that, unless events between the convenience date and the actual acquisition date result in material differences in the amounts recognized, an entity’s practice to designate a convenience date complies with the requirements of ASC Topic 805 (see FASB Statement 141(R), Basis for Conclusions par. B110 for detailed discussion). An acquirer can designate an acquisition date that precedes the actual closing date under ASC Topic 805 only if it has determined that the effect of this non-GAAP accounting policy on its financial statements is immaterial, both in the period of the acquisition and in subsequent periods. Further, if a designated date is used on the basis of its immateriality, the *iron curtain* method of assessing materiality described in ASC paragraph 250-10-S99-2 requires the acquirer to have an unadjusted difference that will carry forward for a significant period of time and, in many instances, indefinitely.

**STEP ACQUISITIONS**

ASC Paragraph 805-10-25-9

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. This Topic refers to such a transaction as a *business combination achieved in stages*, sometimes also referred to as a step acquisition.

ASC Paragraph 805-10-25-10 (Pre-adoptions of ASU 2016-01)

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment...
was classified as available for sale). If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

ASC Paragraph 805-10-25-10 (Post-adoption of ASU 2016-01*)

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

5.005 A business combination occurs whenever an entity obtains control over one or more businesses. In a step acquisition, an entity (the acquirer) acquires shares of another entity (the investee) in two or more transactions in which the acquirer ultimately gains control of the investee. On the date the acquirer obtains control over the acquiree, a business combination has occurred, and the acquirer accounts for the combination by the acquisition method on that date.

5.006 Acquisition by a parent of some or all of a noncontrolling interest in a subsidiary (that is a business) after it initially gains control is not a business combination, because control is not obtained as a result of this transaction (i.e., the parent had control over the subsidiary before the transaction). A business combination occurs only on the acquisition date (i.e., when control is obtained). See Appendix 4-1 in KPMG’s Guide To Accounting For Foreign Currency, for guidance on accounting for foreign currency translation adjustments in business combinations of foreign equity method investments achieved in stages.

ACQUISITIONS OF NONCONTROLLING INTERESTS AFTER CONTROL IS OBTAINED

5.007 Changes in the parent’s ownership interest, as long as it continues to retain control, are accounted for as equity transactions (investments by owners and distributions to
owners acting in their capacity as owners) under ASC Subtopic 810-10. Thus, no gains or losses with respect to these changes are recognized in net income or comprehensive income, nor are the carrying amounts of the assets and liabilities of the subsidiary adjusted (i.e., step acquisition accounting is not applied). Rather, the parent adjusts the carrying amount of the noncontrolling interest to reflect the change in its ownership interest in the subsidiary. See discussion of Noncontrolling Interests in Consolidated Financial Statements in Section 15. See discussion of Business Combinations Achieved in Stages (Step Acquisitions) in Section 9.

ACQUISITION DATE DOCUMENTATION

5.008 ASC Topic 350, Intangibles -- Goodwill and Other, requires that the assets acquired and liabilities assumed in a business combination, including goodwill, be assigned to reporting units as of the acquisition date. ASC Topic 350 also requires that the basis for and method of determining the fair value of the acquiree and other related factors (such as the underlying reasons for the acquisition and management’s expectations related to dilution, synergies, and other financial measurements) be documented at the acquisition date. ASC paragraph 350-20-35-40

* ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, eliminates the use of available-for-sale accounting (fair value through OCI) for investments in marketable equity securities that is referred to in this paragraph. ASU 2016-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for nonpublic business entities in annual periods in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.
Section 6 - Recognizing and Measuring the Consideration Transferred

Detailed Contents

Consideration Transferred Includes only the Consideration Exchanged by the Acquirer for the Acquiree
Consideration Transferred Is not Eligible for Hedge Accounting
Measurement of the Consideration Transferred
  Consideration in the Form of Equity Interests
    Issuing Shares of a Nonpublic or Closely Held Entity
    Preferred Shares Issued in a Business Combination
    Convertible Preferred Shares and Other Convertible Instruments Issued in a Business Combination
Liabilities Incurred to Former Owners of the Acquiree
Contingent Consideration
  Assets or Liabilities Transferred by the Acquirer
    Example 6.1: Consideration Includes a Cost Method Investment
    Example 6.2: Consideration Includes a Technology License
    Assets or Liabilities Transferred to an Acquiree That Remain Under the Control of the Acquirer Are Not Remeasured, and No Gain Or Loss Is Recognized
    Example 6.3: Transfer of a Subsidiary to an Acquiree
    Example 6.4: Shares of a Subsidiary Issued in a Business Combination
    Example 6.5: Acquisition Achieved in Stages Through the Exchange of an Indirect Noncontrolling Interest in a Subsidiary, Including Payment of a Control Premium
  Share-Based Payment Awards Included in the Consideration Transferred
Contingent Consideration
  Forms of Contingent Consideration
  Initial Recognition of Contingent Consideration
  Statement of Cash Flows
  Determining the Classification of Contingent Consideration
    Example 6.6: Cash-Settled Contingent Consideration Based on Earnings
    Classification of Equity-Linked Contingent Consideration Arrangements That Are Within the Scope of ASC Subtopic 480-10
    Illustrations of Contingent Consideration Arrangements That Are Classified as Liabilities Under ASC Subtopic 480-10
    Example 6.7: Contingent Consideration That Embodies a Written Put Option
    Example 6.8: Contingent Consideration That Embodies a Guarantee of the Acquirer’s Share Price
    Example 6.9: Contingent Consideration in the Form of a Freestanding Financial Instrument
    Example 6.10: Contingent Consideration Based on Earnings
Example 6.11: Fixed Minimum Payment and Contingent Consideration Based on Earnings
Classification of Equity-Linked Contingent Consideration Arrangements That Are Not Within the Scope of ASC Subtopic 480-10
Example 6.12: Contingent Consideration That Provides for Different Outcomes Involving the Issuance of Shares That Are Based on the Level of Revenues Achieved
Example 6.13: Reclassification of a Contingent Consideration Arrangement from Equity to a Liability
Example 6.14: Reclassification of a Contingent Consideration Arrangement from a Liability to Equity
Example 6.15: Contingent Consideration That Embodies a Net-Share Settled Written Call Option
Example 6.16: Contingent Consideration That Provides for the Issuance of a Fixed Number of Shares Payable on the Achievement of an Earnings Target
Example 6.17: Fixed Minimum Number of Shares and Contingent Consideration That Provides for the Issuance of a Fixed Number of Additional Shares Payable on the Achievement of an Earnings Target
Example 6.18: Contingent Consideration Based on the Acquirer’s Stock Price
Determining the Unit(s) of Accounting for Contingent Consideration
Example 6.19: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 1
Example 6.20: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 2
Subsequent Issuance of Contingent Shares Based on Earnings in a Reverse Acquisition
Effect of Contingent Consideration on the Computation of Earnings Per Share
Effect of Contingency Based on Security Prices in Computing Earnings Per Share
Effect of Contingency Based on Both Future Earnings and Security Prices in Computing Earnings Per Share
Business Combinations in Which no Consideration Is Transferred
Measurement of Consideration Transferred in Combinations Involving Mutual Entities
CONSIDERATION TRANSFERRED INCLUDES ONLY THE
CONSIDERATION EXCHANGED BY THE ACQUIRER FOR THE
ACQUIREE

ASC Paragraph 805-10-25-20
The acquirer and the acquiree may have a preexisting relationship or other
arrangement before negotiations for the business combination began, or they may
enter into an arrangement during the negotiations that is separate from the
business combination. In either situation, the acquirer shall identify any amounts
that are not part of what the acquirer and the acquiree (or its former owners)
exchanged in the business combination, that is, amounts that are not part of the
exchange for the acquiree. The acquirer shall recognize as part of applying the
acquisition method only the consideration transferred for the acquiree and the
assets acquired and liabilities assumed in the exchange for the acquiree. Separate
transactions shall be accounted for in accordance with the relevant generally
accepted accounting principles (GAAP).

ASC Paragraph 805-10-25-21
A transaction entered into by or on behalf of the acquirer or primarily for the
benefit of the acquirer or the combined entity, rather than primarily for the benefit
of the acquiree (or its former owners) before the combination, is likely to be a
separate transaction. The following are examples of separate transactions that are
not to be included in applying the acquisition method:

a. A transaction that in effect settles preexisting relationships between the
   acquirer and acquiree (see [ASC] paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree
   for future services (see [ASC] paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying
   the acquirer’s acquisition-related costs (see [ASC] paragraph 805-10-25-23).

6.000 ASC Topic 805, Business Combinations, requires an acquirer to identify any
amounts that are not part of what the acquirer and the acquiree (or its former owners)
exchanged in the business combination. The acquiree accounts for separate transactions
that do not represent consideration transferred for the acquiree in accordance with other
relevant GAAP. Only the consideration transferred for the acquiree is included as
consideration transferred in applying the acquisition method.

6.001 Amounts related to the settlement of preexisting relationships between an acquirer
and an acquiree, a transaction that compensates employees or former owners of the
acquiree for future services, and a transaction that reimburses the acquiree or its former
owners for paying the acquirer’s acquisition-related costs, are examples of transactions
that are not included in applying the acquisition method, but rather are accounted for as
separate transactions in accordance with relevant GAAP. See Determining What Is Part
of the Business Combination Transaction in Section 11.
CONSIDERATION TRANSFERRED IS NOT ELIGIBLE FOR HEDGE ACCOUNTING

6.002 The measurement of the consideration transferred in a business combination is not affected by gains and losses from derivative or nonderivative financial instruments. A firm commitment to enter into a business combination is not eligible for designation as a hedged item in a fair value hedge. (ASC paragraph 815-20-25-43(c)(5)) In addition, a forecasted transaction (for which there is no firm commitment) that involves a business combination is not eligible for designation as a hedged transaction in a cash flow hedge. (ASC paragraph 815-20-25-15(g)) Thus, the costs and proceeds (including gains and losses) from financial instruments that are used to reduce the risks of a change in the value of the acquiree’s net assets or the consideration to be issued by the acquirer before the date of acquisition are not part of the consideration transferred and should be recorded currently in earnings.

MEASUREMENT OF THE CONSIDERATION TRANSFERRED

ASC Paragraph 805-30-30-7

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. (However, any portion of the acquirer’s share-based payment awards exchanged for awards held by the acquiree’s grantees that is included in consideration transferred in the business combination shall be measured in accordance with [ASC] paragraph 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:

a. Cash
b. Other assets
c. A business or a subsidiary of the acquirer
d. Contingent consideration (see [ASC] paragraphs 805-30-25-5 through 25-7)
e. Common or preferred equity instruments
f. Options
g. Warrants
h. Member interests of mutual entities.

6.003 Consideration may be issued in many forms and may include, for example, cash, noncash assets (such as a business or a subsidiary), debt issued to the former owners of the acquiree, equity interests issued (such as common or preferred equity instruments, options, warrants, or member interests of mutual entities), the portion of any share-based payment awards required to be issued by an acquirer to replace awards held by grantees of the acquiree (replacement awards) included in the consideration transferred, and contingent consideration. The consideration transferred in a business combination is
measured at fair value, determined in accordance with ASC Topic 820, *Fair Value Measurement*, except for (i) assets and liabilities transferred that remain under the control of the acquiree after the business combination, and (ii) any portion of the acquirer’s share-based replacement awards exchanged for awards held by the acquiree’s grantees included in the consideration transferred, and is the sum of the following:

- The acquisition-date fair value of the equity interests issued by the acquirer (other than share-based payment awards included in the consideration transferred);
- The acquisition-date fair value of the liabilities incurred by the acquirer to former owners of the acquiree;
- The acquisition-date fair value of the assets transferred by the acquirer;
- The amount of the liability or equity instruments related to share-based replacement awards required to be issued by an acquirer and included in the consideration transferred, measured in accordance with ASC Topic 718, *Compensation—Stock Compensation*. ASC paragraph 805-20-30-21 refers to the results of amounts measured in this manner as the *fair-value-based measure* of the awards; and
- The acquisition-date fair value of contingent consideration issued by the acquirer.

### 6.004

Cash payments by an acquirer do not present measurement difficulties. However, the measurement of other forms of consideration can present varying degrees of difficulty and require judgment, and it may be necessary to obtain independent valuations of the consideration exchanged in some situations. This Section addresses measuring the consideration transferred in a business combination. See Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination*, for additional discussion.

### CONSIDERATION IN THE FORM OF EQUITY INTERESTS

#### 6.005

Equity interests issued as consideration in a business combination (other than share-based replacement awards) are measured at fair value at the acquisition date, determined in accordance with ASC Topic 820. Whenever available, the quoted price in an active market should be used to measure the fair value of equity securities issued to effect a business combination. If a quoted price in an active market is not available, other methods or techniques should be used.

### Issuing Shares of a Nonpublic or Closely Held Entity

**ASC Paragraph 805-30-30-2**

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree’s equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer’s equity interests. If so, the acquirer shall determine
the amount of goodwill by using the acquisition-date fair value of the acquiree’s equity interests instead of the acquisition-date fair value of the equity interests transferred.

6.006 The acquisition of a public entity by a nonpublic or closely held entity provides an example of where the acquisition-date fair value of an acquiree’s equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer’s equity interests issued to effect a business combination. In those situations, a nonpublic acquirer may look to the fair value of the acquiree’s equity interests in determining the fair value of the shares issued to effect the combination.

Preferred Shares Issued in a Business Combination

6.007 When preferred shares are issued in a business combination to the shareholders of the acquiree and there is no quoted market price available to determine the fair value of those shares, the characteristics of the preferred shares (e.g., dividend rate, conversion features, or redemption features) should be incorporated into the fair value of the preferred shares. For example, the fair value of nonvoting, nonconvertible preferred shares that lack characteristics of common shares may be determined by comparing the specified dividend and redemption terms with those of comparable securities and by assessing market factors. Thus, the approach to determining the fair value of such shares may be similar to that used to determine the fair value of debt securities.

Convertible Preferred Shares and Other Convertible Instruments Issued in a Business Combination

6.008 If there is no quoted market price available to determine the fair value of convertible preferred shares or other convertible instruments issued in a business combination, the acquirer should refer to other guidance to determine the fair value of the instruments, consistent with ASC Topic 820. Consideration of the guidance in ASC paragraphs 470-20-30-22 through 30-26 may be helpful in determining the fair value of convertible instruments. That guidance indicates that recent issuances of similar convertible instruments for cash to parties that have only a creditor/investor relationship with the issuer may provide the best evidence of fair value of the convertible instruments. The fair value of the convertible instruments will not be less than the fair value of the equity shares into which they can currently be converted. Thus, a currently effective conversion option could not be a beneficial conversion feature (i.e., there would be no intrinsic value) at the acquisition date.

6.009 The entity must consider the conversion feature of any convertible instruments issued as consideration in a business combination. If the conversion feature is in-the-money at the acquisition date (beneficial conversion feature), the acquirer should follow the guidance in ASC paragraphs 470-20-25-4 through 25-9 and 30-3 through 30-8.
LIABILITIES INCURRED TO FORMER OWNERS OF THE ACQUIREE

6.010 Liabilities that an acquirer incurs to former owners of an acquiree are part of the consideration transferred. These liabilities include amounts payable to dissenting shareholders. For guidance on presenting payments to former owners to settle those liabilities in the statement of cash flows, see chapter 18 of KPMG's Handbook, Statement of cash flows.

CONTINGENT CONSIDERATION

6.011 Contingent consideration includes obligations to transfer additional consideration to the former owners of an acquiree if future events occur or conditions are met. Obligations of an acquirer under contingent consideration arrangements may be classified as equity (equity-classified contingent consideration) or a liability (liability-classified contingent consideration). See discussion beginning at Paragraph 6.019.

- Obligations to pay specified amounts at specified future dates are recognized and measured at fair value at the acquisition date and included in the consideration transferred. They are noncontingent obligations and thus are not subsequently remeasured.
- Equity-classified contingent consideration is recognized and measured at fair value at the acquisition date and included in the consideration transferred. Equity-classified contingent consideration is not remeasured following the acquisition date, and its subsequent settlement is accounted for within equity.
- Liability-classified contingent consideration is recognized and measured at fair value at the acquisition date and included in the consideration transferred, and subsequently remeasured to fair value each reporting period until the contingency is resolved. Adjustments resulting from remeasurement are recognized in earnings (unless the contingent consideration is a hedging instrument).

6.012 The nature of the arrangements determines whether payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions. See Transactions That Compensate Employees or Former Owners of the Acquiree for Future Services in Section 11.

6.013 In some business combinations, there may be a preexisting arrangement between the acquirer and acquiree that provides for a payment when a contingent event occurs. For example, the acquirer and acquiree could have a preexisting agreement that granted the acquirer distribution rights to the acquiree's products in a geographic region with payments by the acquirer to the acquiree depending on the sales made in that geographic region. In negotiating the acquisition agreement, if the two parties agree to carry forward the preexisting agreement without change, the payments contingently payable to the former owner of the acquiree under that agreement would be treated as contingent consideration in the acquisition, because the future payment was contemplated in the acquisition negotiations. In effect, the acquisition negotiations change the contingent...
payments from a contingent liability (preacquisition) to contingent consideration in the acquisition.

6.013a However, a new arrangement entered into in conjunction with a business combination may require future payments from the acquirer to the former owner of the acquiree with characteristics of both contingent consideration and compensation for future rights granted or services provided by the former owner to the acquirer or combined entity. The acquirer should carefully evaluate these arrangements when determining whether the future payments should be included as consideration transferred in applying the acquisition method or accounted for separately under other GAAP. For example, a buyer and seller may negotiate contingent consideration in the form of an earnout based on revenue or profits as part of the transaction price when they cannot agree on the transaction price. Conversely, the buyer and seller of a distribution business may enter a new arrangement that includes a long-term, non-cancelable sales or earnings-based royalty payment to the seller for the buyer’s future use of a trademark or distribution within a geographic area. The royalty payments are customary in the seller’s industry and set at market rates. In this case, the royalty arrangement is not contingent consideration in the business combination and is accounted for separately as an expense in the period(s) payments are accruable. In addition to the factors discussed in Section 11, Determining What Is Part of the Business Combination Transaction, the following factors indicate that these future payments are not part of consideration transferred in a business combination:

- The payments are customary in the industry and set at market rates;
- The payment period coincides with the duration of the future services to be provided or rights granted by the former owner of the acquiree;
- The royalty or similar arrangement did not exist before the business combination;
- The resulting consideration transferred in the business combination (excluding the fair value of the future payments) is reasonable relative to the valuation of the business acquired.

**ASSETS OR LIABILITIES TRANSFERRED BY THE ACQUIRER**

**ASC Paragraph 805-30-30-8**

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, nonmonetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognize the resulting gains or losses, if any, in earnings. However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before
the acquisition date and shall not recognize a gain or loss in earnings on assets or liabilities it controls both before and after the business combination.

6.014 ASC paragraph 805-30-30-7 requires that consideration transferred in a business combination is measured at the acquisition-date fair value. If the fair value of assets or liabilities recognized as consideration transferred is different from the carrying amount of those assets or liabilities, a gain or loss is recognized in earnings. However, this guidance applies only if the acquirer does not retain control of the assets or liabilities transferred after the acquisition.

Example 6.1: Consideration Includes a Cost Method Investment

ABC Corp. acquires a business from DEF Corp., and in exchange transfers cash and a cost method investment in an unrelated entity to DEF. How should ABC measure the consideration transferred?

ABC should include the fair value of the cost method investment as part of the consideration transferred. To the extent the fair value differs from the book value of the investment, ABC recognizes a gain or loss in earnings for the difference.

Example 6.2: Consideration Includes a Technology License

ABC Corp. acquires a business from DEF Corp., and in exchange transfers cash and grants a software license for one of ABC’s products to DEF. How should ABC measure the consideration transferred?

ABC should include the fair value of the license as part of the consideration transferred. ABC would follow the appropriate revenue recognition guidance in GAAP to determine when revenue recognition would be appropriate.

Assets or Liabilities Transferred to an Acquiree That Remain Under the Control of the Acquirer Are Not Remeasured, and No Gain Or Loss Is Recognized

6.015 An acquirer may transfer a business or a subsidiary to the acquiree as consideration in a business combination. Other forms of consideration transferred may include assets and liabilities of a subsidiary, or other assets of the acquirer. Regardless of the structure of the transaction, if the acquirer retains control of the transferred assets or liabilities after the acquisition, it recognizes no gain or loss and measures those assets and liabilities at their carrying amounts immediately before the acquisition.

6.016 Additionally, if an acquirer transfers an equity interest in a subsidiary, but continues to hold a controlling financial interest in the subsidiary after the transfer, the change in the parent’s ownership interest in the subsidiary is accounted for as an equity transaction, and no gain or loss is recognized. Any difference between the fair value of
the consideration received or paid and the amount by which the noncontrolling interest is adjusted, is recognized in equity attributable to the parent. (ASC paragraph 810-10-45-23). See discussion of Noncontrolling Interests in Consolidated Financial Statements in Section 15.

6.017 The following are examples of business combinations in which an acquirer retains control of assets and liabilities transferred in connection with a business combination. These examples illustrate that, regardless of how a business combination is structured, if the acquirer retains control of the assets and liabilities transferred after the acquisition, no gain or loss is recognized.

Example 6.3: Transfer of a Subsidiary to an Acquiree

ABC Corp. transfers its wholly owned Subsidiary S to DEF Corp. in exchange for 60% of the common shares of DEF. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). It was also determined that there is no minority discount or control premium in this transaction.

(1) How should ABC account for this transaction in its consolidated financial statements?

(2) How should DEF account for this transaction in its consolidated financial statements?

Before Transaction

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<th>ABC Corp.</th>
<th>Shareholders</th>
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<td>FV - $600</td>
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<td>DEF Corp.</td>
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<td>FV - $400</td>
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(1) Accounting for the transaction in ABC’s consolidated financial statements

The acquisition of control of DEF by ABC is a business combination under ASC Topic 805, in which ABC is the acquirer and DEF is the acquiree. In applying the acquisition method to the transaction, ABC recognizes and measures the assets acquired and liabilities assumed based on the recognition and measurement requirements of ASC Topic 805. However, ABC recognizes no gain or loss in earnings on the transaction:

- ABC controls the transferred asset (Subsidiary S) directly before the transaction, and indirectly after the transaction (through its control of DEF). Therefore, ABC continues to measure the assets and liabilities of Subsidiary S following its acquisition of DEF at their carrying amounts immediately before the acquisition, and does not recognize a gain or a loss in earnings on the transfer of a 40% indirect ownership interest in Subsidiary S to the former owners of DEF (consistent with the guidance in ASC paragraph 805-30-30-8).

- This transaction involves a reduction in the parent’s (ABC’s) ownership interest in Subsidiary S (i.e., from a 100% direct controlling interest to a 60% indirect controlling interest). However, because ABC continues to hold an indirect controlling financial interest in Subsidiary S after the transaction, the exchange by ABC of an indirect 40% interest in Subsidiary S is accounted for as an equity transaction in ABC’s consolidated financial statements in accordance with ASC paragraph 810-10-45-23, with no gain or loss recognized in earnings on the exchange.
Consequently, this transaction is recognized in ABC’s consolidated financial statements as follows:

- ABC recognizes the net assets of its newly acquired subsidiary, DEF, in the amount of $650, which equals the sum of ABC’s carrying amount of Subsidiary S immediately preceding the transaction ($250) plus the $400 acquisition-date fair value of DEF. Note that ABC continues to consolidate the net assets of Subsidiary S, and separately recognizes the noncontrolling interest in Subsidiary S resulting from the transfer of a 40% indirect ownership interest in Subsidiary S to the former owners of DEF (see below).

- ABC recognizes the noncontrolling interest in DEF of $260, which is equal to 40% of the historical carrying amount of Subsidiary S’s net assets immediately preceding the acquisition of DEF (40% × $250, or $100), plus 40% of the fair value of DEF at the acquisition date (40% × $400, or $160).

- Because ABC retains control of Subsidiary S (indirectly, through its acquisition of DEF) after the transaction, the transfer of a 40% indirect interest in Subsidiary S to the noncontrolling interest in DEF (the former owners of DEF) is accounted for as an equity transaction. Thus, the excess of the fair value of the acquired interest in DEF (60% × $400, or $240) over the historical carrying amount of the indirect interest transferred (40% × $250, or $100), or $140, is credited to paid-in capital. The $140 credit to paid-in capital may be viewed as the gain resulting from the transaction, with the noncontrolling interest, equal to the excess of the fair value received of $240 over the carrying amount of the interest transferred of $100.

ABC will record the following entries in its consolidated financial statements to reflect the acquisition of DEF:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets of DEF</td>
<td>650</td>
</tr>
<tr>
<td>Net assets of Subsidiary S</td>
<td>250</td>
</tr>
<tr>
<td>Noncontrolling interest in DEF</td>
<td>260</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>140</td>
</tr>
</tbody>
</table>

(2) Accounting for the transaction in DEF’s consolidated financial statements

Because the former shareholder of Subsidiary S (ABC) receives the larger portion of the voting interest in the combined entity (which includes Subsidiary S and DEF), and assuming no other evidence indicates that DEF is the acquirer, this transaction should be accounted for as the acquisition of DEF by Subsidiary S (i.e., a reverse acquisition in which Subsidiary S effectively issues consideration equal to a 40% ownership interest in Subsidiary S in exchange for the acquisition of a 60% ownership interest in DEF). See Reverse Acquisitions beginning at Paragraph 9.012.
Thus, a business combination has occurred, with Subsidiary S being the accounting acquirer and DEF the accounting acquiree. In DEF’s consolidated financial statements:

- The net assets of DEF are recognized and measured at their acquisition-date fair value, thus requiring an increase in their carrying amount of $200 ($400 fair value less $200 book value).
- The net assets of Subsidiary S are recognized at their historical carrying amount of $250.

DEF’s consolidated financial statements should present the historical financial statements of Subsidiary S before the acquisition as the historical financial statements. Thus, the results of operations of DEF are included in the financial statements of the consolidated entity only for periods after the acquisition date.

Although the equity of Subsidiary S (the accounting acquirer) is presented as the equity of the combined entity, the capital stock account must be adjusted to reflect the outstanding stock of DEF (the surviving entity). That is:

- The retained earnings of Subsidiary S would be presented as the retained earnings of the combined entity.
- The capital stock account of the combined entity would reflect the par value of DEF’s stock.

The additional paid-in capital account of Subsidiary S would be adjusted for the difference between the capital stock account of Subsidiary S and the capital stock account of DEF, and that adjusted amount would be presented as additional paid-in capital of the combined entity.

Example 6.4: Shares of a Subsidiary Issued in a Business Combination

ABC Corp.’s wholly owned Subsidiary S issues new common shares representing a 40% interest to shareholders of DEF Corp. in exchange for all of the common shares of DEF. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). It was also determined that there is no minority discount or control premium in this transaction.
How should ABC account for this transaction in its consolidated financial statements?

**Before Transaction**

- **ABC Corp.** (100%)
  - **Sub S** (100%)
    - BV: $250
    - FV: $600

- **Shareholders** (100%)
  - **DEF Corp.**
    - BV: $200
    - FV: $400

**After Transaction**

- **ABC** (60%)
  - **Sub S** (40%)
    - **DEF** (100%)
      - **Shareholders**

The acquisition of control of DEF by ABC is a business combination under ASC Topic 805, in which Subsidiary S (ABC’s subsidiary) is the acquirer and DEF is the acquiree. In applying the acquisition method to the transaction, Subsidiary S recognizes and measures...
the assets acquired and liabilities assumed based on the recognition and measurement principles of ASC Topic 805. However, no gain or loss is recognized on the transaction:

- ABC controls Subsidiary S both before and after the business combination. Therefore, ABC continues to measure the assets and liabilities of Subsidiary S following its acquisition of DEF at their carrying amounts immediately before the acquisition, and does not recognize a gain or loss on the transfer of a 40% noncontrolling interest in Subsidiary S to the former owners of DEF (consistent with the guidance in ASC paragraph 805-30-30-8).

- Subsidiary S recognizes the net assets acquired in the acquisition of DEF at their fair value of $400, and a corresponding increase in equity to reflect the fair value of the shares issued to effect the acquisition. In consolidation, ABC also recognizes the net assets acquired at their fair value of $400.

- This transaction also involves a reduction in the parent’s (ABC’s) ownership interest in Subsidiary S (from 100% to 60%). However, because ABC continues to control Subsidiary S after the transaction, the issuance of shares by Subsidiary S to the noncontrolling interest (the former owners of DEF) is accounted for by ABC as an equity transaction under ASC paragraph 810-10-45-23, and no gain or loss is recognized on the issuance of the additional shares of Subsidiary S to the former owners of DEF.

Consequently, this transaction is recognized in ABC’s consolidated financial statements as follows:

- Subsidiary S recognizes the net assets resulting from the acquisition of DEF at their fair value of $400, and ABC recognizes an increase in its investment in Subsidiary S in the same amount. ABC continues to recognize its preexisting investment in Subsidiary S at its historical carrying amount of $250 immediately preceding the transaction, resulting in an investment in Subsidiary S of $650 ($400 + $250) after the transaction.

- ABC recognizes the noncontrolling interest in Subsidiary S of $260, which is equal to 40% of the historical carrying amount of Subsidiary S immediately before the acquisition of DEF by Subsidiary S (40% × $250, or $100), plus 40% of the fair value of DEF at the acquisition date (40% × $400, or $160).

- Because ABC retains control of Subsidiary S after the transaction, the transfer of a 40% interest in Subsidiary S to the noncontrolling interest in Subsidiary S (the former owners of DEF) is accounted for as an equity transaction. Thus, the excess of the fair value of the acquired interest in DEF (60% × $400, or $240) over the historical carrying amount of the interest transferred (40% × $250, or $100), which nets to $140, is credited to paid-in capital. The $140 credit to paid-in capital may be viewed as the gain resulting from the transaction with the noncontrolling interest, equal to the excess of the fair value received of $240 over the carrying amount of the of the interest transferred of $100.
ABC will record the following entries in its consolidated financial statements to reflect the acquisition of DEF by Subsidiary S:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets of Subsidiary S</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Noncontrolling interest in DEF</td>
<td>260</td>
<td>260</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>140</td>
<td>140</td>
</tr>
</tbody>
</table>

**Example 6.5: Acquisition Achieved in Stages Through the Exchange of an Indirect Noncontrolling Interest in a Subsidiary, Including Payment of a Control Premium**

ABC Corp. owns 40% of the outstanding common stock of DEF Corp. (the carrying amount of ABC’s investment in DEF was equal to 40% of the book value of DEF). Public shareholders own the remaining 60% of DEF’s shares. DEF issues additional shares of its common stock to ABC in exchange for 40% of the common stock of XYZ Corp. (a wholly owned subsidiary of ABC). After the transaction, ABC owns a controlling interest in DEF of 60%; the remaining 40% is owned by the public shareholders. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). ABC pays a $20 control premium to the public shareholders of DEF on this transaction, as explained below.

How should ABC account for this transaction in its consolidated financial statements?

**Before Transaction**

![Diagram showing the ownership structure before the transaction](image_url)
<table>
<thead>
<tr>
<th></th>
<th>DEF</th>
<th>XYZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value</td>
<td>$150</td>
<td>250</td>
</tr>
<tr>
<td>Fair value:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excluding control premium</td>
<td>$200</td>
<td>375</td>
</tr>
<tr>
<td>Control premium</td>
<td>0</td>
<td>75</td>
</tr>
<tr>
<td><strong>Total fair value</strong></td>
<td>$200</td>
<td>450</td>
</tr>
</tbody>
</table>

1 There is no control premium in the fair value determined for DEF before this transaction. A control premium with respect to DEF arises as a result of this transaction, by which ABC obtains control of DEF.

**After Transaction**

The acquisition of control of DEF by ABC is a business combination under ASC Topic 805, in which ABC is the acquirer and DEF is the acquiree. In applying the acquisition method to this transaction, ABC recognizes and measures the DEF assets acquired and liabilities assumed in accordance with the recognition and measurement requirements of ASC Topic 805.

In this transaction, ABC effectively acquired a 20% additional interest in DEF from the public shareholders in exchange for a 16% indirect interest in XYZ (effected by the transfer of a 40% interest in XYZ to DEF, which is 40% owned by the public shareholders on completion of the transaction; 40% × 40% =16%). ABC also pays a
control premium on this transaction of $20 as a result of its obtaining control of DEF. It has been determined that the fair value of the control premium is $20.¹

¹The following analysis demonstrates that ABC has paid and received equivalent consideration:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of equity interest in XYZ that ABC transferred</td>
<td>$60</td>
</tr>
<tr>
<td>($375 × 16%)</td>
<td></td>
</tr>
<tr>
<td>Fair value of additional equity interest in DEF received by ABC:</td>
<td></td>
</tr>
<tr>
<td>Excluding control premium (20% × $200)</td>
<td>$40</td>
</tr>
<tr>
<td>Control premium</td>
<td>20</td>
</tr>
<tr>
<td>Fair value received by ABC (including ability to control DEF)</td>
<td>$60</td>
</tr>
</tbody>
</table>

Because ABC held a 40% interest in DEF before this transaction, the acquisition of control of DEF results in a business combination achieved in stages (also referred to as a step acquisition). In a business combination achieved in stages, the acquirer remeasures its previously held equity interest in the acquiree at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings. See discussion of Business Combinations Achieved in Stages (Step Acquisitions) in Section 9.

This transaction also results in a reduction of ABC’s direct controlling ownership of XYZ (from 100% to 60%), offset by an increase in ABC’s indirect ownership of XYZ of 24% (through its 60% ownership of DEF and DEF’s ownership of 40% of XYZ on completion of the transaction; 60% × 40% = 24%), and a transfer of a 16% indirect ownership interest in XYZ to the public shareholders of DEF (through the public shareholders’ ownership of 40% of DEF and DEF’s ownership of 40% of XYZ on completion of the transaction; 40% × 40% = 16%). However, ABC continues to control XYZ after the transaction (through its 60% direct ownership interest and its 24% indirect ownership interest). Thus, ABC accounts for its exchange of a 16% interest in XYZ as an equity transaction under ASC paragraph 810-10-45-23, with no gain or loss recognized in income on the exchange.

ABC records the following entries in its consolidated financial statements:

- ABC remeasures its 40% interest in DEF immediately preceding this transaction at its acquisition-date fair value of $80 ($40% × $200), and recognizes the resulting gain of $20 in earnings. The $20 gain is equal to the excess of the fair value of ABC’s 40% interest of $80 over its carrying amount of $60 (40% × $150).

- ABC recognizes the net assets of its newly acquired subsidiary, DEF, at their acquisition-date fair value of $220 (which includes the $20 control premium). Note that ABC continues to consolidate the net assets of XYZ, and separately recognizes the noncontrolling interest in XYZ resulting from the transfer of a 16% indirect interest in XYZ to the public shareholders of DEF (see below).
• ABC eliminates the carrying amount of its investment in DEF of $80 before the acquisition (the sum of the historical carrying amount of its investment before this transaction ($60), plus the $20 gain recognized from the remeasurement of that investment to fair value).

• ABC recognizes the noncontrolling interest in DEF of $120, which is equal to 40% of the historical carrying amount of the 40% interest in XYZ that was transferred to DEF (40% × $100), or $40, plus 40% of the fair value of DEF at the acquisition date, exclusive of the control premium, all of which is ascribable to ABC (40% × $200), or $80).

• Because ABC retains control of XYZ after the transaction, it accounts for the transfer of a 16% indirect interest in XYZ to the public shareholders of DEF as an equity transaction, with no gain or loss recognized in income. Thus, the excess of the fair value of the acquired 20% interest in DEF of $60 (20% × the fair value of DEF of $200, or $40, plus the control premium of $20), over the historical carrying amount of the 16% indirect interest transferred to the public shareholders of $40 (16% × $250), which nets to $20, is credited to paid-in capital. The $20 credit to paid-in capital can be viewed as the gain resulting from the transaction with the noncontrolling interest, equal to the excess of the fair value received of $60 over the $40 carrying amount of the consideration transferred.

ABC would record the following entries in its consolidated financial statements to reflect this transaction:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in affiliate - DEF</td>
<td></td>
</tr>
<tr>
<td>Gain</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Net assets of DEF</td>
<td>220</td>
</tr>
<tr>
<td>Investment in affiliate - DEF</td>
<td>80</td>
</tr>
<tr>
<td>Noncontrolling interest in DEF</td>
<td>120</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>20</td>
</tr>
</tbody>
</table>

**Control Premium Realized by Public Shareholders**

Note that the public shareholders of DEF have realized the benefit of the $20 control premium paid by ABC:
Fair Value of Public Shareholders’ Interests

**Before the transaction:**
60% interest × $200 fair value of DEF

$120

**After the transaction:**
40% interest × $200 fair value of DEF (exclusive of the control premium which is ascribable to ABC)

$80

16% indirect interest × $375 fair value of XYZ

$60

Net premium received by public shareholders

$140

$20

The $20 control premium is equal to the difference between the fair value of the 16% indirect interest in XYZ received by the public shareholders (16% × $375), or $60, and the 20% of the fair value of DEF effectively sold to ABC (20% × $200), or $40. Although the fair value of the noncontrolling interest in DEF is $140 (40% × $350), ABC recognizes this in its consolidated financial statements at $120, due to the measurement of DEF’s interest in XYZ using ABC’s carryover basis.

**SHARE-BASED PAYMENT AWARDS INCLUDED IN THE CONSIDERATION TRANSFERRED**

*ASC Paragraph 805-30-30-9*

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. This Topic refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with [ASC] Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer’s replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree’s awards if replacement is required by any of the following:

- The terms of the acquisition agreement
- The terms of the acquiree’s awards
- Applicable laws or regulations.
ASC Paragraph 805-30-30-10

In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the postcombination financial statements. That is, none of the fair-value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

6.018 See discussion of Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree in Section 11.

CONTINGENT CONSIDERATION

ASC Master Glossary: 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.

ASC Paragraph 805-30-25-5

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

ASC Paragraph 805-30-25-6

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with [ASC] Subtopics 480-10 [Distinguishing Liabilities from Equity - Overall] and [ASC] 815-40 [Derivatives and Hedging - Contracts in Entity’s Own Equity] or other applicable generally accepted accounting principles (GAAP). For example, [ASC] Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer’s shares issued in the business combination.

ASC Paragraph 805-30-25-7

The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

6.019 Contingent consideration refers to a payment that is contingent upon meeting certain conditions or the occurrence of a particular event. When negotiating the transaction price of a business, contingent consideration is often used to bridge the price gap between what the seller would like to receive and what the buyer is willing to pay. For example, additional consideration may be paid if the acquired business meets certain financial targets (e.g., revenue, EBITDA, operating profit), passes regulatory reviews,
achieves certain litigation outcomes, or develops a product. Contingent consideration can also be used as a means of deferred financing or incentive for management performance (see Section 11 for accounting for transactions that compensate employees or former owners of the acquiree for future service). Contingent consideration is usually paid in the form of cash or equity. Additionally, if the acquired business had contingent consideration arrangements from acquisitions it made before its acquisition by the acquirer, the acquiree’s preexisting contingent consideration becomes contingent consideration for the acquirer. However, unlike consideration of the acquirer, preexisting contingent consideration is accounted for as an assumed liability (or asset acquired) in the business combination rather than part of consideration transferred.

6.020 If the business combination requires a stated minimum amount of additional consideration to be paid to the former owners of the acquiree after the acquisition date, this obligation is defined and not contingent and should not be accounted for as part of a contingent consideration arrangement, regardless of how the acquisition agreement characterizes the obligation. Noncontingent obligations should be measured at fair value at the acquisition date as part of the consideration transferred. The acquirer should measure and account for a noncontingent obligation to deliver a minimum level of additional consideration in the future based on other applicable GAAP, depending on the nature of the obligation. ASC Subtopic 835-30, Interest - Imputation of Interest, provides guidance on the subsequent measurement of debt obligations. Examples 6.11 and 6.17 involve both (a) an obligation to deliver a minimum amount of consideration in the future and (b) an obligation under a contingent consideration arrangement.

6.020a Adjustments to the consideration transferred based on net working capital at the acquisition date are not contingent consideration arrangements, because they relate to conditions that existed at the acquisition date and do not depend on future events. Working capital adjustments paid or received during the measurement period would be adjustments to the consideration transferred in accordance with the measurement period guidance in ASC subparagraph 805-10-25-15(b). However, working capital adjustments paid or received after the close of the measurement period would be recorded to income.

FORMS OF CONTINGENT CONSIDERATION

6.021 Contingent consideration may include the issuance of additional securities or distribution of other consideration on resolution of contingencies based on post-combination earnings, post-combination security prices, or other factors.

6.022 Examples of contingent consideration include the following:

- **Contingent Consideration Based on Earnings.** Consideration may be contingent on maintaining or achieving specified earnings levels in future periods. An acquirer may be required to issue additional shares of its common shares to the former shareholders of the acquiree if earnings of the acquiree reach a certain level for a specified period.
• Contingent Consideration Based on Components of Earnings. Consideration could be contingent on components of earnings such as revenue growth, cost containment, or EBITDA. An acquirer may be required to pay additional consideration to the acquiree’s previous owners based on the number of units or dollar amount of sales of specified products sold by the acquirer for the five-year period following the acquisition date.

• Contingent Consideration That Represents a Guarantee of Security Price. Contingent consideration is sometimes issued to guarantee the price of securities issued by the acquirer in an acquisition. This type of guarantee is generally in the form of an agreement by the acquirer to issue additional shares of shares, cash, or other consideration if the market (fair) value of the acquirer’s securities issued to the former shareholders of the acquiree does not reach the guaranteed value by a specified date or maintain the guaranteed value for a stipulated period of time.

• Redeemable Preferred Shares and Put Options. A guarantee of the value of shares issued as consideration in a business combination may be embedded in the securities, i.e., the shares unconditionally issued at the date of acquisition are puttable for the guaranteed value at the option of the holder (i.e., the holder may demand cash in exchange for the shares). Alternatively, in addition to the shares issued to effect the combination, an acquirer could issue put options that give the holder the right to return the shares to the acquirer for the guaranteed value.

• Below-Market Guarantee. A purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller that guarantees a minimum value or security price at a future date that is less than the value or security price at the date the securities are issued (below-market guarantee).

• Contingent Consideration That Does Not Guarantee Security Price. The purchase agreement may include an arrangement for the acquirer to issue additional consideration to the seller based on security prices at a future date, but does not result in a guarantee of the total value of the consideration issued by the acquirer. An acquirer may agree to issue a fixed amount of additional shares should the fair value of the shares originally issued be less than a target value at a specified future date.

INITIAL RECOGNITION OF CONTINGENT CONSIDERATION

6.023 While the amount of future payments by the acquirer resulting from contingent consideration issued in an acquisition is conditional based on future events, the acquirer’s obligation regarding the contingent consideration is unconditional and meets the definition of a liability in FASB Concepts Statement No. 6, Elements of Financial Statements. Contingent consideration issued by an acquirer in a transaction accounted for as a business combination is recognized at the acquisition date at its acquisition-date fair value as part of the consideration transferred in the acquisition. (ASC paragraph 805-30-
25-5) See Section 18, Determining the Fair Value of the Consideration Transferred in a Business Combination, for additional discussion.

6.024 Contingent consideration issued in a business combination is classified at the acquisition date as either equity, or as an asset or a liability, based on applicable GAAP. The accounting for contingent consideration after an acquisition depends on whether the obligation for contingent consideration is classified as equity or as a liability (or in some cases, as an asset).

- Contingent consideration classified as equity is not remeasured after the acquisition date, and subsequent settlement is accounted for within equity.
- Contingent consideration classified as a liability (or an asset) is remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings (i.e., operating income) unless the arrangement is a derivative that has been designated as a hedging instrument in a cash flow hedging relationship for which ASC Topic 815, requires the changes to be initially recognized in other comprehensive income.

6.025 See the discussion of the initial measurement of contingent consideration in Section 18, Determining the Fair Value of the Consideration Transferred in a Business Combination, and the discussion of the subsequent accounting for contingent consideration in Section 12, Subsequent Measurement and Accounting.

STATEMENT OF CASH FLOWS


6.026a Paragraph not used.

Examples 6.5a and 6.5b: Not used.

DETERMINING THE CLASSIFICATION OF CONTINGENT CONSIDERATION

6.027 ASC paragraphs 805-30-25-6 and 25-7 require an acquirer to classify an obligation to pay contingent consideration as a liability or as equity based on ASC Subtopic 480-10, ASC Subtopic 815-40, or other applicable GAAP. The guidance in these and other relevant pronouncements should be considered in determining the classification of contingent consideration issued in a business combination.

6.028 ASC Subtopics 480-10 and 815-40 generally apply to financial instruments (a) for which the payoff to the counterparty is based, in whole or in part, on variations in the fair value of the issuer’s own shares (or the shares of a consolidated subsidiary of the issuer) or (b) that are potentially settled in the issuer’s own shares (or the shares of a consolidated subsidiary of the issuer). The first step in the determination of whether a contingent consideration arrangement is classified as a liability or equity requires a determination of whether the arrangement has either of those characteristics. If neither of those characteristics is present, the contingent consideration arrangement is a liability.
under ASC Topic 805 and no further analysis of classification is necessary. However, if either of those characteristics is applicable to the contingent consideration arrangement, the guidance in this Section should be applied to determine the arrangement’s classification. Contingent consideration arrangements that meet either of those characteristics are referred to herein as equity-linked contingent consideration arrangements.

**Example 6.6: Cash-Settled Contingent Consideration Based on Earnings**

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid in cash two years after the acquisition date. The value of that consideration ranges between $0 and $20 million and is calculated according to an earnings-based formula.

**Analysis.** This example does not involve an equity-linked contingent consideration arrangement, so there is no GAAP that could potentially result in equity classification. The arrangement should be classified as a liability.

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6.029 ASC Subtopics 480-10 and 815-40 are complex, and a complete discussion of those standards is beyond the scope of this publication. However, an overview of those standards and their application to contingent consideration arrangements is presented below. For a more detailed discussion of these and related standards, refer to KPMG’s publication, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity: An Analysis of FASB Statement No. 150 (ASC Topic 480)*, and to KPMG’s *Derivatives and Hedging Accounting Handbook* (Sections 2 and 3).

6.030 This flowchart illustrates the process for evaluating whether to classify an obligation to pay contingent consideration as a liability or as equity in accordance with ASC Subtopics 480-10 and 815-40:
6.031 We believe that certain business combinations may contain multiple contingent consideration arrangements. In those circumstances, the guidance in ASC Subtopics 480-10 and 815-40, and other U.S. GAAP would be applied to each arrangement and the classification of each of those individual arrangements as liabilities or equity may differ. See additional discussion in the subsection titled Determining the Unit(s) of Accounting When a Business Combination Potentially Involves More Than One Contingent Consideration Arrangement.

Classification of Equity-Linked Contingent Consideration Arrangements That Are Within the Scope of ASC Subtopic 480-10

6.032 ASC paragraph 480-10-35-4A requires that financial instruments within its scope that are issued as consideration in a business combination be classified as liabilities (or in some instances, assets). ASC Subtopic 480-10 applies to the following three classes of freestanding financial instruments that embody obligations for the issuer:

(1) **Mandatory Redeemable Financial Instruments (ASC paragraphs 480-10-25-4 through 25-7).** A mandatorily redeemable financial instrument is a financial instrument issued in the form of shares that embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or on an event certain to occur. Mandatorily redeemable financial instruments are not classified as liabilities if redemption is only required to occur on the
liquidation or termination of the reporting entity. Similarly, mandatorily
redeemable noncontrolling interests in a consolidated subsidiary are not
classified as liabilities in the consolidated financial statements of the parent if
redemption is only required to occur on the liquidation or termination of the
subsidiary, even if the parent entity will not be liquidated or terminated at the
redemption date. Additionally, for non-SEC registrants only, mandatorily
redeemable financial instruments are not classified as liabilities unless they
are redeemable on fixed dates for amounts that are fixed or determined by
reference to specified indices. (See ASC paragraph 480-10-65-1 for additional
information about noncontrolling interests that are mandatorily redeemable
only on liquidation of the subsidiary and certain mandatorily redeemable
financial instruments issued by non-SEC registrants.)

(2) Obligations to Repurchase the Issuer’s Shares by Transferring Assets
(ASC paragraphs 480-10-25-8 through 25-13). A financial instrument, other
than an outstanding share, that, at inception, (a) embodies an obligation to
repurchase the issuer’s equity shares or is based on variations in the fair value
of the obligation, and (b) requires or may require the issuer to settle the
obligation by transferring assets, is within the scope of ASC Subtopic 480-10.
Examples include forward purchase contracts or written put options on the
issuer’s equity shares that are physically settled or net-cash-settled, put
warrants, and warrants on shares that are redeemable.

(3) Certain Obligations to Issue a Variable Number of Shares (ASC
paragraph 480-10-25-14). A financial instrument that embodies an
unconditional obligation (or a financial instrument other than an outstanding
share that embodies a conditional obligation) that the issuer must or may settle
by issuing a variable number of its equity shares is within the scope of ASC
Subtopic 480-10 and is classified as a liability (or an asset in some instances)
if, at inception, the monetary value of the obligation is based solely or
predominantly on any of the following:

(a) A fixed monetary amount known at inception (e.g., share-settled debt),

(b) Variations in something other than the fair value of the issuer’s equity
shares (e.g., a financial instrument indexed to the S&P 500 and settleable
with a variable number of the issuer’s shares), or

(c) Variations inversely related to changes in the fair value of the issuer’s
equity shares (e.g., a written put option that could be net share settled).

6.033 ASC Subtopic 480-10 applies to freestanding financial instruments, including those
that comprise more than one option or forward contract, and its guidance applies to an
instrument in its entirety (i.e., ASC Subtopic 480-10 does not apply to embedded
features). A freestanding financial instrument is a financial instrument that is entered into
separately and apart from the entity’s other financial instruments or equity transactions,
or that is entered into in conjunction with some other transaction and is legally detachable
and separately exercisable. In determining whether a feature is a freestanding financial
instrument within the scope of ASC Subtopic 480-10 or an embedded feature, significant
judgment is often required. However, ASC Topic 805 always requires a contingent consideration arrangement issued in a business combination to be recognized as a separate unit of accounting (i.e., either as a liability or equity). ASC paragraph 805-30-25-6 specifies that the analysis of whether a contingent consideration arrangement is a liability requires that the arrangement be evaluated based on the classification guidance contained in ASC Subtopics 480-10 and 815-40, and other relevant GAAP. Based on that guidance, we believe that the evaluation of whether a contingent consideration arrangement should be classified as a liability or as equity would require consideration of the classification requirements in ASC Subtopic 480-10, regardless of whether the arrangement is otherwise considered to be embedded in the related acquisition agreement.

6.034 Although ASC Subtopic 480-10 specifies certain types of financial instruments that are required to be classified as liabilities (or assets in some instances), it does not provide guidance on determining whether a financial instrument should be classified as equity. Consequently, if the guidance in ASC Subtopic 480-10 does not require a contingent consideration arrangement to be classified as a liability, further analysis of other applicable guidance (e.g., ASC Subtopic 815-40) is required to determine the arrangement’s classification as a liability or equity.

Illustrations of Contingent Consideration Arrangements That Are Classified as Liabilities Under ASC Subtopic 480-10

6.035 The following examples illustrate the evaluation of whether contingent consideration arrangements are required to be classified as liabilities under ASC Subtopic 480-10.

Example 6.7: Contingent Consideration That Embodies a Written Put Option

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $50 million ($50 per share). Under the terms of the acquisition agreement, the former shareholders of DEF can require ABC to repurchase those common shares at the end of 4 years for $50 per share. In lieu of purchasing the shares, ABC can elect to satisfy its obligation by making a cash payment equal to 1 million times the excess of $50 over ABC’s share price at the end of the 4-year period.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-8. In this example, the contingent consideration arrangement (a) is not an outstanding share, (b) embodies an obligation to repurchase its equity shares (in this case it is a conditional obligation), and (c) may require ABC to settle the obligation by transferring assets (i.e., ABC can either repurchase 1 million shares for $50 million or make a cash payment equal to 1 million times the excess of $50 over ABC’s share price).
Example 6.8: Contingent Consideration That Embodies a Guarantee of the Acquirer's Share Price

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $30 million ($30 per share). ABC also agrees to issue additional shares if the fair value of its common shares is less than $50 per share at the end of 4 years such that the value of the shares issued to acquire DEF will be at least $50 million.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(c). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) the issuer must settle the obligation by delivering a variable number of common shares (i.e., if ABC’s share price is less than $50 per share at the end of 4 years), and (c) has a monetary value, at inception, that is based on variations inversely related to changes in the fair value of its common shares (i.e., the monetary value of the consideration that must be delivered to the former shareholders of DEF increases as ABC’s stock price declines).

Example 6.9: Contingent Consideration in the Form of a Freestanding Financial Instrument

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. ABC also issues a freestanding written put option to the former shareholders of DEF that permits those holders to sell (put) 500,000 shares of ABC’s common shares to ABC in exchange for $25 million ($50 per share) at the end of 4 years. At ABC’s option, the put option can either be physically settled or it can be net-cash settled by making a cash payment equal to 500,000 times the excess of $50 over ABC’s share price.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-8. In this example, the contingent consideration arrangement (a) is not an outstanding share, (b) embodies an obligation of the issuer to repurchase its equity shares (in this case it is a conditional obligation), and (c) may require ABC to settle the obligation by transferring assets (i.e., ABC can either repurchase 500,000 shares for $25 million or make a cash payment equal to 500,000 times the excess of $50 over ABC’s share price).

Example 6.10: Contingent Consideration Based on Earnings

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid two years after the acquisition date. The value of that consideration ranges between $0 and $20 million and is calculated based on an earnings-
based formula. ABC can elect to settle its obligation under the contingent consideration arrangement in cash or a variable number of its common shares with an equivalent value.

**Analysis.** The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(b). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) may be settled by delivering a variable number of common shares, and (c) has a monetary value, at inception, that is based on variations in something other than the issuer’s stock price. ABC’s earnings are the sole basis for the monetary value of the obligation. Although ABC’s share price affects the number of shares delivered at settlement, its stock price does not affect the monetary value of that consideration.

**Example 6.11: Fixed Minimum Payment and Contingent Consideration Based on Earnings**

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for additional consideration to be paid two years after the acquisition date. The value of that additional consideration ranges between $30 million and $50 million and is calculated according to an earnings-based formula. ABC can elect to settle its obligation under the arrangement in cash or a variable number of its common shares with an equivalent value.

**Analysis.** Regardless of how the acquisition agreement characterizes the arrangement, the $30 million minimum consideration to be transferred at the end of 2 years is noncontingent and should not be accounted for as contingent consideration. Rather, the obligation to deliver cash or a variable number of shares worth $30 million in 2 years represents a separate accounting unit and should be recognized as a debt obligation at the acquisition date and initially measured at fair value, with the resulting debt discount amortized to interest expense using the effective interest method over the 2-year period.

The contingent consideration arrangement represents the conditional obligation to remit up to $20 million of additional consideration (i.e., the amount in excess of the $30 million minimum) at the end of 2 years based on an earnings formula. That arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(b). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) may be settled by delivering a variable number of common shares, and (c) has a monetary value, at inception, that is based on variations in something other than the issuer’s stock price. ABC’s earnings are the sole basis of the monetary value of the obligation. Although ABC’s stock price affects the number of shares delivered at settlement, its stock price does not affect the monetary value of that consideration.
Classification of Equity-Linked Contingent Consideration Arrangements That Are Not Within the Scope of ASC Subtopic 480-10

6.036 For an equity-linked contingent consideration arrangement issued in a business combination that is not required to be classified as a liability in accordance with ASC Subtopic 480-10, other GAAP that provides guidance on the classification of equity-linked contracts must be applied to determine the classification of the arrangement. Applying the guidance in other GAAP requires that both of the following two criteria be met for a contingent consideration arrangement to be classified as equity:

(a) The arrangement must be considered to be indexed to the entity’s own stock based on the guidance in ASC paragraphs 815-40-15-5 through 15-8; and

(b) The arrangement must meet the conditions for equity classification in ASC Section 815-40-25.

6.037 If the contingent consideration arrangement does not meet either of these criteria, it would be classified as a liability, regardless of whether the arrangement has all the characteristics of a derivative in ASC paragraphs 815-10-15-71, 15-83, 15-85, 15-89, 15-90, 15-92 through 15-96, 15-99, 15-100, 15-110, 15-119, 15-120, and 15-128.

Determining Whether a Contingent Consideration Arrangement Is Indexed to an Entity’s Own Stock under ASC Paragraphs 815-40-15-5 through 15-8

6.038 ASC paragraphs 815-40-15-5 through 15-8 establish a framework for determining whether an instrument (or embedded feature) is indexed to an entity’s own stock. When an equity-linked contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10, the guidance in ASC paragraphs 815-40-15-5 through 15-8 is applied in determining whether it should be considered indexed to the entity’s own stock, which is one of the requirements for the arrangement to be classified as equity.

6.039 The decision process for determining whether an equity-linked financial instrument is indexed to an entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8 is illustrated through a number of examples presented in an exhibit to that Issue. Those examples are an integral component of that consensus and should be considered in applying its guidance.

6.040 ASC paragraphs 815-40-15-5 through 15-8 require an entity to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using a two-step approach:

   Step 1: Evaluate the instrument’s contingent exercise provisions, if any.

   Step 2: Evaluate the instrument’s settlement provisions.

6.041 In applying ASC paragraphs 815-40-15-5 through 15-8, an exercise contingency is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying (as defined in ASC Topic 815), including the occurrence (or nonoccurrence) of a specified event. An exercise contingency would not preclude an instrument from being considered indexed to an entity’s own stock, provided that it is not based on:

(a) An observable market, other than the market for the issuer’s stock (if applicable), or
(b) An observable index, other than an index calculated or measured solely by reference to the issuer’s own operations (e.g., sales revenue of the issuer, EBITDA (earnings before interest, taxes, depreciation, and amortization) of the issuer, net income of the issuer, or total equity of the issuer).

6.042 If the evaluation of Step 1 does not preclude a contingent consideration arrangement from being considered indexed to an entity’s own stock under ASC paragraphs 815-40-15-7A and 15-7B, the analysis proceeds to Step 2 of that model. ASC paragraphs 815-40-15-7C through 15-7H

6.043 For a contingent consideration arrangement, the guidance in Step 1 of the model (ASC paragraphs 815-40-15-7A and 15-7B) would apply to a contingency that causes the transfer of consideration to be triggered or that causes the arrangement to be terminated. However, if the amount of consideration to be transferred (or forfeited) is adjusted when an exercise contingency occurs, the exercise contingency would be evaluated under Step 1 of the model (ASC paragraphs 815-40-15-7A and 15-7B) and the potential adjustment to the amount of consideration would be evaluated under Step 2 of that model (ASC paragraphs 815-40-15-7C through 15-7H). For example, if the achievement of an earnings target for a specified period triggers payment under a contingent consideration arrangement and the amount of that payment varies based on the level of those earnings, then the arrangement should be evaluated under both Step 1 and Step 2 of the model (ASC paragraph 815-40-15-7). See Example 6.12 for an illustration of those circumstances.

Step 2 of the model: Evaluation of Settlement Provisions (ASC paragraphs 815-40-15-7C through 15-7H)

6.044 If an instrument’s settlement provisions provide for a settlement amount equal to the difference between the fair value of a fixed number of an entity’s equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity, the instrument would be considered indexed to an entity’s own stock under ASC paragraph 815-40-15-7C. An issued share option that gives the counterparty a right to buy a fixed number of an entity’s shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity’s own stock. Certain
**all or nothing** contingent consideration arrangements, as discussed below, would meet this fixed-for-fixed criterion and be considered indexed to an entity’s own stock.

6.045 An instrument’s strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity’s control. If an instrument’s strike price or the number of shares used to calculate the settlement amount are not fixed, but the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares, the instrument would still be considered indexed to an entity’s own stock under ASC paragraph 815-40-15-7D.

6.046 The fair value inputs of a fixed-for-fixed forward or option on equity shares may include additional variables beyond the entity’s stock price, such as the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity’s credit spread, and the ability to maintain a standard hedge position. Determinations and adjustments related to the settlement amount (including determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity’s own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument’s settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity’s own stock.

*All or Nothing Contingent Consideration Arrangements*

6.047 Consistent with the preceding discussion, a contingent consideration arrangement that provides for a settlement amount based on the difference between the fair value of a fixed number of the acquirer’s shares and a fixed monetary amount, which may be zero (i.e., an *all or nothing* arrangement) would meet the fixed-for-fixed criteria in Step 2 of the model (ASC paragraph 815-40-15-7E). If the contingency that triggers payment of the consideration (i.e., an exercise contingency) is based on an observable market other than the market for the issuer’s stock (if applicable), or is based on an observable index other than an index calculated or measured solely by reference to the issuer’s own operations, the arrangement would not be considered indexed to the acquirer’s own stock under Step 1 and the arrangement would be classified as a liability. See Example 6.16 for an illustration of an all or nothing arrangement.
Illustration of the Application of ASC Subtopic 480-10 and ASC Paragraphs 815-40-15-5 through 15-8 to a Contingent Consideration Arrangement

6.048 The following example illustrates the evaluation of whether a contingent consideration arrangement is required to be classified as a liability under ASC Subtopic 480-10 and ASC paragraphs 815-40-15-5 through 15-8.

Example 6.12: Contingent Consideration That Provides for Different Outcomes Involving the Issuance of Shares That Are Based on the Level of Revenues Achieved

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares if the revenues of DEF are at least $10 million in the year following the acquisition or 150,000 additional shares if the revenues of DEF are at least $12 million for that year.

Analysis under ASC Subtopic 480-10. In this example, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. The determination of whether this contingent consideration arrangement should be classified as a liability under ASC paragraph 480-10-25-14 depends on the entity’s assessment of the predominant nature of the monetary value that will be received by the counterparty at settlement.

The monetary value of the consideration to be delivered at settlement varies in the same direction as ABC’s stock price (i.e., the monetary value of the consideration increases when the stock price increases, and vice versa). However, the monetary value of the consideration to be delivered at settlement also varies based on changes in something other than the fair value of ABC’s equity shares (i.e., the monetary value of the consideration is affected by the entity’s revenues, which determines the number of shares to be delivered at settlement). The monetary value of the consideration to be delivered at settlement is affected by a variable that would meet the characteristic in ASC paragraph 480-10-25-14(b) (i.e., its monetary value varies based on something other than the fair value of ABC’s equity shares) if it were the sole variable affecting the monetary value of the obligation. Consequently, the entity must evaluate whether the overall monetary value of the obligation is predominantly based on variations in revenues. Significant judgment is often required when assessing predominance under ASC paragraph 480-10-25-14. If ABC concludes based on the relevant facts and circumstances that the monetary value of the arrangement is predominantly based on variations in something other than the fair value of its equity shares (i.e., the entity’s revenues), the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10.
Analysis under ASC paragraphs 815-40-15-5 through 15-8. If ABC concludes based on the relevant facts and circumstances that the monetary value of the arrangement is not predominantly based on variations in something other than the fair value of its equity shares (i.e., the entity’s revenues), the arrangement would not be within the scope of ASC Subtopic 480-10. However, the contingent consideration arrangement is not considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 and, therefore, is required to be classified as a liability based on the following evaluation:

**Step 1.** The exercise contingency (i.e., the accumulation of at least $10 million of revenues in the 3-year period following the acquisition) is an observable index. However, it can only be calculated or measured by reference to ABC’s own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity’s own stock. Proceed to Step 2.

**Step 2.** The consideration paid at settlement would not equal the difference between a fixed number of the entity’s equity shares and a fixed strike price. Although the strike price to be received at settlement ($0) is fixed, the number of shares to be issued to the counterparty is not fixed (i.e., 100,000 shares if revenues are greater than $10 million but less than $12 million in the year following the acquisition and 150,000 shares if revenues for that year are at least $12 million). The amount of an entity’s annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

Determining Whether a Contingent Consideration Arrangement Is Classified in Equity under ASC Section 815-40-25

6.049 ASC Section 815-40-25 addresses the classification and measurement of contracts that are indexed to, and potentially settled in, a company’s own stock. If an entity concludes that (a) a contingent consideration issued in a business combination is not required to be classified as a liability under ASC Subtopic 480-10 and (b) the arrangement is indexed to the entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8, then the classification guidance in ASC Section 815-40-25 is applied to determine the arrangement’s classification as a liability or equity.

6.050 ASC Section 815-40-25 generally bases classification on the concept that contracts that may require net-cash settlement are assets or liabilities and contracts that permit or require settlement in shares are equity. If a contract provides the entity with a choice of net-cash settlement or settlement in shares, settlement in shares is assumed; if a contract provides the counterparty with a choice of net-cash settlement or settlement in shares, settlement in cash is assumed. However, these general principles do not apply when the settlement alternatives do not have the same economic value or if one of the alternatives is fixed or has caps or floors. In that case, the economic substance of the transaction should be the basis for the classification. However, the principles do apply when the settlement alternatives have different economic values if the reason for the difference is a
limit on the number of shares that the entity must deliver under a net-share settlement alternative.

6.051 Based on the model described in the preceding paragraph, a contingent consideration arrangement that is evaluated under ASC Section 815-40-25 (i.e., liability classification is not otherwise required under ASC Subtopic 480-10 or ASC paragraphs 815-40-15-5 through 15-8) would be classified as a liability or equity in the following circumstances unless the economic substance indicates otherwise:

**Equity Classified**
- Contracts that require physical settlement or net-share settlement, provided that all of the criteria in ASC Section 815-40-25 are met; and
- Contracts that give the entity a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement), provided that all of the criteria in ASC Section 815-40-25 are met.

**Liability Classified**
- Contracts that require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and that event is outside the control of the entity); and
- Contracts that give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement).

**Reclassifications of Contingent Consideration Arrangements**

6.052 The classification of a contingent consideration arrangement that is evaluated under ASC Section 815-40-25 is reassessed at each balance sheet date, including the additional requirements for equity classification described above. If the classification of a contingent consideration arrangement changes as a result of events during the period, the arrangement should be reclassified as of the date of the event that caused the reclassification. There is no limit to the number of times an equity-linked contingent consideration arrangement may be reclassified. If an arrangement is reclassified from equity to a liability, the change in the fair value of the arrangement during the period(s) in which it was classified as equity should be accounted for as an adjustment to equity. The arrangement should subsequently be measured at fair value with changes in fair value reported in earnings (i.e., operating income). If an arrangement is reclassified from a liability to equity, gains or losses recorded to account for the arrangement at fair value during the period(s) in which it was classified as a liability should not be reversed.

**Example 6.13: Reclassification of a Contingent Consideration Arrangement from Equity to a Liability**

A contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10 and it is initially classified as equity based on the guidance in ASC paragraphs 815-40-15-5 through 15-8 and ASC Section 815-40-25.
However, due to the issuance of shares in a subsequent period, the entity no longer has sufficient authorized and unissued shares available to settle its obligations under the arrangement.

Consequently, the arrangement no longer meets the condition for equity classification described in ASC paragraphs 815-40-25-19 through 25-24.

**Analysis.** The contingent consideration arrangement should be reclassified from equity to a liability as of the date that the requirements for equity classification were no longer met. The liability should be recorded at its fair value on the date of reclassification with an offsetting adjustment to equity. The arrangement should subsequently be measured at fair value with changes in fair value reported in earnings (i.e., operating income).

**Example 6.14: Reclassification of a Contingent Consideration Arrangement from a Liability to Equity**

A contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10 and it is considered indexed to the entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8. However, the entity is required to settle any obligations under the arrangement by delivering registered shares. Consequently, the arrangement does not meet the condition for equity classification described in ASC paragraphs 815-40-25-11 through 25-16 and it is initially classified as a liability. The contingent consideration arrangement is subsequently amended to permit the entity to settle any obligations under the arrangement by delivering unregistered shares. Additionally, the arrangement does not include any provision that could require net-cash settlement and the remaining conditions for equity classification in ASC Section 815-40-25 are met.

**Analysis.** The contingent consideration arrangement should be reclassified from a liability to equity at its carrying amount (i.e., its fair value) as of the reclassification date. Gains or losses previously recognized when the arrangement was classified as a liability should not be reversed.

**Illustrations of the Application of ASC Subtopic 480-10, ASC Paragraphs 815-40-15-5 through 15-8, and ASC Section 815-40-25 to Contingent Consideration Arrangements**

6.053 The following examples illustrate the evaluation of whether contingent consideration arrangements are required to be classified as liabilities or equity under ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, and ASC Section 815-40-25.
Example 6.15: Contingent Consideration That Embodies a Net-Share Settled Written Call Option

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $50 million ($50 per share). Under the terms of the acquisition agreement, if ABC’s share price exceeds $50 per share at the end of 4 years, ABC must deliver a variable number of registered shares with a fair value equal to 1 million times the amount of ABC’s share price in excess of $50 to the former shareholders of DEF. The arrangement does not include a provision that would explicitly require net-cash settlement. However, it requires the delivery of registered shares to satisfy ABC’s obligation, if any, at the end of four years. At inception of the arrangement, ABC does not have registered shares that could be delivered at settlement without additional timely filing or registration requirements during the term of the arrangement.

Analysis under ASC Subtopic 480-10. ASC Subtopic 480-10 does not require the contingent consideration arrangement in this example to be classified as a liability. The arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. The arrangement (a) embodies a conditional obligation and is not an outstanding share, and (b) may require ABC to settle the obligation by delivering a variable number of its common shares (i.e., if ABC’s share price exceeds $50 at the end of 4 years). However, the arrangement is not a liability under ASC paragraph 480-10-25-14, because the monetary value of that obligation, at inception, is based solely on variations directly related to changes in the fair value of its common shares.

Analysis under ASC paragraphs 815-40-15-5 through 15-8. The contingent consideration arrangement is considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The arrangement does not contain an exercise contingency. Proceed to Step 2.

Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity’s equity shares (1 million shares) and a fixed strike price ($50 per share).

Analysis under ASC Section 815-40-25. The contingent consideration arrangement in this example does not include a provision that would explicitly require net-cash settlement. However, it does not permit ABC to settle its obligation by delivering unregistered shares, which is one of the requirements for equity classification in ASC Section 815-40-25.

Conclusion. The contingent consideration arrangement does not meet the conditions for equity classification in ASC Section 815-40-25, so it should be classified as a liability.
Example 6.16: Contingent Consideration That Provides for the Issuance of a Fixed Number of Shares Payable on the Achievement of an Earnings Target

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares if the revenues of DEF are at least $10 million in the year following the acquisition. The arrangement does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC paragraphs 815-40-25-7 through 25-35.

**Analysis under ASC Subtopic 480-10.** ASC Subtopic 480-10 does not require the contingent consideration arrangement in this example to be classified as a liability. The arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to the obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the arrangement is not a liability under ASC paragraph 480-10-25-14 because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (it embodies an obligation that ABC may be required to settle by delivering a fixed number of its shares).

**Analysis under ASC paragraphs 815-40-15-5 through 15-8.** The contingent consideration arrangement is considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

**Step 1.** The exercise contingency (i.e., the accumulation of at least $10 million of revenues) is an observable index. However, it can only be calculated or measured by reference to ABC’s own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity’s own stock. Proceed to Step 2.

**Step 2.** The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity’s equity shares (100,000 shares) and a fixed strike price ($0).

**Analysis under ASC Section 815-40-25.** The arrangement in this example does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC paragraphs 815-40-25-7 through 25-35.

**Conclusion.** The contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10; it is considered indexed to the entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8, and it meets the conditions for equity classification in ASC Section 815-40-25. The arrangement should be classified as equity.
Example 6.17: Fixed Minimum Number of Shares and Contingent Consideration That Provides for the Issuance of a Fixed Number of Additional Shares Payable on the Achievement of an Earnings Target

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares in 3 years to the former shareholders of DEF if total EBITDA of DEF for the 3-year period following the acquisition is less than $10 million. However, if total EBITDA for that period is at least $10 million, the number of shares to be delivered at the end of 3 years increases to 500,000. The arrangement does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC paragraphs 815-40-25-7 through 25-35.

Analysis under ASC Subtopic 480-10. Regardless of how the arrangement is characterized in the acquisition agreement, the 100,000 minimum additional shares to be transferred at the end of 3 years is noncontingent and should not be accounted for as contingent consideration. Rather, the unconditional obligation to deliver 100,000 shares in 3 years represents a separate accounting unit. That obligation is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the unconditional obligation to deliver 100,000 shares in 3 years is not a liability under ASC paragraph 480-10-25-14, because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (that accounting unit embodies an obligation that ABC will be required to settle by delivering a fixed number of its shares).

The contingent consideration arrangement represents a conditional obligation to remit 400,000 of additional shares (i.e., the amount in excess of the 100,000 minimum) at the end of 3 years based on an EBITDA target. That arrangement is not a liability under ASC paragraph 480-10-25-8, because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-14, because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (the contingent consideration arrangement embodies a conditional obligation that would be settled by delivering 400,000 of ABC’s shares, a fixed number).

Analysis under ASC paragraphs 815-40-15-5 through 15-8. The unconditional obligation to deliver 100,000 shares in 3 years is considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The obligation to deliver 100,000 shares at the end of 3 years does not contain an exercise contingency. Proceed to Step 2.

Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity’s equity shares (100,000 shares) and a fixed strike price ($0).
The contingent consideration arrangement represents the conditional obligation to remit 400,000 of additional shares (i.e., the amount in excess of the 100,000 minimum) at the end of 3 years based on an EBITDA target. That arrangement is considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

**Step 1.** The exercise contingency (i.e., the accumulation of at least $10 million of total EBITDA in the 3-year period following the acquisition) is an observable index. However, it can only be calculated or measured by reference to ABC’s own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity’s own stock. Proceed to Step 2.

**Step 2.** The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity’s equity shares (400,000 shares) and a fixed strike price ($0).

**Analysis under ASC Section 815-40-25.** Neither the fixed obligation to deliver 100,000 shares in 3 years nor the contingent consideration arrangement includes a provision that could require net-cash settlement. Additionally, those obligations meet the additional conditions for equity classification that are prescribed in ASC paragraphs 815-40-25-7 through 25-35.

**Conclusion.** Neither the fixed obligation to deliver 100,000 shares in 3 years nor the contingent consideration arrangement is required to be classified as a liability under ASC Subtopic 480-10, as they are both considered indexed to the entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8, and they both meet the conditions for equity classification in ASC paragraphs 815-40-25-7 through 25-35. Both the fixed obligation to deliver 100,000 shares in 3 years and the contingent consideration arrangement should be classified as equity.

**Example 6.18: Contingent Consideration Based on the Acquirer's Stock Price**

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $30 million ($30 per share). ABC also agrees to issue additional shares to the former shareholders of DEF if the fair value of its common shares is less than $60 per share at the end of 4 years. If ABC’s stock price is between $20 and $60 per share at the end of 4 years, ABC will issue a variable number of shares to achieve an overall target value of $60 million (including the fair value at the end of 4 years of the 1 million shares issued at acquisition). However, if ABC’s stock price is less than $20 per share at the end of 4 years, 2 million additional shares will be issued. The arrangement does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC paragraphs 815-40-25-7 through 25-35.
**Analysis under ASC Subtopic 480-10.** In this example, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-8, because (a) it does not embody an obligation to repurchase the issuer’s shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. However, the determination of whether this contingent consideration arrangement should be classified as a liability under ASC paragraph 480-10-25-14 depends on the entity’s assessment of the predominant nature of the monetary value of the consideration that would be transferred at settlement. If ABC’s stock price is less than $20 per share at settlement, the holder is entitled to 2 million shares and the monetary value of that consideration varies in the same direction as changes in the fair value of the entity’s shares. However, when ABC’s stock price is greater than $20 but less than $60 at settlement, the holder is entitled to a variable number of shares with a monetary value that varies inversely with changes in the fair value of the entity’s common shares. In other words, when ABC’s stock price is between $20 and $60 per share, the monetary value of the shares that would be delivered at settlement moves in the opposite direction of its stock price. For example, if ABC’s stock price is $30 at settlement, the counterparty would receive 1 million shares with a fair value of $30 million. However, if ABC’s stock price is $50 at settlement, the counterparty would receive 200,000 shares with a fair value of $10 million. Because the contingent consideration arrangement is comprised of multiple options embodying obligations to issue shares and one of those component obligations meets the characteristics in ASC paragraph 480-10-25-14(c) (i.e., its monetary value varies inversely to changes in ABC’s stock price), the entity must evaluate whether that component obligation is predominant relative to the other component obligations. Significant judgment is often required when assessing predominance under ASC paragraph 480-10-25-14. If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is predominant relative to the component obligation without that characteristic, the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10.

**Analysis under ASC paragraphs 815-40-15-5 through 15-8.** If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is not predominant relative to the component obligation(s) without that characteristic, the arrangement would not be a liability under ASC Subtopic 480-10. The contingent consideration arrangement is considered indexed to ABC’s own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

**Step 1.** The arrangement does not contain an exercise contingency. Proceed to Step 2.

**Step 2.** The consideration paid at settlement would not equal the difference between a fixed number of the entity’s equity shares and a fixed strike price. Although the strike price to be received at settlement ($0) is fixed, the number of shares to be issued to the counterparty varies based on ABC’s stock price at the settlement date. Because the only variable that can affect the settlement amount is the entity’s stock price, which is an input to the fair value of a fixed-for-fixed option contract on equity shares, the arrangement is considered indexed to the entity’s own stock.
**Analysis under ASC Section 815-40-25.** The arrangement in this example does not include a provision that could require net-cash settlement and it meets the conditions for equity classification that are prescribed in ASC paragraphs 815-40-25-7 through 25-35.

**Conclusion.** As discussed above, classification of the contingent consideration arrangement in this example depends on the entity’s evaluation of predominance for purposes of evaluating classification under ASC Subtopic 480-10. If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is predominant relative to the component obligation(s) without that characteristic, the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10. If not, the arrangement would be classified as equity because it is considered indexed to the entity’s own stock under ASC paragraphs 815-40-15-5 through 15-8 and it meets the conditions for equity classification in ASC Section 815-40-25.

**DETERMINING THE UNIT(S) OF ACCOUNTING FOR CONTINGENT CONSIDERATION**

6.054 Contingent consideration in a business combination may contain multiple contingent payment triggers. ASC Topic 805 does not specify whether these payments should be viewed as multiple units of accounting or a single unit of accounting. The determination is important because it may affect the presentation as liabilities or equity under ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP. It also may affect the presentation in the statement of cash flows.

6.055 Whether contingent consideration in a business combination should be viewed as multiple units of accounting or a single unit of accounting is a matter of judgment that depends on the substance of the arrangement, rather than the manner in which the contingent consideration provisions are characterized in the related legal documents. Additionally, that determination is not affected by whether the contingent consideration provisions are prescribed in separate legal documents (i.e., papered separately) or within the same document.

6.055a We believe that payments with discrete risk exposures would be separate units of accounting. For example, if a business combination’s contingent consideration provisions embody separate payment triggers applicable to multiple discrete reporting periods, and the consideration that would be delivered on the attainment of each trigger would not be affected by the outcome(s) of the payment triggers for other reporting periods, then it would be appropriate to conclude that the contingent consideration consists of separate units of accounting for each reporting period. In contrast, if in substance the contingent consideration is based on a single risk exposure, the arrangement would be viewed as a single unit of accounting, regardless of the payment structure. If there are multiple scheduled payments, ordinarily the interim payments would need to be subject to a
clawback to conclude that there is only a single risk exposure and therefore a single unit of accounting.

**Example 6.19: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 1**

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid to the former shareholders of DEF as follows: 100,000 shares of ABC’s common shares if DEF’s cumulative EBITDA for the 3-year period following the acquisition is more than $1 million but less than $2 million; 200,000 shares if cumulative EBITDA for the same 3-year period is at least $2 million but less than $3 million; and 300,000 shares if cumulative EBITDA for that 3-year period is at least $3 million.

**Analysis.** In this example, the contingent consideration provisions do not involve separate payment triggers based on discrete risk exposures. Rather, those provisions embody an obligation to deliver a variable number of shares that is determined based on cumulative EBITDA for the 3-year period following the acquisition. The contingent consideration arrangement should be viewed as a single unit of accounting and classification of the arrangement as a liability or equity should be determined based on the guidance in ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP. Under that guidance, the arrangement would be classified as a liability (see Example 6.12 for a detailed description of how a similar arrangement would be evaluated under ASC Subtopic 480-10 and ASC paragraphs 815-40-15-5 through 15-8).

**Example 6.20: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 2**

ABC Corp. acquires DEF Corp. in 20X5 and the terms of the acquisition agreement provide for contingent consideration to be paid to the former shareholders of DEF as follows: 100,000 shares of ABC’s common shares if DEF’s EBITDA is at least $1 million in 20X6; 100,000 shares if EBITDA is at least $1 million in 20X7; and 100,000 shares if EBITDA is at least $1 million in 20X8.

**Analysis.** In this example, the payment triggers are based on discrete risk exposures. Specifically, the contingent consideration provisions embody separate payment triggers based on DEF’s EBITDA for three independent reporting periods. The outcome of the payment trigger for a particular reporting period does not affect the consideration to be transferred in other periods. The business combination can be viewed as having three separate contingent consideration arrangements for 20X6, 20X7, and 20X8, respectively. Each of those contingent consideration arrangements would represent a separate unit of accounting and the classification of those arrangements as liabilities or equity should be determined based on the guidance in ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP.
In some instances, the determination of the appropriate unit of accounting may not be clear. For example, contingent consideration provisions may provide for separate payment triggers for multiple reporting periods that would each require delivery of consideration that is not affected by the outcome of triggers in other periods; however, one or more of those payment triggers may be based on a cumulative performance measure that overlaps with the periods covered by earlier triggers. All facts and circumstances should be considered and judgment will be necessary when determining the appropriate unit(s) of accounting for contingent consideration.

SUBSEQUENT ISSUANCE OF CONTINGENT SHARES BASED ON EARNINGS IN A REVERSE ACQUISITION

Contingent shares issued to the stockholders of the accounting acquirer based on earnings in a reverse acquisition should be accounted for similar to a stock dividend and included in earnings per share from the date of issuance. Contingent shares issued to the former stockholders of the legal acquirer based on earnings in a reverse acquisition should be accounted for as contingent consideration.

Effect of Contingent Consideration on the Computation of Earnings Per Share

An agreement to provide consideration contingent on future earnings may affect an acquirer’s computation of earnings per share during the contingency period if the agreement requires the issuance of additional common shares on resolution of the contingency.

ASC paragraph 260-10-45-13 indicates that shares issuable for little or no cash consideration on the satisfaction of certain conditions (contingently issuable shares) should be considered outstanding common shares and included in the computation of basic earnings per share (EPS) as of the date that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent). For instance, if the earnings level stipulated in the contingency agreement is being attained currently, the additional shares to be issued should not be considered outstanding for the purposes of basic EPS until the earnings level is attained and the end of the contingency period is reached, but the additional shares would be included in diluted EPS when the earnings level is being currently attained (see following paragraphs). If the earnings levels were not being attained currently, the contingently issuable shares would not be included in basic or diluted EPS. Contingently issuable shares include shares that (a) will be issued in the future on the satisfaction of specified conditions, (b) have been placed in escrow and all or part must be returned if specified conditions are not met, or (c) have been issued but the holder must return all or part if specified conditions are not met.

ASC paragraphs 260-10-45-48 through 45-50 indicate that shares whose issuance is contingent on the satisfaction of certain conditions should be considered outstanding and included in the computation of diluted EPS as follows:
(a) If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares should be included as of the beginning of the period in which the conditions were satisfied.

(b) If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS should be based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (e.g., the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares should be included in the denominator of diluted EPS as of the beginning of the period (or the date of the acquisition if later).

6.061 A determination of whether contingently issuable shares are considered outstanding for the purposes of computing both basic and diluted EPS data should be made for each period, including interim periods, that EPS data are presented. Contingent shares included in previously presented diluted EPS data because the earnings level had been attained should not be included in computing diluted EPS for the current period if the specified earnings level is not being attained currently.

6.062 EPS data previously presented should not be restated to give retroactive effect to shares issued as a result of subsequently meeting the earnings level specified in the contingent consideration arrangement.

Effect of Contingency Based on Security Prices in Computing Earnings Per Share

6.063 ASC paragraph 260-10-45-52 provides guidance on the treatment of contingently issuable shares in EPS calculations when the number of contingently issuable shares depends on the market price of the stock at a future date. In that case, computations of diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive. If the condition is based on an average of market prices over a period of time, the average for that period should be used. Because the market price may change in a future period, basic EPS should not include such contingently issuable shares because all necessary conditions have not been satisfied.

Effect of Contingency Based on Both Future Earnings and Security Prices in Computing Earnings Per Share

6.064 ASC paragraph 260-10-45-53 provides guidance on computing EPS when contingently issuable shares depend on both future earnings and future market prices of the common stock. In that case, the determination of the number of shares included in diluted EPS should be based on both conditions, that is, earnings to date and current market price, as they exist at the end of each reporting period. If both conditions are not met at the end of the reporting period, no contingently issuable shares should be included in diluted EPS.
BUSINESS COMBINATIONS IN WHICH NO CONSIDERATION IS TRANSFERRED

6.065 In business combinations in which no consideration is transferred, an acquirer uses the acquisition-date fair value of its interest in the acquiree, determined using one or more valuation approaches, instead of the acquisition-date fair value of the consideration transferred to determine the amount of goodwill. See discussion of Business Combinations Achieved without the Transfer of Consideration in Section 9.

MEASUREMENT OF CONSIDERATION TRANSFERRED IN COMBINATIONS INVOLVING MUTUAL ENTITIES

ASC Paragraph 805-30-55-3
When two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, [ASC] paragraphs 805-30-30-2 through 30-3 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree’s equity interests instead of the acquisition-date fair value of the acquirer’s equity interests transferred as consideration. In addition, the acquirer in a combination of mutual entities shall recognize the acquiree’s net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.

ASC Paragraph 805-30-55-4
Although they are similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

ASC Paragraph 805-30-55-5
A fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, an estimated cash flow model may be used to determine the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

6.066 A mutual entity is an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly to its owners, members, or
participants. For example, a mutual insurance company, a credit union, and a cooperative entity, are all mutual entities. ASC Section 805-10-20

6.067 When a business combination takes place between mutual entities, the acquisition method is applied. In a combination involving mutual entities, the acquirer and acquiree exchange only equity interests. If the fair value of the equity or member interests in the acquiree is more reliably measurable than the fair value of the member interests transferred by the acquirer, ASC Topic 805 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree’s equity interests instead of the acquirer’s equity interests transferred as consideration.

6.068 The acquirer in a combination of mutual entities recognizes the acquiree’s net assets as a direct addition to capital or equity in its balance sheet and not as an addition to retained earnings.
Section 7 - Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

Detailed Contents

Recognition Principle*
  Recognition Conditions
  Assets and Liabilities: Concepts Statement 6
  Example 7.1: Substantive Obligation of the Acquiree Transactions That Are Not a Part of the Business Combination Transaction (Separate Transactions)

Classifying and Designating Identifiable Assets Acquired and Liabilities Assumed
  Classification Principle
  Exceptions to the Classification Principle
    (Pre-ASC Topic 842) Classification of Leases
    (ASC Topic 842) Classification of Leases
    Classification of Insurance and Reinsurance Contracts

Accounting Policies Applicable to the Assets Acquired and Liabilities Assumed

Recognizing Particular Assets Acquired and Liabilities Assumed
  (ASC Topic 606) Contract Assets and Contract Liabilities
    Example 7.1a: Contract Assets for an Acquisition Occurring prior to ASC Topic 606 Adoption
  Liabilities Associated with Restructuring or Exit Activities of the Acquiree
    Restructuring or Exit Activities of the Acquirer and Integration Costs an Acquirer Expects to Incur as a Result of an Acquisition
      Restructuring and Exit Activities of the Acquirer
      Integration Costs the Acquirer Expects to Incur
    Example 7.2: Costs to Prepare Acquired Equipment for Its Intended Use
  Recognition of Prepayment Penalties Associated with Debt Assumed in a Business Combination
  (ASC Topic 842) Lease Contracts
  (Pre-ASC Topic 842) Lease Contracts
    (Pre-ASC Topic 842) Classification of Leases Acquired in a Business Combination
    (Pre-ASC Topic 842) Summary of Assets and Liabilities Arising from Lease Contracts of an Acquiree Recognized by the Acquirer in a Business Combination
    (Pre-ASC Topic 842) In-Place Leases
    (Pre-ASC Topic 842) Favorable or Unfavorable Lease Contract Terms
Example 7.3: Contingent Rental Provisions in an Operating Lease
(Pre-ASC Topic 842) Presentation of Assets and Liabilities for Favorable or Unfavorable Operating Lease Contracts Acquired in a Business Combination
(Pre-ASC Topic 842) Customer Relationships and Other Identifiable Intangible Assets Associated with Lease Contracts
Example 7.4: Airport Gate Operating Lease
(Pre-ASC Topic 842) Assets Subject to Operating Leases When the Acquiree Is the Lessor
Example 7.5: Operating Lease of an Acquiree as the Lessor
(Pre-ASC Topic 842) Assets Subject to Operating Leases When the Acquiree Is the Lessee
(Pre-ASC Topic 842) Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases
Example 7.6: Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases
(Pre-ASC Topic 842) Capital Lease Contracts of an Acquiree
(Pre-ASC Topic 842) Leasehold and Tenant Improvements
(Pre-ASC Topic 842) Sales-Type and Direct Financing Leases
(Pre-ASC Topic 842) Leveraged Leases
(Pre-ASC Topic 842) Additional Considerations Related to Lease Contracts
Involvement of a Third-Party Lessor in a Business Combination (pre-Topic 842)
Recognition of Intangible Assets Separately from Goodwill--Public Business Entities
Contractual-Legal Criterion
Separability Criterion
Example 7.7: Depositor Relationships
Example 7.8: Registered Trademarks
Items That Are Not Identifiable
Illustrative List of Intangible Assets That Are Identifiable
Marketing-Related Intangible Assets
Customer-Related Intangible Assets
Example 7.9: Order Backlog
Example 7.10: Customer Relationships (No Existing Contracts)
Example 7.11: Customer Relationships—Contractual-Legal Criterion
Example 7.12: Customer Relationships—More Than One Relationship with a Single Customer
Example 7.13: Customer Relationships—Contractual-Legal Criterion
Example 7.14: Customer Relationships Not Recognized (Contractual-Legal Criterion Not Met) and Customer List Not Recognized Due to Confidentiality Restrictions)
Example 7.15: Customer Relationships—Overlapping Customer Relationships – Scenario 1
Example 7.16: Customer Relationships—Overlapping Customer Relationships – Scenario 2
Example 7.17: Acquirer’s Preexisting Customer Relationship With Acquirer Is Not Recognized as a Customer Relationship Intangible Asset by the Acquirer
Artistic-Related Intangible Assets
Contract-Based Intangible Assets
Example 7.18: Supply Contracts
Technology-Based Intangible Assets
Research And Development Assets
Example 7.19: Activities That Typically Would Be Included in Research and Development Activities
Example 7.20: Activities That Typically Would Be Excluded from Research and Development Activities
In-Process Research And Development Activities
Q&A 7.1: Initial Measurement – IPR&D in a Development Arrangement
Q&A 7.2: Subsequent Measurement – IPR&D in a Development Arrangement
Example 7.21: The IPR&D Guide Q&A, par. 2.60: Specific R&D Projects – Incompleteness
Example 7.22: The IPR&D Guide Q&A, par. 2.61: Specific R&D Projects – Incompleteness
Example 7.23: The IPR&D Guide Q&A, par. 2.62: Specific R&D Projects – Incompleteness
Example 7.24: The IPR&D Guide Q&A, par. 2.63: Specific R&D Projects – Incompleteness
Example 7.25: The IPR&D Guide Q&A, par. 2.51: Specific R&D Projects – Substance
Example 7.26: The IPR&D Guide Q&A, par. 2.52: Specific R&D Projects – Substance
Example 7.27: The IPR&D Guide Q&A par. 2.53: Specific R&D Projects – Substance
Considerations for Financial Services Entities – Customer-Related Intangible Assets
Recognizing Any Noncontrolling Interest in an Acquiree
Example 7.28: Recognizing Noncontrolling Interest at Fair Value
Measurement Principle
Application Guidance Related to Measuring the Fair Values of Particular Identifiable Assets and a Noncontrolling Interest in an Acquiree
Assets with Uncertain Cash Flows (Valuation Allowances)
Example 7.29: Acquired Trade Receivables – Valuation Allowance
(Pre-ASC Topic 842) Assets Subject to Operating Leases in which the Acquiree Is the Lessor
Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use
Example 7.30: Acquirer Does Not Intend to Use Acquired Trade Name
Example 7.31: Acquired IPR&D the Acquirer Does Not Intend to Use
Contingent Consideration Arrangements of an Acquiree Assumed by the Acquirer
Measuring the Fair Value of a Noncontrolling Interest in an Acquiree
Exceptions to the Recognition and Measurement Principles (Pre-ASC Topic 842)
  Exceptions to Both the Recognition and Measurement Principles
  Assets and Liabilities Arising from Contingencies
  Deferred Tax Assets and Liabilities and Tax Uncertainties
Employee Benefits
  Example 7.32: Funded Status of a Single-Employer Defined Benefit Pension Plan
  of an Acquiree before and after a Business Combination
  Example 7.33: Plan Amendments an Acquirer Is Not Required to Make
  Example 7.34: Employees of Acquiree Included in Pension Plan of Acquirer
  Example 7.35: Postretirement Benefit Plan That Will Be Amended as a Condition
  of the Acquisition Agreement
  Indemnification Assets
  Example 7.36: Indemnification Asset Related to Noncontractual Contingency
Exceptions to the Measurement Principle
  Reacquired Rights
  Example 7.37: Reacquired Right
Share-Based Payment Awards
Assets Held for Sale
7.000 ASC Topic 805, *Business Combinations*, requires an acquirer to recognize, separately from goodwill, the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree, and to measure these items at their acquisition-date fair values, with limited exceptions. ASC Topic 805 does not provide guidance on how to measure fair value, but instead refers to the fair value measurement requirements of ASC Subtopic 820-10, *Fair Value Measurement - Overall*. ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value, and establishes disclosure requirements related to fair value measurements.

7.001 This Section provides guidance on the recognition and measurement of the assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree, including those subject to the exceptions to the fair value measurement principle. Sections 16 through 21 on Fair Value Measurements provide additional guidance on the estimation of the fair value of assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree.

7.002 Subsequent measurement and accounting for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination are based on other applicable GAAP. However, ASC Topic 805 does provide guidance on the subsequent measurement and accounting for certain assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination. See Section 12 for a discussion of *Subsequent Measurement and Accounting*.

**RECOGNITION PRINCIPLE***

**ASC Paragraph 805-20-25-1**

As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in [ASC] paragraphs 805-20-25-2 through 25-3. However, an entity (the acquirer) within the scope of ASC paragraph 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination as described in ASC paragraphs 805-20-25-29 through 25-32.

* See discussion of exceptions to this principle in this Section under Exceptions to Both the Recognition and Measurement Principles. These exceptions relate to assets and liabilities arising from contingencies, deferred tax assets and liabilities and uncertain tax positions, indemnification assets, employee benefits, reacquired rights, share-based payment awards, and assets held for sale. In addition, Section 26, *Private Company and Not-for-Profit Accounting Alternatives*, discusses additional exceptions for private companies and not-for-profit entities.

**RECOGNITION CONDITIONS**

**ASC Paragraph 805-20-25-2**

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

**ASC Paragraph 805-20-25-3**

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

7.003 Two conditions are required to be met before identifiable assets acquired and liabilities assumed can be recognized in a business combination. These conditions state that identifiable assets acquired and liabilities assumed:

- Meet the definitions of assets and liabilities in Concepts Statement 6 *at the acquisition date*; and
- Are part of what the acquirer and acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions. See the discussion of Determining What Is Part of the Business Combination Transaction in Section 11.

7.004 See the discussion of Exceptions to Both the Recognition and Measurement Principles.

**Assets and Liabilities: Concepts Statement 6**

7.005 Concepts Statement 6 defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” (Concepts Statement 6, par. 25) and liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events” (Concepts Statement 6, par. 35). A footnote to paragraph 35 of Concepts Statement 6 provides additional clarification of the meaning of obligations: “Obligations in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth. It includes equitable and constructive obligations as well as legal obligations.”
Applying the recognition provisions of ASC Topic 805 may result in the acquirer recognizing some assets and liabilities that the acquiree had previously not recognized as assets and liabilities in its financial statements. For example, the acquirer would recognize the acquired identifiable intangible assets such as in-process research and development, brand names, patents, and customer relationships, even if the acquiree did not recognize these assets because they were developed internally and the related costs were charged to expense.

Under ASC Topic 805, transaction costs for services received in connection with a business combination, such as legal fees, other professional and consulting fees, and due diligence fees, would not be considered an asset acquired at the date of acquisition and are not part of the fair value of the consideration transferred to the seller. Those costs would be expensed as incurred, unless they are costs related to the issuance of debt or equity instruments, in which case they are accounted for under applicable GAAP. (ASC paragraph 805-20-25-2; Statement 141(R), par. B114) See discussion of Acquisition-Related Costs and Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred in Section 11.

For guidance on presenting transaction costs in the statement of cash flows, see chapter 18 of KPMG's Handbook, Statement of cash flows.

Expected Restructuring Costs. Under Concepts Statement 6, an example of costs that do not meet the definition of a liability assumed at the acquisition date is expected restructuring costs. An acquirer recognizes liabilities for restructuring or exit activities of the acquiree as part of the accounting for a business combination under ASC Topic 805 only if they meet the definition of liabilities under Concepts Statement 6 at the acquisition date. Costs the acquirer expects, but is not obligated, to incur in the future are not liabilities at the acquisition date and are not accounted for as part of the business combination. See the discussion of Liabilities Associated with Restructuring or Exit Activities of the Acquiree.

Deferred Revenue of an Acquiree Where There Is No Legal Performance Obligation. An example of an item that does not meet the definition of a liability under Concepts Statement 6 (and would not be recognized by the acquirer in accounting for the acquisition under ASC Topic 805 is deferred revenue recognized by an acquiree where there is no legal performance obligation assumed by the acquirer (such as a legal obligation to provide goods, services, the right to use an asset, or other consideration to customers). An acquiree may have delivered all goods or services under an arrangement with a customer in exchange for a promissory note, but may have deferred revenue recognition because collectibility of the note was not reasonably assured. The deferred revenue does not relate to a legal performance obligation, and the acquirer would not recognize a liability in its accounting for the acquisition. However, the promissory note would be recognized at its fair value, which would reflect an assessment of the note’s collectibility.
7.011 (Pre-ASC Topic 842) Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases. Another example of an item that may not meet the definition of an asset or a liability under Concepts Statement 6 is prepaid or accrued rent related to an operating lease that was recognized by an acquiree (as required under ASC paragraph 840-20-25-2) before its acquisition. See discussion of Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases under Lease Contracts in this Section.

7.011a (ASC Topic 842) Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases. For guidance on accounting for prepaid or accrued rent in a business combination after adopting ASC Topic 842, see chapter 11 of KPMG’s Handbook, *Leases*.

7.012 Substantive Obligations of an Acquiree. An acquiree may have recognized a liability for a substantive obligation. If the acquirer concludes that there is a substantive obligation and assumes that obligation, the acquirer should recognize a liability for the substantive obligation at its acquisition-date fair value.

**Example 7.1: Substantive Obligation of the Acquiree**

ABC Corp. acquires DEF Corp. in a business combination. DEF had a widely published policy that it historically honored product defects after the warranty expiration period, and determined that it had a substantive obligation to continue its historical practice and recorded a liability related to this historical practice before its acquisition by ABC. ABC reviewed this matter in connection with its accounting for the acquisition of DEF, and also concluded that DEF had a substantive obligation to continue its historical practice. ABC will therefore recognize a liability for DEF’s substantive obligation at the acquisition date, measured at fair value, because the obligation falls within the definition of a liability in Concepts Statement 6.

**Transactions That Are Not a Part of the Business Combination Transaction (Separate Transactions)**

7.013 Amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in a business combination are not recognized as assets acquired or liabilities assumed in the business combination. For example, amounts related to the settlement of preexisting relationships between an acquirer and an acquiree, a transaction that compensates employees or former owners of the acquiree for future services, and a transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs are not part of the accounting for the acquisition, but rather are accounted for as separate transactions based on other relevant GAAP. See the discussion of *Determining What Is Part of the Business Combination Transaction* in Section 11.
CLASSIFYING AND DESIGNATING IDENTIFIABLE ASSETS
ACQUIRED AND LIABILITIES ASSUMED

CLASSIFICATION PRINCIPLE

ASC Paragraph 805-20-25-6

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

7.014 The accounting for a particular asset or liability subsequent to an acquisition may differ depending on how it is classified or designated. ASC Topic 805 requires the acquirer to classify and designate assets acquired and liabilities assumed in an acquisition at the acquisition date as required to enable it to apply other GAAP, based on the contractual terms, economic conditions, the acquirer’s accounting policies, and other pertinent conditions at the acquisition date. ASC paragraph 805-20-25-7 provides three examples of classifications required to be made by the acquirer at the acquisition date:

a. Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with ASC Section 320-10-25 (see discussion of the effect of adopting ASU 2016-01 beginning at Paragraph 17.021a);

b. Designation of a derivative instrument as a hedging instrument in accordance with ASC paragraph 815-10-05-4; and

c. Assessment of whether an embedded derivative should be separated from the host contract in accordance with ASC Section 815-15-25 (which is a matter of classification as used in ASC Subtopic 805-20).

7.015 The above examples are not all-inclusive. For example:

- **Long-Lived Assets or Disposal Groups.** An acquirer may intend, at the acquisition date, to dispose of a long-lived asset (or disposal group) of the acquiree. In these instances, the acquirer would follow the guidance in ASC paragraphs 360-10-35-37 through 35-43 and 45-9 through 45-14 in determining the classification and presentation of the long-lived asset (or disposal group) in the acquirer’s postcombination consolidated financial statements.

- **Fair Value Option.** The acquirer may elect the fair value option for eligible items included in the assets acquired or liabilities assumed in a business combination. The classification of and subsequent accounting for these items are determined in accordance with ASC paragraphs 825-10-15-3 through 15-7 and 25-4.
EXCEPTIONS TO THE CLASSIFICATION PRINCIPLE

7.016 ASC Topic 805 includes two exceptions to the principle discussed above in classifying or designating assets acquired and liabilities assumed where the acquiree classification is retained. Those exceptions are (a) classification of a lease contract as either an operating lease or a capital lease under either ASC Topic 840, *Leases*, or ASC Topic 842, *Leases*, and (b) classification of a contract written by an entity that is in the scope of ASC Topic 944, *Financial Services—Insurance*. ASC paragraph 805-20-25-8

(Pre-ASC Topic 842) Classification of Leases

7.017 ASC Topic 805 retains the guidance in ASC Subtopic 840-10 which specifies that lease contracts assumed by an acquirer in a business combination should be classified on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date). (ASC paragraph 805-20-25-8) See Classification of Leases Acquired in a Business Combination and Leveraged Leases under the discussion of Lease Contracts in this Section.

7.018 A lease agreement may be modified to reflect a change in the identity of one of the parties to the agreement, as a result of a business combination. Such changes are not modifications of the provisions of the lease agreement for this purpose and do not affect the classification of the lease. The acquirer has simply purchased an interest in a lease agreement previously entered into by two other parties.

7.019 At the acquisition date, the acquirer may contemplate renegotiating and modifying leases of the business acquired. Modifications made after the acquisition date, including those that were planned at the time of the business combination, are postcombination events that should be accounted for separately by the acquirer in accordance with the provisions of ASC Topic 840. ASC paragraph 840-10-35-5

(ASC Topic 842) Classification of Leases

7.019a For guidance on classifying an assumed lease after adopting ASC Topic 842, see chapter 11 of KPMG's Handbook, *Leases*.

Classification of Insurance and Reinsurance Contracts

7.020 ASC Topic 805 amended ASC Topic 944 to require the acquirer to classify contracts within the scope of ASC Topic 944 on the basis of the contractual terms and other factors at the inception of the contract (or the modification date). As a result, the acquirer carries forward the acquiree’s classification of an acquired contract as an insurance or reinsurance contract or a deposit contract based on an understanding of the contractual terms of the acquired contract and any related contracts or agreements at the inception of the contract or, if the terms of those contracts or agreements were later modified in a manner that would change the classification, at the date of that modification (which may be the acquisition date).
7.021 While the insurance contracts retain the acquiree's classification, the liability is measured at fair value at the acquisition date and accounted for in two components based on the guidance in ASC paragraph 944-805-30-1. First, assets and liabilities are measured using the acquirer's accounting policies for insurance and reinsurance contracts it issues or holds. For example, the contractual assets acquired could include a reinsurance recoverable and the liabilities assumed could include a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts, and a liability to pay incurred contract claims and claims expenses. However, the assets acquired and liabilities assumed would not include the acquiree's deferred acquisition costs and unearned premiums that do not represent future cash flows. The second component would be an intangible asset (or occasionally another liability), representing the difference between the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed and the amount determined in the first step. The intangible asset may be presented as one caption in the statement of financial position in accordance with ASC paragraph 944-805-30-1.

7.022 The assumptions used to compute the first component are established and locked in for post-acquisition accounting using current assumptions as of the date of the business combination.

7.023 Other related contracts that are not insurance or reinsurance contracts are measured at the acquisition date in accordance with the guidance in ASC Topic 805, generally at fair value. For example, an employer's workers' compensation liability is measured at fair value in acquisition accounting rather than at an undiscounted amount, even if the acquiree's pre-acquisition policy had been to record the workers' compensation liability at an undiscounted amount.

ACCOUNTING POLICIES APPLICABLE TO THE ASSETS ACQUIRED AND LIABILITIES ASSUMED

7.024 Accounting policies applicable to the assets acquired and liabilities assumed from an acquiree should be conformed to those of the acquirer after a business combination. Dissimilar operations, assets, or transactions may be a basis for different accounting policies. Alternatively, the acquirer may wish to change its accounting policies to conform to those of the acquiree; however, any such changes would be permitted only if the acquirer can justify the use of an alternative accounting principle as preferable under ASC Subtopic 250-10, Accounting Changes and Error Corrections - Overall.

RECOGNIZING PARTICULAR ASSETS ACQUIRED AND LIABILITIES ASSUMED

7.025 This section discusses recognition considerations related to certain assets acquired and liabilities assumed in a business combination. The following sections discuss measurement considerations and the exceptions to the recognition and measurement principles.
7.025a A contract asset represents the right to consideration from the performance of the acquiree under a customer contract as of the acquisition date. It is distinguished from a trade receivable because it is conditional on something other than the passage of time. A contract asset is recognized at its acquisition date fair value. For further discussion of contract assets, see paragraph 17.084d.

Example 7.1a: Contract Assets for an Acquisition Occurring prior to ASC Topic 606 Adoption

Entity Z acquired Business Software Corp. on September 15, 2015. Entity Z adopts Topic 606 on January 1, 2018 using the full retrospective transition approach. Entity Z is an SEC registrant and recasts its financial statements for the years ended December 31, 2017 and 2016 and records a transition adjustment as of January 1, 2016.

Business Software enters into agreements with its customers to provide up to 2-year term licenses that are bundled with coterminous maintenance, for a fixed fee paid in monthly installments. Before adopting Topic 606, Business Software recognized license and maintenance revenue ratably as a single deliverable over the term of the maintenance as the payments came due. Under Topic 606, the promised goods and services - the software license and maintenance - are determined to be distinct and therefore accounted for as separate performance obligations. The portion of the transaction price allocated to the license is recognized at a point in time on initial delivery of the software, while the portion of the transaction price allocated to the maintenance is recognized ratably over the contract term.

While calculating the transition adjustment, Entity Z notes that some of Business Software's revenue recognized in Entity Z's 2016 and 2017 consolidated financial statements would have been recognized under Topic 606 before the acquisition date. Ordinarily, under Topic 606, the cash flows received in 2016 and 2017 related to the license would be credited against a contract asset that would have been recognized on delivery of the license. However, Entity Z did not record a contract asset in its historical acquisition accounting.

Entity Z notes that the post-acquisition cash flows associated with pre-acquisition software license arrangements were included in the cash flow forecast used to value the customer relationship intangible at the acquisition date. As such, a portion of the customer relationship intangible asset relates to the cash flows attributable to licenses sold before the acquisition date.

Entity Z concludes that, as part of adopting Topic 606, it should recast its accounting for the 2015 business combination to reclassify a portion of the customer relationship intangible as a separate contract asset (measured at the acquisition date fair value and rolled forward to January 1, 2016) to align the acquired assets with the corresponding post-acquisition cash flows associated with the Topic 606 performance obligations. The adjustment results in an increase to a contract asset and an offsetting decrease to customer
relationship intangible in the acquisition accounting, as well as a corresponding decrease in post-acquisition amortization expense over the useful life of the customer relationship intangible. This approach results in no adjustment to goodwill recorded in the acquisition and allows Entity Z to properly account for Business Software's post-acquisition software license cash collections under Topic 606.

7.025b A contract liability is an obligation to transfer goods or services to a customer for which the acquiree has either received consideration or has an unconditional right to payment under a non-cancellable contract with a customer. For further discussion of contract liabilities, see paragraph 17.084f.

7.025c As ASC Topic 606 specifies that contract assets and contract liabilities for a single contract are presented on a net basis, we believe the unit of account for recognition and measurement of contract assets and liabilities in a business combination is also at the contract level.

LIABILITIES ASSOCIATED WITH RESTRUCTURING OR EXIT ACTIVITIES OF THE ACQUIREE

7.026 Before the effective date of ASC Topic 805, EITF Issue No. 95-3, “Recognition of Liabilities in Connection with a Purchase Business Combination,” specified that costs associated with an acquirer’s plan to (a) exit an activity of an acquiree, (b) involuntarily terminate employees of an acquiree, or (c) relocate employees of an acquiree, should be recognized as liabilities assumed in a business combination if specified conditions were met.

7.027 However, in deliberating ASC Topic 805, the FASB noted that an exit or disposal plan by itself does not create a present obligation and that an entity’s commitment to such a plan is not a sufficient condition for recognition of a liability. Accordingly, ASC Topic 805 nullified EITF 95-3. Under ASC Topic 805, an acquirer recognizes liabilities related to restructuring and exit activities of the acquiree only if they represent an existing substantive liability of the acquiree at the acquisition date and the acquiree has little or no discretion to avoid a settlement of the liability. For restructuring and exit activities of the acquiree that the acquirer initiates, the acquirer incurs a liability associated with the costs only after it gains control of the acquiree’s business. ASC paragraph 805-20-25-2; Statement 141(R), pars. B132-133

7.028 Thus, an acquirer only recognizes the acquisition-date fair value of a liability associated with exit or disposal activities of the acquiree as part of a business combination if those costs meet the criteria for recognition under ASC Subtopic 420-10, Exit or Disposal Cost Obligations - Overall, as of the acquisition date.

7.029 If an exit or disposal activity is undertaken by an acquiree shortly before the date of acquisition, consideration should be given to whether the activity should be accounted for as part of the business combination, or as a separate transaction. If the exit or disposal activity is undertaken at the request of, and for the benefit of, the acquirer, the activity is
not a part of the business combination and should be accounted for as a separate transaction.

7.030 An acquiree may undertake an exit or disposal activity that will be implemented only if a planned business combination occurs. ASC paragraphs 805-20-55-50 through 55-51 indicate that, if a company that has agreed to a business combination develops a plan to terminate certain employees, but the plan will be implemented only if the combination is consummated, a liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination should be recognized only when the business combination is consummated, even if consummation is probable at an earlier date. If the activity was undertaken at the request of the acquirer or was designed primarily for the economic benefit of the acquirer or the combined entity following the acquisition, the associated costs would not be a part of the accounting for the business combination and no liability would be recorded at the acquisition date. Instead, the activity would be accounted for as a separate transaction. See the discussion of Determining What Is Part of the Business Combination Transaction in Section 11.

RESTRUCTURING OR EXIT ACTIVITIES OF THE ACQUIRER AND INTEGRATION COSTS AN ACQUIRER EXPECTS TO INCUR AS A RESULT OF AN ACQUISITION

Restructuring and Exit Activities of the Acquirer

7.031 An acquirer may expect to incur costs associated with restructuring or exit activities related to its preexisting operations as a result of an acquisition. These costs are not liabilities of the acquiree, and are not part of the accounting for the acquisition. Rather, such costs are accounted for in accordance with other applicable GAAP including but not limited to ASC paragraphs 715-30-25-8 through 25-13, ASC Subtopics 712-10 and 420-10.

Integration Costs the Acquirer Expects to Incur

7.032 Costs an acquirer expects to incur to integrate the activities of an acquiree into the acquirer’s operations are neither liabilities of the acquiree nor part of the accounting for the acquisition. The combined entity would capitalize or expense these costs in its postcombination financial statements, based on the nature of the item and the acquirer’s accounting policy for the costs. However, plans to incur certain integration costs may affect the determination of the fair value of assets of the acquired entity. If market participants would be expected to incur integration costs with respect to an asset acquired in a business combination, then the fair value of the asset would be determined giving consideration to such expectation. For example, if market participants would be expected to relocate specialized manufacturing activities of an acquiree to reduce freight costs, then the anticipated costs of relocating the specialized equipment used in the manufacturing process would be considered in determining the fair value of the machinery and equipment.
Examples of planned integration costs that would not be liabilities of an acquiree and would not be recognized in the accounting for the acquisition, but depending on the facts and circumstances, may be capitalized in the postcombination financial statements of the combined entity based on the acquirer’s accounting policy for such costs, if they extend the useful life or enhance the service potential of the related assets, are:

- Costs to purchase new signs with the acquirer’s logo to replace acquiree’s existing signs;
- Costs to upgrade the acquiree’s plant or store locations to meet specifications of the acquirer;
- Costs to upgrade the acquiree’s computer software and hardware; and
- Costs to purchase new computers for the acquiree’s location.

**Example 7.2: Costs to Prepare Acquired Equipment for Its Intended Use**

ABC Corp., a company involved in the mining industry, acquires DEF Corp. in a business combination. The assets acquired from DEF include mining equipment located in an abandoned mine in a remote location. There is no expectation that the mine will be reopened, nor is there a reasonable prospect that a market participant could use the equipment in the immediate surrounding area. ABC decided that, following the acquisition, it will dismantle the acquired mining equipment and transport it to one of its existing mining properties, where it will use the equipment together with existing mining equipment to increase output and lower extraction costs. ABC has also determined that other market participants would dismantle the mining equipment and employ it in a similar manner at mining activities in other locations.

In applying the acquisition method to this transaction, ABC recognizes the mining equipment as an asset, measured at its acquisition-date fair value. The acquisition-date fair value of the equipment might be determined based on observed prices for similar equipment, adjusted for dismantling costs, and differentials in the condition and location of the equipment and installation costs, such that the fair value measurement reflects the current condition and location of the equipment. The cost of dismantling, overhauling and reconditioning, relocating, and reassembling the mining equipment is not a liability at the acquisition date, and thus is not part of the accounting for the acquisition.

Examples of integration costs that would not be liabilities of an acquiree and would not be recognized in the accounting for the acquisition, and would be expensed as incurred are:

- Consulting fees to identify combined entity goals; and
- Advertising costs for a program to announce the acquisition or to promote the combined entity.
RECOGNITION OF PREPAYMENT PENALTIES ASSOCIATED WITH DEBT ASSUMED IN A BUSINESS COMBINATION

7.035 An acquirer recognizes a liability equal to the acquisition-date fair value of the acquiree’s debt assumed by the acquirer as part of the acquisition. If the debt’s terms require it to be extinguished as part of or immediately following a business combination, for example because of a change-in-control provision included in the debt agreement, the fair value of the debt should be determined giving consideration to the contractual provision of the debt agreement requiring prepayment in the event of a change-in-control. See Section 17 for a discussion of the fair value measurement of debt assumed by the acquirer in a business combination.

(ASC TOPIC 842) LEASE CONTRACTS

7.035a ASU 2016-02, Leases, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted. For guidance on accounting for lease contracts assumed in a business combination after an acquirer has adopted ASC Topic 842, see chapter 11 of KPMG’s Handbook, Leases. The guidance in this section addresses accounting for leases assumed in a business combination before an acquirer has adopted ASC Topic 842.

(PRE-ASC TOPIC 842) LEASE CONTRACTS

7.036 Entities enter into lease agreements as the lessor or lessee as part of their normal operations. This section provides recognition and measurement guidance associated with assets and liabilities typically arising from lease contracts. See Section 17 for guidance on the fair value measurement of assets and liabilities arising from lease contracts acquired or assumed in a business combination.

7.037 ASC Topic 840 establishes standards of financial accounting and reporting for leases by lessees and lessors. ASC Subtopic 840-10 describes a lease as:

**ASC Master Glossary: Lease**

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

**ASC Paragraph 840-10-15-9**

This [ASC] Topic also includes agreements that, although not nominally identified as leases, meet the definition of a lease, such as a heat supply contract for nuclear fuel.
The definition of a lease does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. Further, although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment.

Agreements that transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this [ASC] Topic even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

Because a lease is defined as conveying the right to use property, plant, or equipment (land and/or depreciable assets), inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease for accounting purposes because those assets are not depreciable. This [ASC] Topic does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, timber, precious metals, or other nature resources. Similarly, intangibles such as workforce and licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights are not deemed the subject of a lease for accounting purposes even though those assets may be amortized.

If the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment, that arrangement conveys the right to use the property, plant, or equipment. See ASC paragraph 840-10-15-6 for additional guidance in determining whether an arrangement includes a lease.

(Pre-ASC Topic 842) Classification of Leases Acquired in a Business Combination

ASC Topic 805 generally requires that the assets acquired and liabilities assumed in an acquisition be classified or designated by the acquirer based on the contractual terms, economic conditions, the acquirer’s operating or accounting policies, and other pertinent conditions as they exist at the acquisition date. See discussion of Classifying and Designating Identifiable Assets Acquired and Liabilities Assumed in this Section. In an exception to this requirement, ASC Topic 805 specifies that lease contracts assumed by an acquirer in a business combination should be classified (as a capital or operating lease) on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date). (ASC paragraph 805-20-25-8) This is consistent with the guidance previously included in FIN 21, Accounting for Leases in a Business Combination (now ASC paragraph 840-10-35-5). If the provisions of the lease agreement are modified in connection with a business combination in a way that would require the revised...
agreement to be considered a new agreement under ASC paragraph 840-10-35-4, the lease should be classified by the acquirer at the acquisition date in accordance with the criteria in ASC Topic 840.

7.040 As discussed in Exceptions to the Classification Principle, a lease agreement may be modified to reflect a change in the identity of one of the parties to the agreement as a result of a business combination. Such changes are not modifications of the provisions of the lease agreement for this purpose and do not affect the classification of the lease. The acquirer has simply purchased an interest in a lease agreement previously entered into by two other parties.

7.041 ASC Topic 805 amended ASC paragraph 840-10-35-5 to make it clear that an acquirer’s intent at the acquisition date to negotiate the modification of leases of an acquiree subsequent to the acquisition date does not change the classification of the leases:

… At the acquisition date, an acquirer may contemplate renegotiating and modifying leases of the business or nonprofit activity acquired. Modifications made after the acquisition date, including those that were planned at the time of the combination, are postcombination events that shall be accounted for separately by the acquirer in accordance with the provisions of [ASC] Topic [840]. …

(Pre-ASC Topic 842) Summary of Assets and Liabilities Arising from Lease Contracts of an Acquiree Recognized by the Acquirer in a Business Combination

7.042 ASC Topic 805 does not provide recognition or measurement exceptions with respect to lease contracts. Assets and liabilities arising from lease contracts that an acquiree is party to are evaluated for recognition and measurement in accordance with the recognition and measurement principles of ASC Topic 805.

7.043 The following table summarizes assets and liabilities that typically arise from lease contracts of an acquiree assumed in a business combination:

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<thead>
<tr>
<th>Lease Type</th>
<th>Acquiree as</th>
<th>Assets and Liabilities Typically Recognized by Acquirer</th>
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<td>Lessor</td>
<td>Lessee</td>
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<td>Operating leases</td>
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| **Sales-type and direct financing leases** | **Customer relationships and other identifiable intangible assets** | **Lease receivable and unguaranteed residual value of the leased asset** |
| **Leveraged leases** | **Customer relationships and other identifiable intangible assets** | **Net rentals receivable** |
| | | **Estimated residual value of the leased assets** |
| | | **Customer relationships and other identifiable intangible assets** |

* From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases. ASC paragraph 840-10-25-33

**(Pre-ASC Topic 842) In-Place Leases**

**7.044** An acquirer may identify value associated with leases in place at the acquisition date. Value related to in-place leases may reflect, for example, the value associated with avoiding the cost of originating the acquired in-place leases (costs to execute similar leases, including marketing costs, leasing commissions, legal, and other related costs), as well as the value associated with the avoidance of holding costs that would be incurred if an asset intended to be leased was acquired without a lessee. An acquirer should separately measure an intangible asset (or liability) for in-place leases and for favorable (unfavorable) leases on a lease-by-lease basis. Generally, we would expect that the intangible asset for in-place leases, the intangible asset for favorable leases, and the liability for unfavorable leases to be reported separately in the financial statements.

**7.045** We are aware, however, that there is an alternate view that a separate intangible asset for in-place leases should not be recognized by an acquirer in a business combination. Under this view, any value ascribed to in-place leases is subsumed in the measurement of the intangible asset or liability recognized if the terms of the assumed leases are favorable or unfavorable relative to market terms. However, regardless of whether a separate intangible asset is separately recognized, or considered in determining the intangible asset or liability to be recognized for favorable or unfavorable leases, the value ascribed to in-place leases would be the same. Likewise, there should be no difference in the subsequent income recognized by the acquiree in postcombination periods, because the amortization of a separately recognized asset for in-place leases would be the same as the amortization of the recognized intangible asset or liability recognized for favorable or unfavorable leases.

**7.046** The alternative view (i.e., net presentation) is based in part on an analogy to loan origination costs related to loans acquired in a business combination, which are not separately recognized by the acquirer. It is also similar to the FASB’s conclusion...
regarding deferred acquisition costs related to insurance contracts, as discussed in FASB Statement 141(R), par. B190:

The FASB decided that insurance and reinsurance contracts acquired in a business combination should be accounted for on a fresh-start (new contract) basis. Accordingly, all assets and liabilities arising from the rights and obligations of insurance and reinsurance contracts acquired in a business combination are recognized at the acquisition date, measured at their acquisition-date fair values…However, those assets acquired and liabilities assumed would not include the acquiree’s insurance and reinsurance contract accounts such as deferred acquisition costs and unearned premiums that do not represent future cash flows. The FASB considers that model the most consistent with the acquisition method and with the accounting for other types of contracts acquired in a business combination.

7.047 In determining the fair value of a lease agreement from the lessor’s perspective, all of the terms of the lease agreement and the assumptions other market participants (e.g., other lessors) would be expected to make required consideration. Currently obtainable rental rates (the rate at which the asset can be leased) for a similar asset may require adjustment to arrive at the rate used to determine fair value based on the exit price notion in accordance with ASC Subtopic 820-10 (the rental rate at which a market participant would replace the acquirer as the lessor). For example, we believe market participants would consider both the current market rates and the avoided costs normally associated with in-place leases (which normally would not incrementally affect competitive rates) in determining the rental rates they would require to assume another lessor’s position in a lease arrangement.

(Pre-ASC Topic 842) Favorable or Unfavorable Lease Contract Terms

ASC Paragraph 805-20-25-12

Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree’s operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.

7.048 The terms of lease contracts acquired in a business combination may be favorable or unfavorable relative to market terms of comparable leases (e.g., with respect to fixed rental rates, purchase options, renewal provisions, or other terms such as contingent rental payment adjustments based on revenues or price changes). All of the terms should be considered in determining whether a lease contract is favorable or unfavorable. In situations where an acquiree is the lessor in an operating lease contract, we do not believe the acquirer would ascribe significant value to renewal options that are favorable from the lessor’s perspective unless circumstances are such that market participants expect that the lessee will exercise the renewal options. Conversely, if the renewal options are unfavorable from the perspective of the lessor (acquiree), renewal by the lessee would
normally be assumed by the acquirer. See Section 17 for a discussion of the valuation of favorable or unfavorable leases.

7.049 Contingent rentals are generally not recognized outside of a business combination until they become payable. However, the existence of contingent rentals in a lease contract may affect the measurement of an asset or a liability to be recognized by the acquirer as a result of terms that are favorable or unfavorable relative to market terms.

Example 7.3: Contingent Rental Provisions in an Operating Lease

ABC Corp. acquires DEF Corp. in a business combination. DEF is a retailer and leases its retail outlets under operating lease contracts. One of DEF’s operating lease agreements, with a remaining lease period of 8 years, requires a fixed annual lease payment of $500,000 plus an additional contingent rental payment equal to 2.5% of annual sales in excess of $1,000,000. The market rate of an 8-year lease for a similar property is a fixed annual lease payment of $500,000 plus an additional contingent rental payment equal to 2% of annual sales in excess of $1,000,000. ABC has determined that all other terms of the lease contracts are consistent with market terms.

In applying the acquisition method, ABC recognizes a liability for an unfavorable lease contract, due to the unfavorable contingent rental payments relative to market terms for the remaining 8 years of the lease term (i.e., the contingent rental payments of 2.5% on annual sales in excess of $1,000,000 is unfavorable to the market rate of 2% on a comparable lease).

(Pre-ASC Topic 842) Presentation of Assets and Liabilities for Favorable or Unfavorable Operating Lease Contracts Acquired in a Business Combination

7.050 When the acquirer estimates the fair value of acquired operating leases, and determines that some leases are favorable and others are unfavorable, the acquirer should present both the respective asset and liability on its balance sheet. Additionally, a measurement unit should not include both favorable and unfavorable contracts (i.e., assets and liabilities should not be netted).

(Pre-ASC Topic 842) Customer Relationships and Other Identifiable Intangible Assets Associated with Lease Contracts

ASC Paragraph 805-20-25-13

An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants’ willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with [ASC] paragraph 805-20-25-10.
An acquiree’s lease contract may be at market terms, but market participants may be willing to pay a price for the lease because of other identifiable intangible assets associated with the lease agreement. For example, an acquiree who is the lessor in direct financing leases may have established customer relationships that meet the recognition requirements for customer relationship intangible assets in ASC Topic 805. Likewise, an acquiree who is the lessee of assets may have established customer relationships through the use of such assets (e.g., through the sublease of such assets) that might also meet the recognition requirements for customer relationship intangible assets of ASC Topic 805. Customer relationship intangible assets and other identifiable intangible assets associated with lease contracts entered into by the acquiree that meet the recognition requirements of ASC Topic 805 should be separately recognized by the acquirer in its accounting for the acquisition. See the discussion of Recognition of Intangible Assets Separately from Goodwill, including the discussion of Customer-Related Intangible Assets, in this Section and the discussion of valuation of customer relationship intangible assets in Section 17.

Example 7.4: Airport Gate Operating Lease

The amount assigned to an airport gate operating lease contract acquired in a business combination should be the amount a market participant would be willing to pay for the contract. The present value of the rent differential may not be an appropriate basis to estimate the fair value of an acquired gate lease. Generally, airlines lease gates in the U.S. on a cost recovery basis. The per gate lease amount is established annually through reference to the annual operating budget of the airport authority. The airport authority passes on to holders of gate leases a surplus or shortfall of actual-to-budgeted results through lease rate adjustments in the future. Thus, the lease rate currently obtainable from the airport authority (assuming availability of a gate) does not necessarily represent a market rate that could be used to value the acquired lease. Rather, fair value should be determined through reference to market transactions for the purchase of gate leases, adjusted for characteristics of the acquired gate lease.

(Pre-ASC Topic 842) Assets Subject to Operating Leases When the Acquiree Is the Lessor

ASC Paragraph 805-20-30-5

The acquirer shall measure the acquisition-date fair value of an asset, such as a building or a patent or other intangible asset, that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. In other words, the fair value of the asset shall be the same regardless of whether it is subject to an operating lease. In accordance with [ASC] paragraph 805-20-25-12, the acquirer separately recognizes an asset or a liability if the terms of the lease are favorable or unfavorable relative to market terms.

Note that although ASC paragraph 805-20-30-5 refers to a patent or other intangible asset that is subject to an operating lease, such arrangements would not be accounted for as leases under ASC Topic 840 because ASC Topic 840 does not apply to licensing agreements for patents or other intangible assets. ASC paragraph 840-10-15-15
7.052 The fair value of the favorable or unfavorable aspect of an operating lease is separately recognized and measured as an intangible asset or liability by the acquirer, and amortized to lease expense on a straight-line basis over the remaining term of the operating lease subsequent to the acquisition. The fair value of an asset is the same, regardless of whether it is subject to an operating lease. Separate recognition and measurement of the favorable or unfavorable aspect of an operating lease and the asset subject to the operating lease facilitates the appropriate amortization and depreciation of the respective amounts recognized over their respective useful lives. Statement 141(R), pars. B144-B147

Example 7.5: Operating Lease of an Acquiree as the Lessor

ABC Corp. acquires DEF Corp. in a business combination. DEF owns an office building, which is leased to a number of tenants under operating lease contracts for $10 million per year, with average remaining lease terms of 15 years. The market rate for comparable 15-year leases is determined to be $8 million per year. ABC determines that market participants (i.e., lessors of commercial office space) would require a lower rate of return ($7.5 million per year), as a buyer of the leases would not incur marketing costs (including leasing commissions), costs to negotiate and execute similar lease contracts (including legal costs), and other related costs. The operating leases provide the lessees with 2 five-year renewal options, at historical rates plus an inflation factor tied to the consumer price index. All of the renewal options are favorable to DEF (the lessor), and thus are unfavorable to the lessees, with no unusual circumstances causing market participants to assume the renewal options will be exercised. There are no other off-market terms associated with the operating leases.

ABC recognizes the following assets as of the acquisition date:

1. **Building.** The building and related assets are recognized and measured at their acquisition-date fair value, without any consideration being given to the related lease contracts. The building may or may not be valued as a leased building, depending on the determination of its highest and best use as required by ASC Subtopic 820-10.

2. **Favorable Lease Contracts.** ABC recognizes an asset for the favorable lease contracts, due to the difference between the fair value of the future rental payments ($10 million per year) and the current market rentals required by market participants ($7.5 million per year). No value is ascribed to the renewal options, as they are unfavorable to the lessees and there are no unusual circumstances indicating that the lessees will exercise the renewal options.

If another identifiable intangible asset is associated with an operating lease, such as a customer relationship intangible asset, that asset would also be recognized. See Recognition of Intangible Assets Separately from Goodwill in this Section.
(Pre-ASC Topic 842) Assets Subject to Operating Leases When the Acquiree Is the Lessee

ASC Paragraph 805-20-25-11

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

7.053 An acquirer recognizes separately only the assets and liabilities that are specified in ASC paragraphs 805-20-25-12 and 25-13 related to operating leases in which the acquiree is the lessee. An acquirer would also recognize leasehold improvements made by the acquiree at their acquisition-date fair value. See discussion of Operating Leases under Leasehold and Tenant Improvements in this Section.

(Pre-ASC Topic 842) Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases

7.054 Regardless of whether an acquiree is the lessee or lessor, prepaid or accrued rent previously recorded by an acquiree to recognize rental expense or income on a straight-line basis in accordance with the provisions of ASC Topic 840 including ASC paragraph 840-20-25-2 should not be recognized under the acquisition method, as such amounts do not meet the definition of an asset or a liability under Concepts Statement 6. Rather, the remaining future rental payments required under the terms of an operating lease are considered in assessing whether an asset or a liability should be recognized by the acquirer for a favorable or unfavorable contract at the acquisition date.

Example 7.6: Prepaid or Accrued Rent Recognized by an Acquiree on Operating Leases

Q. ABC Corp. purchases DEF Corp. in a business combination. DEF, as lessee, had recorded $5,000 in accrued rent as of the acquisition date as a result of recognizing lease expense on existing operating leases on a straight-line basis in accordance with the provisions of ASC Topic 840. Should ABC recognize the accrued rent as a liability when accounting for the business acquisition?

A. ABC should not recognize the accrued rent recorded by DEF. The accrued rent is not a liability under Concepts Statement 6 and, therefore, is not recognized by ABC in accounting for the business combination. Instead, ABC would recognize an intangible asset related to operating leases for which the terms for the remainder of the lease periods (including the required future rental payments) are favorable relative to market terms, or recognize a liability related to operating leases for which the terms for the remainder of the lease periods are unfavorable relative to market terms. Any intangible asset or liability so recognized would be amortized to lease expense during the postcombination period on a straight-line basis over the remaining term of the operating lease.
(Pre-ASC Topic 842) Capital Lease Contracts of an Acquiree

Capital Lease Assets

7.055 An acquirer should recognize and measure an asset recognized by an acquiree under a capital lease at its fair value at the acquisition date, consistent with the criteria in ASC Topic 840 that resulted in capital lease treatment by the acquiree:

- If the acquired lease was capitalized by the acquiree because the lease transfers title to the lessee (acquiree) or contains a bargain purchase option at the end of the lease term (i.e., under ASC paragraphs 840-10-25-1(a) and (b)), the asset underlying the lease would be recognized and measured by the acquirer at its acquisition-date fair value.

- If the acquired leased asset was capitalized by the acquiree because the lease term is equal to 75% or more of the estimated economic life of the leased property or because the present value of the minimum lease payments equal or exceed 90% of the fair value of the leased property (i.e., under ASC paragraphs 840-10-25-1(c) or (d)), the asset underlying the lease would be recognized and measured by the acquirer at the fair value of the right to use the property for the remaining lease term.

7.056 We do not believe that an acquirer would separately recognize an additional asset or liability related to a favorable or unfavorable contract in either situation, because the fair value measurements of the capital lease asset and capital lease obligation would consider all the terms of the lease contract.

Capital Lease Obligations

7.057 An acquirer recognizes a capital lease obligation assumed in a business combination at its acquisition-date fair value. See Section 17 for a discussion of the determination of the fair value of debt obligations, including capital lease obligations.

(Pre-ASC Topic 842) Leasehold and Tenant Improvements

Operating Leases

7.058 An acquirer recognizes leasehold or other improvements to assets subject to operating leases made by an acquiree, measured at their acquisition-date fair values, regardless of whether the acquiree is the lessor or the lessee.

7.059 An acquiree may be the lessor under an operating lease agreement. In such situations, the acquirer also recognizes leasehold or other tenant improvements made by lessees to the extent the improvements revert to the acquiree (lessor) at the termination of the operating lease agreement. These amounts should be measured at the acquisition-date fair value of the rights to the improvements at the termination of the lease agreement.
Capital Leases

7.060 An acquirer recognizes leasehold or other improvements made by an acquiree to assets for which the acquiree is the lessee under capital lease contracts, using the above guidance for capital lease assets.

(Pre-ASC Topic 842) Sales-Type and Direct Financing Leases

Lease Receivables and Unguaranteed Residual Values

7.061 An acquirer recognizes lease receivables and unguaranteed residual values arising from sales-type and direct financing leases of an acquiree at their acquisition-date fair values, determined based on the assumptions about discount rates and other factors market participants would use. We do not believe that an acquirer would separately recognize an additional asset or liability related to favorable or unfavorable contracts, because measurement of the fair value of the lease receivables and the unguaranteed residual values at fair value would consider all of the terms of the lease contracts.

(Pre-ASC Topic 842) Leveraged Leases

7.062 ASC Subtopic 840-30 provides guidance on the accounting by an acquirer for an acquiree’s investment as a lessor in a leveraged lease.

ASC Paragraph 840-30-25-10

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

ASC Paragraph 840-30-30-15

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

ASC Paragraph 805-40-35-32

In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall subsequently account for its acquired investment as a lessor in a leveraged lease in accordance with the guidance in this Subtopic [840-30] as for any other leveraged lease. Example 5 (see [ASC] paragraph 840-30-55-50) illustrates an acquiring entity's accounting for its acquired investment as a lessor in a leveraged lease.
7.063 See ASC paragraphs 840-30-55-50 through 55-56 for a detailed example and additional guidance on the accounting by an acquirer for an acquiree’s investment in leveraged leases. A leveraged lease that was entered into before the effective date of Topic 842 is not subject to the requirements of that Topic (i.e., leveraged lease accounting continues) unless the lease is modified after the effective date of Topic 842. A leveraged lease acquired in a business combination on or after the effective date of ASC Topic 842 retains its classification as a leveraged lease unless the lease is modified as part of the acquisition. See KPMG’s Handbook, Leases, Question 7.8.250, Acquisition of a grandfathered lease.

(Pre-ASC Topic 842) Additional Considerations Related to Lease Contracts

Leases between an Acquirer and an Acquiree Existing at the Acquisition Date

7.064 An acquirer may have a preexisting relationship with the acquiree in the form of a lease agreement (e.g., where the acquirer is the lessor and the acquiree is the lessee). Regardless of whether there are noncontrolling interests after the acquisition, the lease contract would be effectively settled as a result of the acquisition (as the acquirer consolidates the acquiree following the acquisition). The acquirer recognizes a gain or loss on the effective settlement of the preexisting relationship in an amount equal to the lesser of (a) the amount by which the lease is favorable or unfavorable from the perspective of the acquiree relative to market terms, or (b) the amount of any stated settlement provisions in the lease available to the counterparty to whom the contract is unfavorable. See discussion of Preexisting Relationships in Section 11.

Subleases of an Acquiree

7.065 An acquiree may be party to a sublease agreement. For example, a sublease contract would arise when an acquiree, as the original lessee under an operating lease, subleases some or all of its right to use the leased asset to a third party. The acquirer should recognize an intangible asset or a liability if the terms of the operating lease between the acquiree and the original lessor are favorable or unfavorable from the perspective of the acquiree relative to market terms, and should also separately recognize an intangible asset or a liability associated with the sublease contract if the terms of the sublease contract are favorable or unfavorable from the perspective of the acquiree relative to market terms.

INVOlVEMENT OF A THIRD-PARTY LESSOR IN A BUSINESS COMBINATION (PRE-TOPIC 842)

7.065a In some business combinations, an unrelated third party may acquire an asset directly from the acquiree, and in turn lease that asset to the acquirer. If the transaction between the acquiree and the unrelated third party is contingent on the business combination between the acquirer and the acquiree, the acquirer should account for the sale of the asset by the acquiree and the lease from the unrelated third party as a sale-leaseback transaction.
The acquirer should also account for the sale of the asset by the acquiree and the lease from the unrelated third party as a post-acquisition sale-leaseback transaction if the transaction between the acquiree and the unrelated third party is entered into either (1) after or (2) at or near the same time as the business combination is agreed to by the acquiree and the acquirer. In these cases, it should be presumed that the sale of the asset by the acquiree to the unrelated third party contemplated the subsequent lease of that asset to the acquirer.

RECOGNITION OF INTANGIBLE ASSETS SEPARATELY FROM GOODWILL--PUBLIC BUSINESS ENTITIES

7.066 ASC Section 805-10-20 defines an intangible asset as an asset (not including a financial asset) that lacks physical substance (see Section 26 for a discussion of alternatives available for nonpublic entities). As used in ASC Topic 805, the term *intangible asset* excludes goodwill.

7.067 An acquirer recognizes separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it either:

1. 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 (referred to as the separability criterion); or

2. 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 (referred to as the contractual-legal criterion). ASC Section 805-10-20, ASC paragraph 805-20-25-10

7.068 The separability and contractual-legal criteria were originally developed and included in Statement 141. The issuance of explicit guidance to assist preparers in identifying such assets, and requiring that such assets be accounted for separately from goodwill, was deemed appropriate by the FASB in view of the various types of intangible assets that represent an increasing proportion of the assets of many entities. This guidance was carried forward to ASC Topic 805.

Contractual-Legal Criterion

ASC Paragraph 805-20-55-2

…An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations. For example:

a. An acquiree leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset...
that meets the contractual-legal criterion for recognition separately from goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract. See also [ASC] paragraphs 805-20-25-12 through 25-13.

b. An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the fair value of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

7.069 Many intangible assets arise from rights conveyed legally by contract, statute, or similar means. For example, franchises are granted to automobile dealers, fast food outlets, and professional sports teams; trademarks and service marks may be registered with the government; contracts are often negotiated with customers or suppliers; and patents often protect technological and scientific innovations. The FASB concluded that an intangible asset arising from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill, and an acquired intangible asset with that characteristic should be recognized separately from goodwill. Statement 141(R), par. B163

7.070 All intangible assets acquired in a business combination that meet the contractual-legal criterion are recognized at the acquisition date. Some intangible assets that meet the contractual-legal criterion may also be separable; however, separability is not a required condition for an intangible asset that meets the contractual-legal requirement to be recognized.

Separability Criterion

ASC Paragraph 805-20-55-3

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it.
ASC Paragraph 805-20-55-4

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

7.071 An intangible asset meets the separability criterion if it is capable of being sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. Thus, only the capability of an asset to be separated from the entity and exchanged for something else of value is required, not management’s intent to do so. If the sale, transfer, license, rent or exchange of an intangible asset is restricted by law or agreement, then the separability criterion has not been met.

7.072 If an intangible asset is not capable of being separated from the entity by itself, but can be combined with a related contract, identifiable asset, or liability and separated, the separability criterion is met. This provision is included in ASC Topic 805 to address the FASB’s observation that some intangible assets are so closely related to another asset or liability that they are usually sold as a package; and if those intangible assets were subsumed into goodwill, gains might inappropriately be recognized if the intangible asset was later sold along with the related asset or obligation. However, related contract, identifiable asset, or liability requires a close relationship to the identified intangible asset (e.g., deposit liabilities and the related depositor relationship intangible asset), and does not extend to intangible assets that can only be separated as part of an asset group (ASC Section 360-10-20 defines asset group as “the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities”). Statement 141(R), pars. B166-B167 and B169

7.073 The following examples from ASC paragraph 805-20-55-5 illustrate the identification of acquired intangible assets that are separable from the acquiree only in combination with a related contract, asset, or liability.

Example 7.7: Depositor Relationships

Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognize a depositor relationship intangible asset separately from goodwill.
Example 7.8: Registered Trademarks

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

Items That Are Not Identifiable

7.074 ASC Section 805-10-20 defines goodwill as “an asset representing the future economic benefits arising from other assets acquired in a business combination . . . that are not individually identified and separately recognized.” An intangible asset that does not meet either the separability criterion or the legal-contractual criterion at the acquisition date is subsumed into goodwill. Likewise, any value attributable to items that do not qualify as assets at the acquisition date are subsumed into goodwill. See Section 22 for additional guidance on goodwill and other intangible assets.

Assembled Workforce

7.075 An assembled workforce is an example of an item that is not an identifiable intangible asset, and thus is not recognized separately but is subsumed into goodwill. An assembled workforce is “an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.” ASC paragraph 805-20-55-6

7.076 The FASB noted that because an assembled workforce is a collection of employees, it does not arise from contractual or legal rights (although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract). The FASB also noted that an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset, or liability. An assembled workforce cannot be sold, transferred, licensed, rented, or otherwise exchanged without causing disruption to the acquirer’s business. In contrast, an entity could continue to operate after transferring an identifiable asset. Statement 141(R), par. B178

7.077 We do not believe that a collective bargaining agreement would support recognition of an intangible asset for the workforce covered by the agreement. Such agreements normally do not obligate the covered employees to remain with the employer for a specified period. However, we believe the underlying contract, similar to other contractual agreements, could meet the criteria for identification as a separate intangible asset (favorable contract terms) or a liability (unfavorable contract terms), although we believe these situations would arise only in limited circumstances, such as those in which
the existence of a collective bargaining agreement gives an acquiree a distinct advantage in its competitive marketplace.

7.078 We do not believe that a group of individual employment contracts entered into by an acquiree with a broad group of employees should be viewed, collectively, as an assembled workforce. However, the facts and circumstances in each situation should be evaluated. For example, noncompete provisions included in such contracts should be separately evaluated and recognized as identifiable intangible assets. See discussions of Noncompete Agreements and Employment Contracts in this Section.

Items That Do Not Qualify as Assets at the Acquisition Date

7.079 The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets (i.e., do not meet the definition of assets in Concepts Statement 6) at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because the potential contracts are not themselves assets at the acquisition date, the acquirer does not recognize them separately from goodwill. The acquirer should not reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date. (ASC paragraph 805-20-55-7) See Section 10 for a discussion of the Measurement Period.

7.080 If potential contracts the acquiree was negotiating with new customers at the date of the acquisition were a significant consideration in negotiating and completing the acquisition, and the potential contracts are not obtained following the acquisition, consideration should be given as to whether the event is a change in events or circumstance that would more likely than not reduce the fair value of a reporting unit below its carrying amount and, thus, trigger an impairment test. See Section 22 for additional discussion on frequency of impairment testing.

Illustrative List of Intangible Assets That Are Identifiable

7.081 The following table lists intangible assets that meet the identifiable criteria (i.e., that either arise from contractual-legal rights or are separable) for recognition as intangible assets apart from goodwill. This list, compiled from ASC paragraphs 805-20-55-11 through 55-45 with the addition of in-process research and development, is not intended to be all-inclusive. Additional discussion and examples of intangible assets that would be recognized separately from goodwill are presented following the table. See Section 26 for more information.

<table>
<thead>
<tr>
<th>Contractual / Legal*</th>
<th>Separable**</th>
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<tbody>
<tr>
<td>Marketing-Related</td>
<td>Trademarks and trade names</td>
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<tr>
<td></td>
<td>Service marks, collective marks, and certification marks</td>
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<tr>
<td>Contractual / Legal*</td>
<td>Separable**</td>
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<tr>
<td>Trade dress (unique color, shape, or package design)</td>
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<td>Newspaper mastheads</td>
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<td>Internet domain names</td>
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<td>Noncompete agreements</td>
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<tr>
<th>Customer-Related</th>
<th>Noncontractual customer relationships</th>
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<tr>
<td>Order or production backlog</td>
<td></td>
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<tr>
<td>Customer contracts and related customer relationships</td>
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<tr>
<th>Artistic-Related</th>
<th>Noncontractual customer relationships</th>
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<tr>
<td>Plays, operas, ballets</td>
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<tr>
<td>Books, magazines, newspapers, and other literary works</td>
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<tr>
<td>Musical works such as compositions, song lyrics, and advertising jingles</td>
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<tr>
<td>Pictures and photographs</td>
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<tr>
<td>Video and audiovisual material, including motion pictures or films, music videos, and television programs</td>
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<tr>
<th>Contract-Based</th>
<th>Noncontractual customer relationships</th>
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<tbody>
<tr>
<td>Licensing, royalty, and standstill agreements</td>
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<tr>
<td>Advertising, construction, management, service, or supply contracts</td>
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<tr>
<td>Lease agreements (whether the acquiree is the lessee or the lessor)</td>
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<td>Construction permits</td>
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<tr>
<td>Franchise agreements</td>
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<tr>
<td>Operating and broadcast rights</td>
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<tr>
<td>Use rights (e.g., drilling, water, air, mineral, timber cutting, and route authorities)</td>
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<tr>
<td>Servicing contracts (e.g., mortgage servicing)</td>
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<td>Employment contracts</td>
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<tr>
<th>Technology-Based</th>
<th>Unpatented technology</th>
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<td>Patented technology</td>
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<tr>
<td>Computer software and mask works</td>
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<tr>
<td>Trade secrets (e.g., secret formulas, processes, and recipes)</td>
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<tr>
<td>Databases (e.g., title plants)</td>
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<tr>
<td>In-process research and development</td>
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</table>
* Inangible assets arising from contractual or other legal rights without regard to separability. Assets meeting this criterion might also be separable, but separability is not a necessary condition for an asset to meet the contractual-legal criterion.

** Intangible assets arising because of an ability to separate. Customer lists would not meet the separability criterion to be recognized apart from goodwill if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging the asset. ASC paragraphs 805-20-55-3 through 55-4

Marketing-Related Intangible Assets

7.082 Marketing-related intangible assets are often protected through registration with governmental agencies or by other means and, in such instances, meet the contractual-legal criterion. If such assets do not meet the contractual-legal criterion, they are recognized separately from goodwill only if the separability criterion is met. ASC paragraphs 805-20-55-16 through 55-19 include a discussion of certain marketing-related intangible assets:

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

   ** ASC Paragraph 805-20-55-16

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

   ** ASC Paragraph 805-20-55-17

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

   ** ASC Paragraph 805-20-55-18

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

ASC Paragraph 805-20-55-19

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

Noncompete Agreements

7.083 Noncompete agreements are agreements that place restrictions on a person’s or a business’ ability to compete with another entity and, as such, meet the contractual-legal criterion for recognition as intangible assets. The restrictions generally relate to specified markets and/or specified products or activities for some period of time. These agreements may be entered into on a stand-alone basis, or may be embedded in another agreement, such as an acquisition agreement or an employment contract.

7.084 The valuation of noncompete agreements is often difficult and requires consideration of many factors, including uncertainties about enforceability, the effect of competition absent the noncompete agreement, etc. See Section 17 for a discussion of the fair value measurement of noncompete agreements. Section 26 discusses the private company and not-for-profit accounting alternative related to recognition of noncompete agreements.

Customer-Related Intangible Assets

7.085 Customer-related intangible assets typically include intangible assets that meet the contractual-legal criterion and intangible assets that meet the separability criterion. See Section 26 for a discussion of the private company and not-for-profit accounting alternative related to recognition of certain customer-related intangible assets.

Customer Lists

7.086 A customer list consists of information about customers, such as names and contact information. A customer list also may be a database that includes other information about the customers, such as order histories and demographic information. Customer lists generally do not arise from contractual or other legal rights, but are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion. (ASC paragraph 805-20-55-21) If terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers, the acquired customer list would not meet the separability criterion. ASC paragraph 805-20-55-4

7.087 It is important to distinguish between a customer list and a customer base. A customer list includes specific information about the customer, such as name, contact information, order history, and demographic information. A customer base does not meet the criteria for recognition apart from goodwill because a customer base represents a
group of customers that are neither known nor identifiable to the entity (e.g., the customers that visit a particular fast-food restaurant).

**Order or Production Backlog**

7.088 Order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable. ASC paragraph 805-20-55-22

**Customer Contracts and Related Customer Relationships**

7.089 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree. ASC paragraph 805-20-55-23

7.090 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ. ASC paragraph 805-20-55-24

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

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**Example 7.9: Order Backlog**

Acquirer Company (AC) acquires Target Company (TC) in a business combination on December 31, 20X5. TC does business with its customers solely through purchase and sales orders. At December 31, 20X5, TC has a backlog of customer purchase orders from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of TC’s customers also are recurring customers. However, as of December 31, 20X5, TC has no open purchase orders or other contracts with those customers. Regardless of whether they are cancelable or not, the purchase orders from 60 percent of TC’s customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 percent of its customers through contracts, not only the purchase orders but also TC’s customer relationships meet the contractual-legal criterion. Because
TC has a practice of establishing contracts with the remaining 40 percent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at December 31, 20X5. ASC paragraph 805-20-55-56

Example 7.10: Customer Relationships (No Existing Contracts)

An entity may acquire an acquiree involved in a seasonal business during its off-season when typical customer contracts do not exist. If the acquiree has a practice of establishing customer relationships through contracts at a time other than at the acquisition date, the acquiree’s customer relationships are considered to arise from contractual rights.

7.092 Additional examples of customer contracts and related customer relationships intangible assets are presented below.

Example 7.11: Customer Relationships—Contractual-Legal Criterion

AC acquires TC in a business combination on December 31, 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable. The agreement, whether cancelable or not, meets the contractual-legal criterion.

Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC’s customer relationship with Customer meet the contractual-legal criterion. ASC paragraph 805-20-55-54

Example 7.12: Customer Relationships—More Than One Relationship with a Single Customer

AC acquires TC in a business combination on December 31, 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC 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 TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer’s exclusive supplier of sporting goods, whether cancelable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC’s relationship with Customer related to both sporting goods and electronics. However, if
AC determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, AC would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset. ASC paragraph 805-20-55-55

Example 7.13: Customer Relationships—Contractual-Legal Criterion

AC acquires TC, an insurer, in a business combination on December 31, 20X5. TC has a portfolio of one-year motor insurance contracts that are cancelable by policyholders. Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. ASC Subtopic 350-30 applies to the customer relationship intangible asset. ASC paragraph 805-20-55-57

Example 7.14: Customer Relationships Not Recognized (Contractual-Legal Criterion Not Met) and Customer List Not Recognized Due to Confidentiality Restrictions

ABC Corp. acquires DEF Corp., a medical testing facility, in a business combination on December 31, 20X5. DEF provides testing services to patients, such as blood screening, based on referrals from their physicians (i.e., DEF does not have a contractual relationship with its customers). DEF maintains a database with each patient’s information, such as name, address, telephone number, doctor’s name, insurer’s name, and policy number. DEF’s patients are Medicare patients, and patient information is protected by privacy rules (e.g., HIPPA).

ABC should not recognize a separate intangible asset for DEF’s customer relationships because ABC determines that those relationships do not meet the contractual-legal criterion. Additionally, the customer list does not meet the separability criterion because privacy rules and regulations over patient information prevent selling, transferring, licensing, or exchanging patient information separately from the acquired entity.

Example 7.15: Customer Relationships—Overlapping Customer Relationships – Scenario 1

Q. ABC Corp. acquires DEF Corp. in a business combination. ABC and DEF operate in the same industry and both sell their products to Customer A. Assuming that the relationship meets the separability or legal-contractual criterion, should ABC recognize an intangible asset for DEF’s relationship with Customer, in view of the fact that ABC already has a relationship with Customer A?
A. ABC should recognize a customer relationship intangible asset for DEF’s relationship with Customer. However, the fair value of the asset depends on the specific facts and circumstances. For example, if other market participants are expected to have a customer relationship with Customer A and would not ascribe any value to DEF’s relationship with Customer A as a result of the acquisition of DEF, the intangible asset may have very little value. However, if other market participants are not expected to have a customer relationship with Customer A, or would be expected to place additional value on the relationship as a result of the acquisition of DEF, ABC should recognize the acquired customer relationship as a separately identifiable intangible asset, measured at fair value, based on the assumptions market participants would use.

Example 7.16: Customer Relationships—Overlapping Customer Relationships – Scenario 2

Q. Assume the same fact pattern as Example 7.15, except ABC Corp. intends to discontinue selling the products that are the basis of DEF’s relationship with Customer A. Should ABC recognize the relationship with Customer A as a separately identifiable intangible asset?

A. It depends. If market participants would also discontinue selling the products that are the basis of DEF’s relationship with Customer A and would place no value on the relationship, then ABC would not recognize an intangible asset for DEF’s relationship with Customer A. However, if market participants would continue selling the products that are the basis of DEF’s relationship with Customer A, ABC should recognize the acquired customer relationship as a separately identifiable intangible asset measured at fair value, based on the assumptions market participants would use. See discussion of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use in this Section.

Example 7.17: Acquiree’s Preexisting Customer Relationship With Acquirer Is Not Recognized as a Customer Relationship Intangible Asset by the Acquirer

ABC Corp. acquires DEF Corp., one of its suppliers, in a business combination. One of the strategic reasons for acquiring DEF is to gain access to DEF’s customers (ABC is one DEF’s customers). It would not be appropriate for ABC to include DEF’s relationship with ABC in the measurement of the customer relationship intangible asset arising from the acquisition of DEF, because the asset cannot be disposed of and there are no future economic benefits from the customer relationship that the consolidated entity could realize with parties outside of the group. In addition, from the perspective of the consolidated group, the definition of an asset is not met.
Noncontractual Customer Relationships

7.093 A customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of noncontractual customer relationship would provide evidence that the noncontractual customer relationship is separable. For example, relationships with depositors are frequently exchanged with the related deposits and therefore meet the criteria for recognition as an intangible asset separately from goodwill. ASC paragraph 805-20-55-27

Artistic-Related Intangible Assets

7.094 Artistic-related assets acquired in a business combination are identifiable if they arise from contractual or legal rights such as those provided by copyright. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. An acquirer is not precluded from recognizing a copyright intangible asset and any related assignments or license agreements as a single asset, provided they have similar useful lives. ASC paragraph 805-20-55-30

Contract-Based Intangible Assets

7.095 Many contract-based intangible assets arise from noncancelable executory contracts. Accounting for noncancelable executory contracts acquired in a business combination is similar to accounting for operating leases acquired in a business combination. An asset or liability should be recognized as part of the accounting for the acquisition to the extent the terms of the noncancelable contract are favorable or unfavorable compared with the market terms of the same or similar items at the acquisition date.

7.096 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible asset. If the terms of a contract are favorable or unfavorable relative to market terms, the acquirer recognizes an intangible asset or a liability in its accounting for the acquisition. (ASC paragraph 805-20-55-31) If a separate favorable or unfavorable intangible asset or liability is recognized for a customer contract, we believe the amortization of that asset or liability should be classified as revenue in the income statement. Additionally, an at-market executory contract such as a revenue, lease or other type of contract may also have inherent fair value that gives rise to other identifiable intangible assets that should be recognized in the acquisition accounting. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship.

Licensing Agreements

7.097 Licensing agreements involve contractual arrangements under which the owner (licensor) of an asset (e.g., intellectual property, trademarks, or copyrighted works) grants
permission to a licensee to use the asset, usually for a fee. Licensing agreements typically include terms relating to the fees to be paid by the licensee to the licensor, period of use, stipulations on use (e.g., geographic area), and renewal.

(Pre-ASC Topic 606) Long-Term Construction-Type Contracts

7.098 If an acquiree in a business combination is involved in long-term construction-type contracts (LTCCs), the acquirer should recognize an asset or a liability with respect to each contract of the acquiree that is in process as of the acquisition date. The amount recognized is equal to the acquisition-date fair value of each LTCC. Fair value is the amount market participants would require to be paid or would pay to assume the rights and obligations of the acquiree under the contract, and is not affected by the method used by the acquiree to account for the contract (i.e., the percentage-of-completion method or the completed-contract method). An acquired LTCC may consist of a customer relationship, contract backlog, an off-market component, and an asset (liability) to the extent that costs exceed billings (or vice versa). If some contracts result in the recognition of an asset, and others result in the recognition of a liability, the amounts should be separately presented in the postcombination financial statements of the combined entity (i.e., assets and liabilities should not be offset). In addition, to the extent that a separately identifiable customer relationship intangible asset exists, we believe that its fair value should be recognized separately from the LTCC. See Section 17 for guidance on the measurement of fair value of long-term construction-type contracts.

7.099 The method of accounting used by the acquirer to account for long-term construction-type contracts subsequent to the acquisition is not an accounting policy election, but is based on the facts and circumstances related to each contract. The acquirer should evaluate each acquired contract at the acquisition date to determine the appropriate method of accounting under the provisions of ASC Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts. The method of accounting used by an acquiree to account for a long-term construction-type contract before its acquisition in a business combination is not necessarily determinative of the accounting method to be used by the acquirer after the acquisition.

Purchase and Supply Contracts

7.100 Purchase and supply contracts for the acquisition of supplies or items used in the manufacturing and production process, and contracts for the sale of products, are executory contracts. To the extent the terms of a purchase or supply contract of an acquiree are favorable or unfavorable compared with the market terms for the same or similar items at the acquisition date, the acquirer should recognize an intangible asset or a liability.

Example 7.18: Supply Contracts

Q. An acquiree has several long-term supply contracts on which it is generating operating losses. The losses arise because the business is operating at less than full capacity, and because the selling prices in the contracts are below the market terms of the same or
Should the acquirer recognize a liability at the acquisition date for the supply contracts as part of the acquisition accounting?

**A. Yes.** The acquirer should recognize a liability for the unfavorable contracts. The amount recognized should be the fair value of the amount by which the terms of the supply contract are unfavorable relative to market terms. In this case, the determination of the liability to be recognized would be based on the fair value of the differential between the selling prices in the contracts and the current market terms for the same or similar items at the acquisition date. However, the acquirer should not recognize a liability for the inefficiencies of operating the plant at less than full capacity.

See Sections 16 through 21 for guidance on the measurement of intangible assets or liabilities arising from unfavorable contracts assumed in an acquisition.

*(Pre-ASC Topic 842) Lease Contracts*

**7.101** Various assets and liabilities arise from lease contracts of an acquiree assumed by an acquirer in a business combination.

**Franchise Agreements**

**7.102** Franchise agreements are contractual arrangements through which a party (the franchisor) grants rights to another party (the franchisee) to operate a franchised business for a specified period. The purpose of the agreement is the distribution of a product or service, or an entire business concept, within a particular market area. See ASC Topic 952, *Franchisors*. In addition to intangible assets or liabilities an acquirer recognizes as a result of terms of a franchise agreement entered into by an acquiree that are favorable or unfavorable relative to market terms, there may be additional intangible assets that the acquirer should recognize (e.g., customer list and/or customer contracts and related customer relationships intangible assets).

**Use Rights**

**7.103** Use rights such as drilling, water, air, timber cutting, and route authorities are contract-based intangible assets that are accounted for separately from goodwill. However, certain use rights may have characteristics of tangible assets, rather than intangible assets. For example, certain mineral rights, defined as the right to explore, extract, and retain at least a portion of the benefits from mineral deposits, are tangible assets. Use rights should be accounted for based on their nature. ASC paragraph 805-20-55-37
Servicing Contracts

7.104 Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset (or liability) by one of the following:

(a) If the transfer of the servicer’s financial assets meet the requirements for sale accounting; or
(b) Through the separate acquisition or assumption of a servicing obligation that does not relate to financial assets of the combined entity.

7.105 ASC Subtopic 860-50, Transfers and Servicing - Servicing Assets and Liabilities, provides guidance on accounting for servicing contracts. ASC paragraphs 805-20-55-33 through 55-34

7.106 If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with the servicing obligation, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset. ASC paragraph 805-20-55-35

Employment Contracts

7.107 Employment contracts that are favorable to an acquiree (employer) because the pricing of the contracts is favorable (from the acquiree’s perspective) relative to market terms (using a market participant’s perspective) are recognized as intangible assets by the acquirer. (ASC paragraph 805-20-55-36) Employment contracts that are unfavorable to an acquiree (employer) are recognized as liabilities by the acquirer.

7.108 Identifying employment contracts of an acquiree that are favorable or unfavorable, and that would qualify for recognition as an intangible asset or a liability by an acquirer, will often prove difficult. For example, such identification will first require a determination as to the enforceability of the contract. The measurement of such contracts, if determined to be enforceable, may also prove difficult. For example, if an employment contract is identified as favorable and enforceable, little or no value may be assigned to the contract by the acquirer unless a market participant would be expected to enforce the contract. Similarly, if a contract is identified as unfavorable and enforceable, the measurement of the fair value of the unfavorable contract would take into consideration, among other things, the likelihood that the employee would seek enforcement of the contract, the likelihood that the contract could be settled, and other relevant considerations.

7.109 An example of a situation where favorable or unfavorable employment contracts might be recognized would be the acquisition of a professional sports team where player contracts prohibit or place limitations on players’ ability to move to another team, and prohibit or place limitations of the sports team’s ability to trade its player rights to another team. In such instances, there may be sufficient evidence to support the
enforceability of both favorable and unfavorable player contracts and, in such event, an acquirer would recognize an intangible asset for favorable contracts and a liability for unfavorable contracts, based on the pricing of the contracts relative to market terms.

7.110 Employment contracts entered into by an acquiree may include noncompete provisions. Noncompete agreements should be separately recognized and measured by the acquirer. See Section 17 for a discussion of the measurement of favorable or unfavorable employment contracts and noncompete agreements.

Technology-Based Intangible Assets

Patented and Unpatented Technology

7.111 Technology-related assets generally comprise a set of technical processes, intellectual property, and the institutional understanding within an organization with respect to various processes and products. Those assets generally can be classified as patented and unpatented technology. By definition, a patent is a right granted from the government or other public authorities that confers on the creator the sole right to make, use, or sell an invention for a set period of time. As some companies do not aggressively pursue patents, unpatented or proprietary technology also should be examined. Patented technology with legal protection meets the contractual-legal criterion for recognition as an intangible asset. Unpatented technology may meet the separability criterion to be recognized apart from goodwill unless there are restrictive terms that prohibit an entity from selling, leasing, or otherwise exchanging the technology.

Computer Software and Mask Works

7.112 Computer software and program formats acquired in a business combination that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets. Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works with legal protection that are acquired in a business combination meet the contractual-legal criterion for recognition as intangible assets separately from goodwill. ASC paragraphs 805-20-55-40 through 55-41

Trade Secrets (e.g., Secret Formulas, Processes, and Recipes)

7.113 A trade secret is “information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (1) derives independent economic value, actual or potential, from not being generally known and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.” If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination are identifiable only if the separability criterion is met, which is likely to be the case. However, if the trade secret is not legally protected, the fair value of the trade secret could be lower. ASC paragraph 805-20-55-45
Databases, Including Title Plants

7.114 Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. A database acquired in a business combination that is protected by copyright meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity’s normal operations, such as customer lists, or specialized information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed, or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in a business combination meets the separability criterion. ASC paragraph 805-20-55-42

7.115 Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired in a business combination meet the separability criterion. ASC paragraph 805-20-55-43

Research And Development Assets

Statement 141(R)

B149. This Statement requires an acquirer to recognize all tangible and intangible research and development assets acquired in a business combination, as was proposed in the 2005 Exposure Draft. Previously, FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, required an acquirer to measure and immediately expense tangible and intangible assets to be used in research and development that had no alternative future use. A research and development asset was recognized as such only if it had an alternative future use. …

B150. The FASB concluded that the requirement to immediately write off assets to be used in research and development activities if they have no alternative future use resulted in information that was not representationally faithful. In addition, eliminating that requirement furthers the goal of international convergence of accounting standards. Therefore, this Statement supersedes Interpretation 4 and requires research and development assets acquired in a business combination to be recognized regardless of whether they have an alternative future use.

7.116 Before the issuance of ASC Topic 805, FIN 4 required an acquirer to measure and immediately expense tangible and intangible assets of an acquiree to be used in research and development (R&D) activities, unless such assets had an alternative future use. ASC Topic 805 nullifies FIN 4 and requires all R&D assets acquired in a business combination to be recognized at the acquisition date at their acquisition-date fair value, regardless of
whether they have an alternative future use. See the discussion of Research and Development Activities below and the discussion of the fair value measurement of research and development assets in Section 17.

Research and Development Activities

7.117 The ASC Master Glossary defines research and development as follows:

Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

ASC paragraphs 730-10-15-4(d) through 15-4(e) state that it does not apply to routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though those alterations may represent improvements nor to market research or market testing activities.

7.118 ASC Section 730-10-55 provides the following examples of activities that typically would be included or excluded from R&D activities:

**Example 7.19: Activities That Typically Would Be Included in Research and Development Activities**

a. Laboratory research aimed at discovery of new knowledge.
b. Searching for applications of new research findings or other knowledge.
c. Conceptual formulation and design of possible product or process alternatives.
d. Testing in search for or evaluation of product or process alternatives.
e. Modification of the formulation or design of a product or process.
f. Design, construction, and testing of pre-production prototypes and models.
g. Design of tools, jigs, molds, and dies involving new technology.
h. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production.
i. 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.
Example 7.20: Activities That Typically Would Be Excluded from Research and Development Activities

a. Engineering follow-through in an early phase of commercial production.

b. Quality control during commercial production including routine testing of products.

c. Trouble-shooting in connection with breakdowns during commercial production.

d. Routine, ongoing efforts to refine, enrich, or otherwise improve on the qualities of an existing product.

e. Adaptation of an existing capability to a particular requirement or customer’s need as part of a continuing commercial activity.

f. Seasonal or other periodic design changes to existing products.

g. Routine design of tools, jigs, molds, and dies.

h. Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants, and (2) facilities or equipment whose sole use is for a particular research and development project.

i. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

Research Performed for Others under Contractual Arrangements

7.119 Costs associated with performing R&D activities for others under a contractual arrangement are not R&D activities within the scope of ASC Subtopic 730-10. Indirect costs that specifically are reimbursable under the terms of a contract also are excluded from the scope of ASC Subtopic 730-10. ASC paragraph 730-10-15-4(a)

Completed Research and Development Activities

7.120 Identifiable assets resulting from R&D activities of an acquiree might include patents received or applied for, blueprints, formulas, and specifications or designs for new products or processes. These assets also include assets referred to in practice as core technology and/or base technology. As discussed in this Section, the acquirer recognizes
any such assets arising from an acquisition separately from goodwill, measured at their acquisition-date fair value.

**In-Process Research And Development Activities**

7.121 R&D projects that are underway but have not been completed are referred to as in-process research and development (IPR&D).

**IPR&D Activities Are Subject to ASC Topic 805’s Recognition Principle**

7.122 ASC Topic 805 provides no exception to the recognition principle for IPR&D assets. IPR&D projects acquired in a business combination that meet the definition of an asset in Concepts Statement 6 at the acquisition date are recognized by the acquirer at their acquisition-date fair value.

7.123 Paragraph not used.

**Identifying Research and Development Assets**

7.124 Determining what constitutes an asset used in R&D and measuring its fair value can be difficult. To provide guidance in this area, the AICPA formed a Task Force to develop an AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities* (IPR&D Guide). The IPR&D Guide was issued in December 2013 to identify leading practices in the financial reporting of assets acquired to be used in R&D activities, including specific IPR&D projects. The Task Force noted that business combinations involving the software, electronic devices, and pharmaceutical industries have traditionally exhibited the greatest proportional amount (in terms of total value) of assets acquired to be used in R&D activities. Accordingly, the IPR&D Guide focuses on those industries. Although the IPR&D Guide has no authoritative status, its guidance has been used as a resource by preparers, valuation professionals, and auditors in all industries in identifying, valuing, and reporting IPR&D assets acquired in a business combination.

7.125 The IPR&D Guide reflects guidance in ASC Subtopic 820-10 and ASC Topic 805. ASC Subtopic 820-10 provides a framework for measuring fair value when accounting pronouncements require or permit fair value measurements. See Sections 16 through 21 for a discussion of fair value measurements in accordance with ASC Subtopic 820-10, including the fair value measurement of IPR&D. ASC Topic 805 addresses the accounting for business combinations, and as part of that guidance discusses R&D assets acquired in a business combination.

7.126 ASC Subtopic 820-10 requires a market participant perspective to be used in measuring fair value of assets acquired and liabilities assumed in a business combination. Therefore, it is helpful to consider a market participant’s perspective when identifying IPR&D assets. We believe that if an IPR&D project of an acquiree is expected to have value to a market participant, it would most likely meet the definition of an asset and therefore qualify for recognition by the acquirer at the acquisition date.
Q&A 7.1: Initial Measurement – IPR&D in a Development Arrangement

In 20X7, BioTech Corp. acquires PharmaDev Corp., which has a development arrangement with LabTest, Inc. that entitles each party to 50% of any future cash flows associated with the development, marketing, and sale of a pharmaceutical product.

Q. Does the right to 50% of the future cash flows from the IPR&D project constitute an identifiable asset in a business combination?

A. Yes. ASC paragraph 805-20-25-10 states that an intangible asset is identifiable if it meets the separability criterion or the contractual-legal criterion described in the definition of identifiable in the glossary to ASC Topic 805. In this case, PharmaDev’s right to 50% of the expected cash flows from IPR&D meets the contractual-legal criterion to be recognized as an identifiable intangible asset.

Q&A 7.2: Subsequent Measurement – IPR&D in a Development Arrangement

In 20X8, BioTech Corp. acquires LabTest, Inc., including the other 50% of the future cash flows associated with the IPR&D asset referenced in Q&A 7.1. The IPR&D project is an intangible asset that will be measured and recognized at fair value as of the 20X8 acquisition date.

Q. What effect, if any, will the 20X8 acquisition of the remaining rights to the IPR&D asset have on the existing carrying amount of PharmaDev Corp.’s IPR&D rights acquired in 20X7?

A. The initial intangible asset acquired in 20X7 and the intangible asset acquired in 20X8 should be evaluated as two distinct intangible assets. Specifically:

- A fair value for the additional 50% rights to IPR&D acquired in 20X8 less than the carrying amount of the 50% acquired in 20X7 is an indication that the carrying amount of the 20X7 intangible asset is not recoverable (triggering event) and should be evaluated for impairment.

- A fair value of the additional 50% right to IPR&D acquired in 20X8 greater than the carrying amount of the 50% acquired in 20X7 does not cause a revaluation (write-up) of the 20X7 IPR&D intangible.

7.127 Following is a discussion of additional guidance included in the IPR&D Guide and its relationship to the guidance in ASC Subtopic 820-10 and ASC Topic 805.
An IPR&D Asset Is Recognized Only if an IPR&D Project Has Substance and Is Incomplete

7.128 The IPR&D Guide indicates, in addition to satisfying the general recognition criteria applicable to assets acquired in a business combination to be used in R&D activities, if the asset to be used in R&D activities is a specific IPR&D project, persuasive evidence should exist that each acquired IPR&D project has substance and is incomplete:

- Substance - For a specific IPR&D project of an acquired company to give rise initially to an IPR&D asset, the acquired company has performed R&D activities that constitute more than insignificant efforts and that
  - Meet the definition of R&D under ASC Subtopic 730-10 and
  - Result in the creation of value
- Incompleteness - There are remaining risks (e.g., technological or engineering) or certain remaining regulatory approvals at the date of acquisition, Overcoming those risks or obtaining the approvals requires that additional R&D costs are expected to be incurred after the acquisition.

The IPR&D Guide indicates that, at some point before commercialization and possibly before the end of the development or the pre-production stage, the R&D project is no longer incomplete for accounting purposes. If the project is complete, it is an intangible asset separate and apart from R&D activities.

IPR&D Guide Q&As Illustrating the Assessment of Whether an IPR&D Project Is Incomplete

7.129 The following Q&As taken from the IPR&D Guide illustrate the assessment of whether an IPR&D project is incomplete.

Example 7.21: The IPR&D Guide Q&A, par. 2.60: Specific R&D Projects – Incompleteness

Q. Company T was acquired in a business combination and had an IPR&D project to develop the next generation of its microchip. The project was estimated to be 70 percent complete in terms of costs incurred. Although time-consuming and expensive technological and engineering hurdles remain, they are not believed to be high-risk development issues and are not considered particularly difficult to accomplish. In fact, in similar previous development efforts, Company T consistently demonstrated that it could accomplish the remaining tasks once it got to a similar stage of completion. However, the remaining tasks are of the type described as R&D activities in ASC paragraph 730-10-55-1, rather than of the type of activities described in ASC paragraph 730-10-55-2 that are not considered R&D activities. Is the project incomplete?

A. Yes, because first customer acceptance of the microchip has not occurred. Even though the likelihood of success in achieving first customer acceptance may seem high
based on Company T’s history, first customer acceptance has not occurred, and additional qualifying R&D costs will be incurred. Consequently, completion of the project has not occurred at the date of acquisition.

Example 7.22: The IPR&D Guide Q&A, par. 2.61: Specific R&D Projects – Incompleteness

Q. Company A acquires Company T in a business combination. At the acquisition date, Company T has an R&D project in process to develop the next generation of its job scheduling software. Company T has delivered a working model of the software to several of its customers as part of the beta test stage. As of the acquisition date, engineers are working to incorporate improvements discovered as a result of the beta testing. Company A expects to complete the development and market any resulting product in a manner generally consistent with the plans of Company T that existed at the acquisition date. Is the project incomplete?

A. Yes. The Task Force notes that although the project may have reached technological feasibility as discussed in ASC Subtopic 985-20, in this fact pattern the project is still incomplete. As discussed in ASC paragraph 985-20-25-2, "the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements." Despite reaching technological feasibility, additional research or development, or both, may be required for the product to be available for general release to customers. Conversely, if after reaching technological feasibility, this project required only minor, routine modifications prior to general release to customers, and the general release was imminent, this project would generally be considered to be completed.

Example 7.23: The IPR&D Guide Q&A, par. 2.62: Specific R&D Projects – Incompleteness

Q. Company A acquires Company T in a business combination. At the acquisition date, Company T has an application to market a new drug pending FDA approval. Both Company A and Company T believe that Company T completed all necessary tasks related to the filing (including having obtained satisfactory test results), and they believe that they will ultimately obtain FDA approval. Is the project incomplete?

A. Yes. Industry experience shows that there are uncertainties about obtaining approval for a new drug on filing with the FDA. ASC Subtopic 730-10 does not specifically address whether costs of obtaining FDA approval are R&D; however, the Task Force believes that such future expenditures satisfy the condition that, to be considered incomplete, additional R&D costs must be expected to be incurred by the reporting entity.
Example 7.24: The IPR&D Guide Q&A, par. 2.63: Specific R&D Projects – Incompleteness

Q. Company T is acquired in a business combination and is involved in the design, manufacture, and marketing of consumer video communications devices. Company T has a successful product in the market and has been working on the next generation of the product, which involves significant improvements to features and functions. Given the target market of young retail consumers, Company T plans to debut the new product at an upcoming trade show, followed shortly after by a nationwide marketing campaign. For competitive reasons, Company T does not allow prototypes of the product outside of its facilities, although it does use focus groups representing its target market demographics for feedback on design and features, product and performance quality, and marketing approaches. As of the acquisition date, Company T has approved the design and specifications of the latest prototype of new product as being ready for commercial manufacture. As a result, Company T’s production facilities are preparing to begin mass production of the product intended for commercial sale. However, Company T has yet to finalize specifications of the product shell (e.g., color, ergonomic design, and brand graphics), which are still being tested with focus groups. Commercial manufacturing has not yet begun, and no products have been sold. Is the project incomplete?

A. No. The R&D project related to the significant improvement of the existing product has been completed, and there are no remaining R&D costs to be incurred. The remaining tasks before commercial manufacture and product launch do not involve technological or engineering risks, and the associated costs would not qualify as R&D. Although first customer acceptance has not occurred, Company T has demonstrated an equivalent internal milestone based on its product development practices and life cycle.

7.130 An IPR&D Asset Must Have Substance. The IPR&D Guide indicates that an IPR&D asset will have substance, meaning that the acquirer performed more than insignificant efforts that (a) meet the definition of R&D under ASC Subtopic 730-10, and (b) result in the creation of value. We believe that the examples included in the IPR&D Guide show that the Task Force’s objective in including this criterion was to specify a threshold at which sufficient work had been done for IPR&D to be separately identified. If that threshold is not met, the value otherwise attributable to IPR&D would be subsumed into goodwill unless it meets the general recognition criteria for intangible assets. See discussion of the contractual/legal and separability criteria in this Section under Recognition of Intangible Assets Separately from Goodwill.

7.131 The IPR&D Guide addresses four phases of a project’s life cycle that might be helpful in determining when a project has substance or whether it has been completed. In the earlier phases, the attribute of substance evolves to the point at which substance can be demonstrated, while in the later phases the project gradually reaches a point at which it is no longer considered incomplete. The four phases of a project’s life cycle identified in the IPR&D Guide include:
(a) **Conceptualization.** This phase entails coming up with an idea, thought, new knowledge, or plan for a new product, service, or process, or for a significant improvement to an existing product, service, or process, or it may represent a decision by a company to focus its research activities within certain core competencies. Management might make an initial assessment of the potential market, cost, and technical issues for ideas, thoughts, or plans to determine whether the ideas can be developed to produce an economic benefit.

(b) **Applied research.** This phase represents a planned search or critical investigation aimed at the discovery of additional knowledge in hopes that it will be useful in defining a new product, service, or process that will yield economic benefits, or significantly improve an existing product, service, or process that will yield economic benefits. In addition, work during this phase assesses the feasibility of completing successfully the project and the commercial viability of the resulting expected product, service, or process.

(c) **Development.** This phase represents the translation of research findings or other knowledge into a detailed plan or design for a new product, service, or process, or for a significant improvement to an existing product, service, or process, and carrying out development efforts pursuant to the plan.

(d) **Pre-production.** This phase represents the business activities necessary to commercialize the asset resulting from R&D activities for the enterprise’s economic benefit. The IPR&D Guide, par. 2.45

7.132 The IPR&D Guide lists factors that may demonstrate that a specific IPR&D project has substance:

- The business was acquired to obtain the project, or the project constituted a significant part of the business acquired.
- Management considered the impact of potential competition and other factors (i.e., existing patents that would block plans for further development and commercialization) on the potential economic benefits of the project.
- Management has approved continued project funding.
- Management can make reasonably reliable estimates of the project’s completion date.
- Management can make reasonably reliable estimates of costs to complete the project.

7.133 No single factor is necessarily determinative and judgment will often be needed in evaluating whether a specific IPR&D project has substance.

**The IPR&D Guide Q&As Illustrating the Assessment of Whether an IPR&D Project Has Substance:**

7.134 The following IPR&D Guide Q&As illustrate the assessment of whether an IPR&D project has substance.
Example 7.25: The IPR&D Guide Q&A, par. 2.51: Specific R&D Projects – Substance

Q. Company A, a pharmaceutical company, acquires Company T, a biotechnology company engaged in cancer R&D, in a business combination. Company T is developing a small molecule compound thought to have a therapeutic application in the cancer market. Company T incurs R&D costs in (a) screening approximately 5,000 compounds, (b) identifying a lead compound, and (c) determining that the lead compound has the desired effect on the biological target (a part of the body, such as a protein, receptor, or gene, or something foreign to the body, such as a bacteria or virus, that appears to play an important role in causing certain diseases) whose function is understood and has been validated. The lead compound is considered a potential drug development candidate and Company T has gathered sufficient scientific data to decide to advance this compound to phase I clinical testing (i.e., testing in humans). Based on Company T’s understanding of the biological target’s function and scientific data available in the public domain, Company T is able to make general predictions on potential therapeutic benefits in treating several types of cancer and potential side effects of the compound, if successful. The activities already undertaken by Company T have resulted in R&D expenses incurred. A multi-tumor cancer drug represents a significant market opportunity. Although no detailed market research has been conducted, market projections have been prepared based on patient population and cancer incidence rates. Patent searches have been completed with no patents found that would block Company T’s plans for further development and commercialization of the compound. In addition, Company T has filed for patent protection of this compound. Have sufficient R&D activities been undertaken for this small molecule program such that at the acquisition date the acquired IPR&D project has substance?

A. Yes. The compound that may lead to a possible drug development candidate has progressed far enough through the R&D life cycle to have substance. Company T has selected a specific biological target whose function is understood and has been well validated. Company T has determined that the lead compound has the desired effect on the biological target and does not interact with other tissues in the body. Consequently, it is reasonable to anticipate that this compound may lead to a drug for treating cancer. Company T has gathered enough scientific data to decide to advance this compound to phase I clinical testing. Market potential can be reasonably estimated because incidence of cancer by tumor type is well documented and tracked by several reputable independent organizations. Market share for a particular compound can be estimated by reviewing data currently available in the public domain that tracks patented programs by biologic target from preclinical testing through market launch. Thus, Company T can determine the number of competitors conducting research on a particular biologic target and estimate the potential order of entry, given the competitors’ stages of development. When evaluating whether the acquired IPR&D project has substance, Company T would also need to consider other factors enumerated in Paragraph 7.132 and other relevant circumstances.
Example 7.26: The IPR&D Guide Q&A, par. 2.52: Specific R&D Projects – Substance

Q. Company A acquires Company T in a business combination. Company T designs and markets switches for sale to telecom companies, which use the switches to route telephone communications through their systems. Company T developed a routing technology for a switch that it believes will be pivotal in creating the next generation of switches to route Internet and video data over telephone systems (that is, it had completed the conceptualization and applied research phases of the project). Before the acquisition, Company T surveyed several telecom companies to assist in designing the specifications of the proposed switch. In addition, Company T had a documented plan for development of the switches, which it expected to be complete in 18 months. As of the date of the acquisition, the development of the switches was underway. Have sufficient R&D activities been undertaken such that, at the date of acquisition the specific IPR&D project has substance?

A. Yes. As of the date of the acquisition, Company T had completed the conceptualization and applied research phases of the project and was partially through development of the new switch. As a result, the project satisfied the attribute of substance.

Example 7.27: The IPR&D Guide Q&A par. 2.53: Specific R&D Projects – Substance

Q. Company A acquires Company T in a business combination. Company T is an established contract manufacturer of electronic components. An important aspect of its manufacturing process involves extruding copper wire into extremely fine strands. The R&D department of Company T has as one of its top priorities improving this aspect of the manufacturing process. The basic objective of the project would involve significant improvements to the current process that would further reduce the diameter of the copper strands without significantly increasing manufacturing costs (e.g., through lower yields of acceptable material or increased consumption of energy and indirect materials). As of the date of the acquisition, Company T’s R&D personnel had begun studying possible technological improvements to the extrusion process by researching relevant technical and academic material in the public domain. Company T’s R&D personnel also conducted an all-day brainstorming session in which a number of theoretical approaches were debated. As a result of that meeting, a consensus on the most promising approach was identified and a project plan was being drafted that would define expected timing, resource requirements, and key technical issues of the R&D project. Company T believes that the project has a fairly high likelihood of success. Have sufficient R&D activities been undertaken such that, at the acquisition date, the specific IPR&D project has substance?
A. No. At the date of the acquisition, Company T’s R&D project had only been conceptualized. Company T had not expended a more than insignificant effort in R&D activities to advance existing knowledge and technology toward the project objective. As a result, although the project concept was promising, the project lacked substance at the acquisition date and would not qualify to be recognized as an asset.

In-Process Research and Development Assets That an Acquirer Does Not Intend to Actively Use

ASC Paragraph 805-20-30-6

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

7.135 A business combination may result in the acquisition of IPR&D or other intangible assets that the acquirer does not intend to actively use (commonly referred to as defensive intangible assets or locked-up assets). While such assets are not being actively used, they are likely contributing to an increase in the value of other assets owned by the acquirer.

7.136 ASC Topic 805 and ASC Subtopic 820-10 require that defensive intangible assets be recognized at a value that reflects the asset’s highest and best use based on market participant assumptions. See discussion of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use in this Section.

7.137 Subsequent to an acquisition, the acquirer accounts for acquired IPR&D assets in accordance with ASC paragraphs 350-30-35-15 through 35-17A. See the discussion of Defensive Intangible Assets in Section 12, Subsequent Measurement and Accounting.

Considerations for Financial Services Entities – Customer-Related Intangible Assets

7.138 An acquisition of a financial institution may include many of the types of intangible assets discussed previously. Because services performed by financial institutions are based on contractual relationships with the institution’s customers, there are many types of customer-related intangible assets present in acquisitions of financial institutions. To ensure that all identifiable intangible assets are recognized, careful consideration should be given to the customer relationship from which projected cash
flows originate. Contractual- and noncontractual-based customer-related intangible assets unique to a financial institution include:

- Core Deposit
- Borrower Base
- Credit-Card Customer-Based
- Mortgage Loan Servicing Rights
- Trust Services
- Private Banking Customer
- Asset Management and Advisory
- Brokerage
- Customer Information Databases

RECOGNIZING ANY NONCONTROLLING INTEREST IN AN ACQUIREE

7.139 As discussed in Section 2, a business combination occurs when an acquirer obtains control of one or more businesses. Applying the acquisition method requires that, at the acquisition date, the identifiable assets acquired and liabilities assumed in an acquisition be recognized and measured by the acquirer in accordance with ASC Topic 805 (i.e., full step-up), and that any noncontrolling interest in the acquiree be measured and recognized at fair value. Noncontrolling interest includes only financial instruments issued by an acquired subsidiary that are classified as equity in the subsidiary’s financial statements.

Example 7.28: Recognizing Noncontrolling Interest at Fair Value

On December 31, 20X0, ABC Corp. acquires 60% percent of DEF Corp. for cash of $1,100 (which includes a control premium). The amount of the identifiable net assets of DEF Corp., measured in accordance with ASC Topic 805, is $1,400. The fair value of the noncontrolling interest (i.e., the equity of DEF not acquired by ABC) is $600.

Under ASC Topic 805, ABC recognizes the identifiable net assets of DEF at $1,400 (full step-up to amounts measured in accordance with ASC Topic 805), the noncontrolling interest at its fair value of $600, and the resulting goodwill at $300 ($1,100 + $600 - $1,400). The net effect of the acquisition of DEF is recognized in ABC’s consolidated financial statements as of December 31, 20X0 as follows:
**DEBIT** | **CREDIT**
---|---
Identifiable net assets of DEF | 1,400
Goodwill* | 300
Equity (noncontrolling interest) | 600
Cash | 1,100

*Although presented as one financial statement caption on the parent’s balance sheet, if goodwill is subsequently determined to be impaired, the impairment loss is required to be attributed to the parent and the noncontrolling interest on a rational basis. The goodwill attributable to ABC is $260 (($1,100 - (60% × $1,400)), and the goodwill attributable to the noncontrolling interest is $40 (($600 - (40% × $1,400). The subsequent impairment loss might be attributed to ABC on the basis of $260/$300, and to the noncontrolling interest on the basis of $40/$300. See *Goodwill Impairment Testing and Disposal of All or a Portion of a Reporting Unit When the Reporting Unit Is Less Than Wholly Owned* in Section 22.

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**MEASUREMENT PRINCIPLE**

**ASC Paragraph 805-20-30-1**

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

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4 See discussion of the exceptions to this principle in this Section under Exceptions to the Recognition and Measurement Principles. These exceptions relate to assets and liabilities arising from contingencies, deferred tax assets and liabilities and uncertain tax positions, indemnification assets, employee benefits, reacquired rights, share-based payment awards, and assets held for sale.

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7.140 ASC Topic 805 requires an acquirer to measure the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, with limited exceptions, which are discussed in this Section under Exceptions to the Recognition and Measurement Principles. ASC Topic 805 does not provide guidance on how to determine fair values, but instead states that fair value is determined in accordance with ASC Subtopic 820-10. See Sections 16 through 21 on Fair Value Measurements, for additional guidance on the fair value measurement of assets acquired and liabilities assumed and any noncontrolling interest in the acquiree.

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7.141 In applying the fair value measurement guidance of ASC Subtopic 820-10, acquirer-specific intent on how an acquired asset will be used is not considered in determining its fair value. Rather, ASC Subtopic 820-10 requires that fair value be determined using a market participant’s perspective, rather than the acquirer’s specific planned use or non-use of an acquired asset. See discussion in this Section of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use.
APPLICATION GUIDANCE RELATED TO MEASURING THE FAIR VALUES OF PARTICULAR IDENTIFIABLE ASSETS AND A NONCONTROLLING INTEREST IN AN ACQUIREE

ASSETS WITH UNCERTAIN CASH FLOWS (VALUATION ALLOWANCES)


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<tr>
<td>Public business entities that are SEC filers</td>
<td>December 15, 2019</td>
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<td>Public business entities that are not SEC filers</td>
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<td>December 15, 2021</td>
</tr>
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(Pre-ASC Topic 326) ASC Paragraph 805-20-30-4

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

7.142 Separate valuation allowances for receivables acquired in a business combination are not recognized at the acquisition date, as the effects of uncertainty about future cash flows are considered in the measurement of fair value. However, ASC Topic 805 requires
that the acquirer disclose, for each business combination that occurs during a reporting period, separately for acquired receivables that are not subject to the requirements of ASC Subtopic 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality*, the fair value of the receivables, the gross contractual amounts receivable, and the best estimate at the acquisition date of the contractual cash flows not expected be collected. These disclosures are required for each major class of receivables, such as loans, direct finance leases, and any other class of receivables. ASC paragraph 805-20-50-1(b)

**Example 7.29: Acquired Trade Receivables – Valuation Allowance**

**Q.** ABC Corp. acquires DEF Corp. in a business combination. At the acquisition date, ABC determines that the trade accounts receivable acquired from DEF of $2,000 had a fair value of $1,800. The $200 difference between the contractual amount and the fair value of the trade receivables was attributed to the estimated credit risk of $180 (i.e., estimated uncollectible accounts), and a reduction of $20 to reduce the receivables expected to be collected to their present value, using an appropriate interest rate. How should ABC reflect the trade receivables in its acquisition accounting?

**A.** ABC should recognize the acquired trade receivables at their acquisition-date fair value of $1,800, with no associated valuation allowance. Based on ASC paragraph 805-20-50-1(b), ABC would disclose in its financial statements the fair value of the receivables, the gross contractual amounts of the receivables, and the best estimate at the acquisition date of the contractual cash flows not expected to be collected.

Subsequent to the acquisition, ABC would accrete the $20 discount to income using the interest method. Accounting for the difference between actual collections and the amounts recognized at the acquisition date, as well as determining whether an allowance for uncollectible accounts is necessary in the postcombination period, will depend on subsequent assessments of collectibility and the units of account identified by the acquirer for the acquired receivables.

**(PRE-ASC TOPIC 842) ASSETS SUBJECT TO OPERATING LEASES IN WHICH THE ACQUIREE IS THE LESSOR**

7.143 ASC Topic 805 requires that an acquirer recognize and measure the acquisition-date fair value of an asset subject to an operating lease in which the acquiree is the lessor, such as a building or a patent or other intangible asset, at its acquisition-date fair value separately from the lease contract. The acquirer recognizes a separate intangible asset or liability if the terms of the related operating lease are favorable or unfavorable relative to market terms. Therefore, the fair value of the leased asset would be the same regardless of whether it is subject to an operating lease. (ASC paragraph 805-20-30-5; Statement 141(R), par. B147) The acquirer would also recognize an asset or liability for a favorable or unfavorable contract to the extent the terms of the operating lease are favorable or unfavorable to the lessor (acquiree) relative to market terms. See discussion of Assets
Subject to Operating Leases When the Acquiree Is the Lessor under Lease Contracts in this Section.

ASSETS THAT THE ACQUIRER INTENDS NOT TO USE OR TO USE IN A WAY OTHER THAN THEIR HIGHEST AND BEST USE

ASC Paragraph 805-20-30-6

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

7.144 A business combination may result in the acquisition of assets, including IPR&D or other intangible assets, that the acquirer does not intend to actively use, or intends to use in a way that is not its highest and best use (these assets are commonly referred to as defensive assets or locked-up assets). While such assets are not being actively used, they are likely contributing to an increase in the value of other assets owned by the acquirer.

7.145 Although defensive intangible assets are not actively used by the acquirer, ASC Topic 805 and ASC Subtopic 820-10 require that defensive intangible assets be recognized at a value that reflects the asset’s highest and best use based on market participant assumptions.

Example 7.30: Acquirer Does Not Intend to Use Acquired Trade Name

As part of a business combination, an entity acquires a trade name that it does not intend to use, but which would provide maximum value to market participants through its use in combination with other assets. The acquirer should recognize and measure the trade name at its acquisition-date fair value, using an in-use valuation premise, because in-use is the highest and best use by market participants.

Example 7.31: Acquired IPR&D the Acquirer Does Not Intend to Use

The reporting entity acquires an IPR&D project in a business combination. The reporting entity does not intend to complete the IPR&D project. If completed, the IPR&D project would compete with one of its own IPR&D projects (to provide the next generation of the reporting entity’s commercialized technology). Instead, the reporting entity intends to hold (lock up) the IPR&D project to prevent its competitors from obtaining access to the technology. The IPR&D project is expected to provide defensive value, principally by
improving the prospects for the reporting entity’s own competing technology. For purposes of measuring the fair value of the IPR&D project at initial recognition, the highest and best use of the IPR&D project would be determined based on its use by market participants. See ASC paragraph 820-10-55-32 for additional analysis as to whether the highest and best use of the IPR&D would be in-use or in-exchange.

7.146 See the discussion of In-Process Research and Development Assets that an Acquirer Does Not Intend to Actively Use, in this Section, and the discussion of Defensive Intangible Assets in Section 12.

CONTINGENT CONSIDERATION ARRANGEMENTS OF AN ACQUIREE ASSUMED BY THE ACQUIRER

ASC Paragraph 805-20-30-9A
Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured initially at fair value in accordance with the guidance for contingent consideration arrangements in [ASC] paragraph 805-30-25-5.

7.147 The acquiree may have contingent consideration from one or more of its acquisitions before being acquired by the acquirer. ASC paragraph 805-20-30-9A specifies that this is recognized and measured in the same manner as any contingent consideration agreed to between the acquirer and the acquiree. However, unlike contingent consideration agreed to between the acquirer and acquiree, which is part of the consideration transferred (see Section 6), we believe that contingent consideration of the acquiree is treated as a liability assumed in the acquisition rather than as consideration transferred.

MEASURING THE FAIR VALUE OF A NONCONTROLLING INTEREST IN AN ACQUIREE

ASC Paragraphs 805-20-30-7
[ASC] paragraph 805-20-30-1 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. An acquirer sometimes will be able to measure the acquisition-date fair value of a noncontrolling interest on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the noncontrolling interest using another valuation technique.

ASC Paragraph 805-20-30-8
The fair values of the acquirer’s interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer’s interest
in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

7.148 Under ASC paragraph 805-20-30-1, noncontrolling interests are measured at fair value at the date of acquisition. See Section 19 for a discussion of the fair value measurement of noncontrolling interests.

EXCEPTIONS TO THE RECOGNITION AND MEASUREMENT PRINCIPLES (PRE-ASC TOPIC 8423)

7.149 ASC Topic 805 provides certain exceptions to the recognition and measurement principles that are applied at the acquisition date in recognizing and measuring the assets acquired, liabilities assumed, and any noncontrolling interest in an acquiree.

7.150 The exceptions to the recognition or measurement principles are as follows:

<table>
<thead>
<tr>
<th>Exceptions to Both the Recognition and Measurement Principles</th>
<th>Exceptions to the Measurement Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and liabilities arising from contingencies</td>
<td>Reacquired rights</td>
</tr>
<tr>
<td>Deferred tax assets and liabilities and tax uncertainties</td>
<td>Share-based payment awards</td>
</tr>
<tr>
<td>Employee benefits</td>
<td></td>
</tr>
<tr>
<td>Indemnification assets</td>
<td>Assets held for sale</td>
</tr>
</tbody>
</table>

7.151 Assets acquired and liabilities assumed in an acquisition that are subject to these limited exceptions are recognized and measured in accordance with the specific guidance provided in ASC Topic 805, rather than based on the general recognition and measurement principles of ASC Topic 805. ASC paragraphs 805-20-25-16 and 30-10

7.152 Subsequent to a business combination, assets acquired and liabilities assumed or incurred, and equity instruments issued in the acquisition are generally measured and accounted for in accordance with the applicable GAAP. However, ASC Topic 805 provides specific guidance on the subsequent measurement and accounting for certain assets acquired, liabilities assumed, and equity instruments issued in a business combination, including guidance with respect to most of the items that are subject to the exceptions to the recognition and measurement principles of ASC Topic 805. See the discussion of Subsequent Measurement and Accounting in Section 12.
Exceptions to Both the Recognition and Measurement Principles

7.153 ASC Topic 805 provides for four exceptions to both its recognition and measurement principles. Those exceptions are for assets and liabilities arising from contingencies, deferred tax assets and liabilities and tax uncertainties, indemnification assets, and employee benefits.

Assets and Liabilities Arising from Contingencies

ASC Paragraph 805-20-25-18A
The following recognition guidance in [ASC] paragraphs 805-20-25-19 through 25-20B applies to assets and liabilities meeting both of the following conditions:

a. Assets acquired and liabilities assumed that would be within the scope of [ASC] Topic 450 if not acquired or assumed in a business combination

b. Assets or liabilities arising from contingencies that are not otherwise subject to specific guidance in [ASC Subtopic 805-20].

ASC Paragraph 805-20-25-19
If the acquisition-date fair value of the asset or liability arising from a contingency can be determined during the measurement period, that asset or liability shall be recognized at the acquisition date. For example, the acquisition-date fair value of a warranty obligation often can be determined.

ASC Paragraph 805-20-25-20
If the acquisition-date fair value of the asset or liability arising from a contingency cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if both the following criteria are met:

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

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

ASC Paragraph 805-20-25-20A
The criteria in the preceding paragraph shall be applied using the guidance in [ASC] Topic 450 for application of similar criteria in [ASC] paragraph 450-20-25-2.

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

**ASC Paragraph 805-20-30-9**

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

**ASC Paragraph 805-20-30-23**

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

**7.154** Under ASC Topic 805, assets and liabilities arising from contingencies of an acquiree existing at the acquisition date are evaluated for recognition and measurement using a two-step process. First, the acquirer needs to consider whether the fair value of an asset or liability arising from a contingency is determinable. If so, then the asset or liability is recognized at its fair value at the acquisition date. In making this determination, the acquirer should consider all information available during the measurement period that bears on whether the fair value of the contingency was determinable as of the acquisition date.

**7.155** ASC paragraph 805-20-25-19 indicates that the FASB believes that the fair value of a warranty obligation generally will be determinable and therefore it is expected that warranty obligations will be measured at fair value by the acquirer in most circumstances. Apart from warranty obligations, based on discussions with the FASB staff, we understand that the FASB did not intend to change the guidance on accounting for contingencies acquired or assumed in a business combination from that which existed under Statement 141.

**7.156** Paragraph 40(a) of Statement 141 contained the following guidance on recognition of preacquisition contingencies at fair value:

> If the fair value of the preacquisition contingency can be determined during the allocation period, that preacquisition contingency shall be included in the allocation of the purchase price based on that fair value.

Additionally, footnote 14 attached to paragraph 40(a) stated: “For example, if it can be demonstrated that the parties to a business combination agreed to adjust the total consideration by an amount because of a contingency, that amount would be a determined fair value of that contingency.”
In practice, the guidance in footnote 14 of Statement 141 is understood to mean that there is a high threshold to be met when evaluating whether fair value of such contingencies can be determined. However, paragraph B10 of FSP FAS 141(R)-1, “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies,” states: “In the deliberations leading to this FSP, the Board decided to adopt a model similar to the guidance in Statement 141 to address the application issues raised by constituents.” Accordingly, while the Board did not carry forward footnote 14 into ASC paragraph 805, we believe that the approach taken previously under Statement 141 continues to be applicable for contingencies arising in a business combination with the exception of warranty obligations.

If the fair value of an asset acquired or liability assumed arising from contingencies is not determinable as of the measurement date (including consideration of all information available during the measurement period), then the second step is to apply the probable and reasonably estimable criteria of ASC Topic 450 to the contingency. If those criteria are met, the contingency is recognized at its estimated amount, including consideration of the guidance in ASC paragraph 450-20-30-1. If, in applying the second step, it either is not probable that an asset or liability exists at the acquisition date or the amount is not reasonably estimable, then the contingency is not recognized in the acquisition accounting. Contingencies that arise as a result of the acquisition, did not exist at the acquisition date, or did not meet the recognition criteria at the acquisition date, are not part of the acquisition accounting and are accounted for separately in accordance with other applicable GAAP, including ASC Topic 450. See the discussion of Subsequent Measurement and Accounting in Section 12.

Deferred Tax Assets and Liabilities and Tax Uncertainties

Deferred tax assets and liabilities that arise as a result of 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, should be recognized and measured in accordance with ASC Topic 740, Income Taxes, including the guidance on uncertain income taxes. (ASC paragraphs 805-740-25-2 and 30-1) The FASB decided not to require measurement of deferred tax assets and liabilities at their acquisition-date fair values because of potential postcombination gains and losses that may result immediately following the acquisition when applying the measurement provisions of ASC Topic 740. (Statement 141(R), par. B281; ASC paragraphs 805-740-25-2 and 30-1) See KPMG's handbook, Accounting for Income Taxes Section 6 for a discussion of income tax considerations in a business combination.

Employee Benefits

ASC Paragraph 805-20-25-22

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

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

ASC Paragraph 805-20-25-24


ASC Paragraph 805-20-25-25

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

ASC Paragraph 805-20-25-26

See also the recognition-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See [ASC] Section 420-10-25.


c. Deferred compensation contracts. See [ASC] Section 710-10-25.


ASC Paragraph 805-20-30-14

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

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

ASC Paragraph 805-20-30-16

The Settlements, Curtailments, and Certain Termination Benefits Subsections of [ASC] Section 715-30-35 establish the measurement guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

ASC Paragraph 805-20-30-17

See also measurement-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See [ASC] Section 420-10-25.


c. Deferred compensation contracts. See [ASC] Section 710-10-25.


7.160 In its deliberations of ASC Topic 805, the FASB concluded that it was not feasible to require all employee benefit obligations assumed in a business combination to be measured at their acquisition-date fair values without a comprehensive reconsideration of the relevant standards for those benefits. The FASB decided to require that such obligations and related assets be measured in accordance with other applicable standards. Statement 141(R), par. B299; ASC paragraphs 805-20-25-23 through 25-26

7.161 Certain considerations in the application of other standards at the acquisition date related to the recognition and measurement of employee benefits as the result of an acquisition are discussed below.

Pension-Related Assets and Liabilities

Single-Employer Defined Benefit Plans

7.162 ASC Subtopic 715-30 requires the acquirer to recognize, as part of the accounting for the business combination, an asset or a liability representing the funded status of the plan. If, at the acquisition date, the fair value of the plan assets exceeds the projected
benefit obligation, an asset is recognized; however, if the projected benefit obligation exceeds the fair value of the plan assets, a liability is recognized. ASC Subtopic 715-30 requires that the measurement of the funded status of the plan exclude the effects of expected plan amendments, terminations, or curtailments that the acquirer has no obligation to make at the acquisition date, and specifies that the projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer’s assessment of relevant future events. ASC paragraph 805-20-30-15

7.163 An acquirer is required to determine the fair value of the plan assets and the projected benefit obligation at the acquisition date, and recognize in its accounting for the acquisition either an asset or a liability, equal to the difference between the fair value of the plan assets and the projected benefit obligation. The determination of the projected benefit obligation includes any necessary changes in assumptions based on the acquirer’s assessment of relevant future events. These events include the actuarial assumptions necessary to measure the projected benefit obligation (e.g., the discount rate, mortality assumptions, turnover, and compensation increases).

Example 7.32: Funded Status of a Single-Employer Defined Benefit Pension Plan of an Acquiree before and after a Business Combination

ABC Corp. acquires DEF Corp. in a business combination on April 30, 20Y0. DEF sponsored a single-employer defined benefit pension plan. At December 31, 20X9, DEF’s financial statements reflected a $300 net unfunded obligation and a debit balance in accumulated other comprehensive income of $100, which represented $75 of accumulated actuarial losses and $25 of prior service cost not yet recognized in earnings. In the 4 months ended April 30, 20Y0, DEF recorded $100 of net periodic pension cost in accordance with ASC Subtopic 715-30. This included $2 of amortization of prior service cost, no amortization of the actuarial loss (because the amount at the prior year-end was within the corridor) and $15 of expected return on plan assets. There were no benefits paid during the period. The funded status of DEF’s plan at the most recent audited balance sheet date and a rollforward to the acquisition date is:

<table>
<thead>
<tr>
<th>Projected Benefit Obligation</th>
<th>Plan Assets</th>
<th>Funded Status</th>
<th>AOCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X9</td>
<td>($1,000)</td>
<td>($300)</td>
<td>$100</td>
</tr>
<tr>
<td>Net periodic pension cost recorded by DEF in accordance with ASC Subtopic 715-30 from January 1, 20Y0 to April 30, 20Y0</td>
<td>($113)</td>
<td>($98)</td>
<td>($2)</td>
</tr>
<tr>
<td>DEF’s pension accounts as of April 30, 20Y0</td>
<td>$715</td>
<td>($398)</td>
<td>$98</td>
</tr>
</tbody>
</table>
The acquisition agreement provides that ABC will continue DEF’s defined benefit pension plan without any changes. ABC engaged its actuaries to determine the projected benefit obligation of DEF’s plan as of the acquisition date. Based on updated measurements of plan assets and benefit obligations, including appropriate changes to actuarial assumptions, as of April 30, 20Y0, the projected benefit obligation is $1,250. In addition, ABC obtained information from the plan trustee indicating that the fair value of plan assets as of that date is $750.

As a result of this information, ABC records a net unfunded pension obligation of $500 related to DEF’s pension plan in its financial statements, comprised of a $1,250 projected benefit obligation and $750 fair value of plan assets. ABC does not record amounts in AOCI as of the acquisition date related to actuarial losses or prior service cost that previously were recorded in DEF’s financial statements.

Example 7.33: Plan Amendments an Acquirer Is Not Required to Make

Assume the same facts as in Example 7.32, except that ABC Corp. plans to make certain amendments to the DEF plan after the acquisition; however, there is no obligation for ABC to make the planned amendments.

The determination of the asset or liability representing the funded status of DEF’s plan, as illustrated in Example 7.32, is not affected by the planned amendments, because ABC has no obligation to make the amendments. Instead, the amendments, when made, are accounted for as plan amendments in accordance with ASC Subtopic 715-30. Therefore, an increase or decrease in the projected benefit obligation (i.e., prior service cost or negative prior service cost) as a result of the amendments would be initially offset by a charge or credit to other comprehensive income at the date of the amendment, and subsequently amortized as a component of net periodic pension cost in accordance with ASC Subtopic 715-30.

Example 7.34: Employees of Acquiree Included in Pension Plan of Acquirer

Q. If the acquirer includes the employees of the acquiree (which did not have a pension plan) in its pension plan and grants them credit for prior service, how is the credit granted for prior service accounted for?

A. If the acquirer’s granting of credit for prior service to the employees of the acquiree is required to complete the acquisition, it is part of the acquisition and is included in the acquisition accounting. If the granting of credit for prior service is not a requirement to complete the acquisition, it is not part of the acquisition and is not included in the acquisition accounting, but rather is accounted for as a plan amendment in the acquirer’s postcombination financial statements.
If the credit granted for prior service is part of the acquisition, the debit offsetting the increase in the projected benefit obligation is an increase in goodwill (or a decrease in the gain from a bargain purchase) recognized in the acquisition accounting. If the credit granted for prior service is accounted for as a plan amendment in the acquirer’s postcombination financial statements, the increase in the projected benefit obligation resulting from the amendment is included in the projected benefit obligation, with an offsetting charge to other comprehensive income as prior service cost, and subsequently amortized as a component of net periodic pension cost. ASC paragraphs 715-30-35-11 and 35-13

**Multiemployer Pension Plans**

7.164 If the acquiree in a business combination participates in a multiemployer pension plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer recognizes as part of the business combination a withdrawal liability in accordance with ASC Topic 450. ASC paragraph 805-20-25-23

**Postretirement Benefits Other Than Pensions**

7.165 ASC Subtopic 715-60 specifies the appropriate accounting for other postretirement benefits-related assets and liabilities of an acquiree. The accounting specified in ASC Subtopic 715-60 is similar to the accounting required by an acquirer under ASC Subtopic 715-30 when an acquiree sponsors a single-employer defined benefit plan.

**Single-Employer Defined Benefit Postretirement Plans**

7.166 If an acquiree sponsors a single-employer defined benefit postretirement plan, ASC Subtopic 715-60 requires the acquirer to recognize as part of the acquisition accounting an asset or a liability representing the funded status of the plan. The funded status of each plan is measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation. ASC Subtopic 715-60 was amended by ASC Topic 805 to specify that the measurement of the funded status of the plan excludes the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make, and requires that the accumulated postretirement benefit obligation assumed reflects any other necessary changes in assumptions based on the acquirer’s assessment of relevant future events. ASC paragraph 805-20-30-15

**Example 7.35: Postretirement Benefit Plan That Will Be Amended as a Condition of the Acquisition Agreement**

ABC Corp. acquires DEF Corp. in a business combination. DEF sponsors a postretirement benefit plan that provides postretirement health care benefits to its employees, subject to a $500 annual deductible to be paid by the employees. As a condition of the acquisition agreement, DEF’s plan is amended to reduce the deductible to be paid by DEF’s employees to $200 annually.
Because the amendment is a requirement of the acquisition, it is part of the acquisition and is included in the acquisition accounting. The offset to the increase in the accumulated postretirement benefit obligation resulting from the amendment would be an increase in goodwill (or a decrease in the gain from a bargain purchase) recognized in the acquisition accounting.

**Multiemployer Defined Benefit Postretirement Plans**

7.167 If an acquiree participates in a multiemployer postretirement plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer recognizes a liability related to withdrawal from the multiemployer plan under ASC Topic 450. ASC paragraph 805-20-25-25

**Indemnification Assets**

**ASC Topic 805-20-25-27**

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer’s liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

**ASC Topic 805-20-30-18**

. . . For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary as noted in [ASC] paragraph 805-20-30-4.

**ASC Topic 805-20-25-28**

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

**ASC Topic 805-20-40-3**

The acquirer shall derecognize an indemnification asset recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

7.168 The accounting discussed in this Section applies to indemnities related to a specific liability or contingent liability of the acquiree. It does not apply to the accounting for general warranties provided by the acquiree to the acquirer that do not create a specific right of reimbursement.

7.169 Acquisition agreements sometimes provide that the seller indemnifies the acquirer against a particular contingent liability outstanding at the acquisition date. A contingent liability could relate, for example, to a legal case of the acquiree for environmental pollution or a tax uncertainty. An indemnification asset arises from the seller’s agreement to reimburse (indemnify) the acquirer for all or a portion of the ultimate liability resulting from the resolution of the legal case or the tax uncertainty.

7.170 When the seller is contractually obligated to indemnify a specific liability assumed by the acquirer, an indemnification asset should be recognized at the same time and measured using the same measurement basis as the liability, subject to the need for a valuation allowance for uncollectible amounts. The FASB included this requirement in ASC Topic 805 to avoid the potential recognition of offsetting gains and losses in different periods that otherwise might arise if indemnified items and the indemnification assets were accounted for on different bases. Thus, both the indemnification asset and the liability are measured on a consistent basis using similar assumptions, subject to any contractual limitations on the indemnified amount and management’s assessment of collectibility of the indemnification asset. Therefore, an indemnification asset would be recognized as of the acquisition date only if the item to which the indemnification relates is recognized at that date.

7.171 If the indemnification relates to an asset or liability that is recognized at the acquisition date and measured at fair value on that date, the acquirer also recognizes the indemnification asset at its acquisition-date fair value. Uncertainties related to collectibility of the indemnification asset are included in the fair value measurement, and a separate valuation allowance would not be necessary.

7.172 If the indemnification relates to an asset or liability that is an exception to the recognition or measurement principles, the indemnification asset is recognized and measured using assumptions consistent with those used to measure the indemnified item. For example, if a contingency that is subject to indemnification by the seller is not recognized at the acquisition date because its fair value is not determinable (which would be the typical case) and it is not probable and reasonably estimable that a liability existed at the acquisition date, the indemnification asset would also not be recognized at the acquisition date. Similarly, if the indemnification relates to an asset or liability that is
measured on a basis other than fair value (e.g., an uncertain tax position that is recognized in accordance with ASC Topic 740, the related indemnification asset would be measured using assumptions consistent with those used to measure the indemnified item, adjusted for management’s assessment of collectibility and any contractual limitations on the indemnification asset.

7.173 An indemnification asset initially recognized at the acquisition date is subsequently measured on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at fair value, management’s assessment of the collectibility of the indemnification asset. An indemnification asset is derecognized only when the acquirer collects it, sells it, or otherwise loses the right to it. See discussion of Indemnification Assets in Section 12 for additional guidance on the subsequent measurement and accounting for indemnification assets.

7.173a Indemnification assets are outside the scope of ASC Topic 326, Financial Instruments—Credit Losses, because they are not measured at amortized cost. Accordingly, we believe that an acquirer should use ASC Subtopic 450-20, Contingencies - Loss Contingencies, to account for credit losses related to indemnification assets that are not measured at fair value.

Example 7.36: Indemnification Asset Related to Noncontractual Contingency

Q. ABC Corp. acquires DEF Corp. in a business combination. At the acquisition date, DEF is subject to a legal claim and indemnifies ABC for up to $2,500 in the event of an unfavorable outcome related to the contingency. ABC determines that, at the acquisition date, that a liability for the contingency does not meet the recognition criteria of ASC paragraphs 805-20-25-19 through 25-20. How should ABC account for the indemnification asset at the acquisition date?

A. Because the contingency (the legal claim) does not meet the recognition criteria at the acquisition date, it is subject to the recognition exception, as discussed in ASC paragraph 805-20-25-20B and Paragraph 7.150. As a result, a liability for the contingency is not recognized at the acquisition date.

ASC Topic 805 requires that the indemnification asset be recognized at the same time it recognizes the indemnified item, measured on the same basis as the indemnified item (subject to the need for a valuation allowance for uncollectible amounts). Accordingly, because ABC does not recognize the indemnified item at the acquisition date, it would also not recognize the indemnification asset at that date.

If ABC subsequently recognizes a liability in its postcombination financial statements for the liability under ASC Topic 450, it would also recognize an indemnification asset at that time, measured using the same assumptions as the liability, subject to management’s assessment of collectibility and contractual limitations on the indemnified amount. See discussion of Indemnification Assets in Section 12.
EXCEPTIONS TO THE MEASUREMENT PRINCIPLE

Reacquired Rights

ASC Paragraph 805-20-30-20

The acquirer shall measure the value of a reacquired right recognized as an intangible asset in accordance with [ASC] paragraph 805-20-25-14 on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

7.174 An acquirer’s acquisition of a right that was granted previously to an acquiree to use one of the acquirer’s assets (recognized or unrecognized) is a reacquired right. For example, the reacquisition in a business combination of a previously granted right to use the acquirer’s trade name under a franchise agreement or the right to use the acquirer’s technology are reacquired rights. A reacquired right represents an identifiable intangible asset that is recognized separately from goodwill as part of the acquisition accounting.

7.175 The FASB observed that a reacquired right is no longer a contract with a third party and that it would therefore not be appropriate to assume renewals of the contract. Accordingly, such rights are measured by taking into account only the remaining contractual terms of the related contract. Potential renewals are ignored even if a market participant considers potential contract renewals in the determination of fair value.

7.176 If the terms of the contract giving rise to a reacquired right are favorable or unfavorable relative to current market transactions for the same or similar items, the acquirer recognizes a gain or loss on the effective settlement of the preexisting relationship. (ASC paragraph 805-20-25-15) See discussion of Preexisting Relationships in Section 11.

Example 7.37: Reacquired Right

On January 1, 20Y0, ABC Corp. granted DEF Corp. (which is a business) an exclusive right to sell products under ABC’s brand name in a specified geographical area for 10 years. ABC subsequently acquires DEF on January 1, 20Y3. As a result, ABC has reacquired a right that it previously had granted to DEF, and ABC can now sell its products under its brand in the specified geographical area. ABC should recognize an intangible asset for this reacquired right at the acquisition date, measured at fair value based on the seven years remaining in the contract. Additionally, if the terms of the existing contract between ABC and DEF are favorable or unfavorable relative to market terms, a gain or loss on the effective settlement of the preexisting contract should also be recognized.

See Section 12 for a discussion of the subsequent accounting and measurement for reacquired rights.
Share-Based Payment Awards

ASC Paragraph 805-20-30-21

The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree’s share-based payment awards with share-based payment awards of the acquirer in accordance with the method in [ASC] Topic 718 [Compensation—Stock Compensation]. [ASC] Topic [805] refers to the result of that method as the fair-value-based measure of the award. [ASC] paragraphs 805-30-30-9 through 30-13 and 805-30-55-6 through 55-13 provide additional guidance.

7.177 Liabilities or equity instruments issued by an acquirer to replace share-based payment awards of an acquiree are measured in accordance with ASC Topic 718. The attribution of the fair-value-based measure of replacement awards to consideration transferred and/or postcombination vesting is based on a number of factors, including the vesting status of the awards and whether the acquirer is required to replace the acquiree awards. See the discussion of Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree in Section 11.

Assets Held for Sale

7.178 An acquirer is required to measure long-lived assets (or a disposal group), including intangible assets, that are classified as held for sale at the acquisition date in accordance with ASC Subtopic 360-10. ASC Subtopic 360-10 requires that such assets be measured at fair value less cost to sell. ASC paragraphs 805-20-30-22, 360-10-35-38 and 35-43

7.179 ASC Topic 805 and ASC Subtopic 820-10 exclude costs to sell in the measurement of fair value. However, ASC Subtopic 360-10 requires that assets classified as held for sale be measured at fair value less costs to sell. This inconsistency would have resulted in the recognition of a loss in the postcombination financial statements of the combined entity immediately following the acquisition, as an acquirer would have been required to remeasure the assets held for sale at fair value less costs to sell immediately following an acquisition. To deal with this inconsistency and avoid the recognition of a loss in the postcombination financial statements of the combined entity immediately following an acquisition, ASC Topic 805 provides for an exception to its fair value measurement principle for assets held for sale. Assets (or a disposal group) that are classified as held for sale at the acquisition date in accordance with ASC Subtopic 360-10 are measured at fair value less costs to sell. ASC paragraph 805-20-30-22

7.180 The FASB indicated that the measurement exception provided in ASC Topic 805 is only an interim step, pending elimination of this inconsistency by amending ASC Subtopic 360-10 to exclude costs to sell from the measurement of fair value (or carrying amount) of assets held for sale. Statement 141(R), par. B307
1 ASU 2014-09, *Revenue from Contracts with Customers*, changes the accounting for revenue from contracts with customers. The ASU is effective for public business entities and not-for-profit entities that are conduit bond obligors for annual periods commencing on or after December 16, 2017. For all other entities, the ASU is effective for annual periods beginning on or after December 16, 2018. Early adoption is permitted.

2 ASU 2016-02, *Leases*, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted. See discussion in Section 11 of KPMG’s Leases Handbook.

3 ASU 2016-02, *Leases*, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted. See discussion in Section 11 of KPMG’s Leases Handbook.
Section 8 - Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

Detailed Contents

Recognizing and Measuring Goodwill
   Nature of Goodwill
   Overpayments
Bargain Purchase
   Example 8.1: A Business Combination in Which the Consideration Transferred for Less Than 100% of the Equity Interests in the Acquiree Is Less Than the Fair Value Received
RECOGNIZING AND MEASURING GOODWILL

8.000 Under ASC Topic 805, Business Combinations, goodwill (or, in some instances a gain on a bargain purchase) is recognized at the acquisition date, and is measured as a residual. Goodwill previously recorded by an acquiree is not recorded as a separate asset by the acquirer. ASC paragraphs 805-30-25-1 and 30-1 discuss the components of the measurement of goodwill.

ASC Paragraph 805-30-30-1
The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b) below:

a. The aggregate of the following:
   1. The consideration transferred measured in accordance with [ASC Section 805-30-30], which generally requires acquisition-date fair value (see [ASC] paragraph 805-30-30-7)
   2. The fair value of any noncontrolling interest in the acquiree
   3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree.

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with [ASC Topic 805].

8.001 Guidance about recognition and measurement of the various components of the goodwill measurement (or the measurement of a gain from a bargain purchase) is included in the following Sections of this book:

(a) The consideration transferred Sections 6 and 18
(b) Noncontrolling interest in the acquiree Sections 7 and 19
(c) For a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree Sections 9 and 20
(d) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with ASC Topic 805 Sections 7 and 17

8.002 A gain on a bargain purchase is recognized in earnings at the acquisition date (see discussion below). Guidance on the accounting for goodwill subsequent to an acquisition is included in Section 22.
NATURE OF GOODWILL

ASC Master Glossary: Goodwill

An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29.

8.003 Goodwill is an asset representing future economic benefits not attributable to other identifiable assets. This definition is consistent with the objective of not subsuming into goodwill amounts that should be separately recognized in a business combination. Thus, in applying the acquisition method, because goodwill is measured as a residual amount, it is important that all components of goodwill measurement (or the measurement of a gain from a bargain purchase) be recognized and measured based on the recognition and measurement principles (including the exceptions to such principles) of ASC Subtopic 805-30. For example, the failure of an acquirer to recognize and measure all identifiable assets acquired and liabilities assumed, such as technology-based intangible assets that were owned by the acquiree but not recognized in the acquiree’s financial statements as of the acquisition date, would result in a misstatement of both the identifiable net assets acquired and an equal and offsetting misstatement of goodwill at the acquisition date. Likewise, following the acquisition, subsuming the identifiable intangible asset into goodwill could result in misstatements of amortization expense or impairment charges or both.

OVERPAYMENTS

8.004 While excess consideration transferred over the identifiable assets acquired and liabilities assumed could represent an overpayment for the acquirer’s interest in the acquiree, the acquirer does not recognize a loss on a business combination at the acquisition date. The FASB concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date. Overpayments are thus subsumed into goodwill and addressed through subsequent impairment testing of goodwill. (Statement 141(R), par. B382) See discussion of Goodwill and Other Intangible Assets in Section 22.

BARGAIN PURCHASE

ASC Paragraph 805-30-25-2

Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in [ASC] paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in [ASC paragraph 805-30-30-1(a)]. If that excess remains after applying the requirements in [ASC] paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. Example 1 (see [ASC] paragraph 805-30-55-14) provides an illustration of this guidance.
ASC Paragraph 805-30-25-3

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items identified in paragraphs 805-20-25-16, and 805-20-30-10 also may result in recognizing a gain (or change the amount of a recognized gain) on a bargain purchase.

ASC Paragraph 805-30-25-4

Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. See [ASC] paragraphs 805-30-30-4 through 30-6 for guidance on the review of measurement procedures in connection with a reassessment required by this paragraph.

ASC Paragraph 805-30-30-5

… As part of that required reassessment, the acquirer shall then review the procedures used to measure the amounts [ASC Topic 805] requires to be recognized at the acquisition date for all of the following:

   a. The identifiable assets acquired and liabilities assumed
   b. The noncontrolling interest in the acquiree, if any
   c. For a business combination achieved in stages, the acquirer’s previously held equity interest in the acquiree
   d. The consideration transferred.

ASC Paragraph 805-30-30-6

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

8.005 Bargain purchases occur if the recognized amounts of the identifiable net assets exceed the sum of consideration transferred, noncontrolling interests in the acquiree, and the fair value of any previously held equity interests in the acquiree, in accordance with ASC paragraph 805-30-30-1(b) The measurement components of the gain on a bargain purchase are the same as the measurement components of goodwill. Because the components in the computation are measured at fair value (subject to exceptions for certain of the identifiable net assets), the FASB concluded that a bargain purchase represents an economic gain that should be immediately recognized by the acquirer in earnings.

8.006 Because an owner generally will not knowingly or willingly sell assets or businesses at prices below their fair values, this situation is expected to occur infrequently. A gain on bargain purchase could occur when the acquiree is under a forced liquidation or distress sale. However, evidence of a forced or distressed sale is not required for a gain on a bargain purchase to be recognized. For example, a gain from a bargain purchase could arise if the acquirer and acquiree previously entered into a
purchase option for the set that does not meet the definition of a derivative and the fair
value of the set when the option is exercised exceeds the sum of the strike price and the
premium paid for the option. A gain could also arise by applying the measurement
requirements of ASC Topic 805 which require, in certain instances, measurement of the
identifiable assets acquired and liabilities assumed at amounts other than fair value (see
Section 7).

8.007 Nonetheless, to address concerns over the potential inappropriate recognition of
gains from bargain purchases, the FASB included the requirement in ASC paragraphs
805-30-25-4 and 30-5 through 30-6 that the acquirer, before recognizing a gain on a
bargain purchase, reassess whether it has correctly identified all of the assets acquired,
the liabilities assumed, any noncontrolling interest in the acquiree, any previously held
equity interest in the acquiree, and the consideration transferred. Following that
reassessment, the acquirer must review the procedures used to measure the following
amounts required to be recognized at the acquisition date to ensure that the measurements
reflect consideration of all available information as of the acquisition date:

- The identifiable assets acquired and liabilities assumed;
- Any noncontrolling interest in the acquiree;
- For a business combination achieved in stages, the acquirer’s previously held
equity interest in the acquiree; and
- The consideration transferred.

Although not specifically mentioned in ASC paragraphs 805-30-25-4 and 30-5 through
30-6, we believe that the reassessment process that an acquirer is required to go through
before recognizing a gain on a bargain purchase should also include a review of the
process used to identify amounts that are not part of what the acquirer and acquiree
exchanged in the business combination. For example, a business combination may result
in the effective settlement of a preexisting relationship between the acquirer and the
acquiree (such as a supply agreement or an operating lease arrangement), may include
transactions that compensates employees or former owners of an acquiree for future
services, or may include transactions that reimburse the acquiree or its former owners for
paying the acquirer’s acquisition-related costs. Such transactions are not part of the
business combination transaction, and should therefore be accounted for as separate
transactions. Accounting for such arrangements as separate transactions, rather than as
part of the acquisition, affects the computation of goodwill or the gain from a bargain
purchase that arises from the business combination. See discussion of Determining What
is Part of the Business Combination Transaction in Section 11.

8.008 Any remaining gain from a bargain purchase after completing the reassessment is
recognized as a gain by the acquirer at the acquisition date. We believe all of the gain
should be attributed to the acquirer and no gain should be attributed to the noncontrolling
interest, if any. ASC paragraph 220-20-45-1 should be considered in determining the
classification in the income statement of any recognized gain from a bargain purchase.
ASC paragraph 805-30-50-1(f) requires disclosure of the amount of any recognized gain
from a bargain purchase, the line items in the income statement in which the gain is recognized, and a description of the reasons why the transaction resulted in a gain.

8.009 Example 8.1 illustrates the procedures an acquirer follows before recognizing a gain on a bargain purchase. This example is adapted from Example 1 appearing in ASC paragraphs 805-30-55-14 through 55-16.

Example 8.1: A Business Combination in Which the Consideration Transferred for Less Than 100% of the Equity Interests in the Acquiree Is Less Than the Fair Value Received

On January 1, 20X5, AC acquires 80% of the equity interests of TC, a private entity, in exchange for cash of $150. Because the former owners of TC needed to dispose of their investments in TC by a specified date, they lacked sufficient time to market TC to multiple potential buyers. AC initially measures the identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of ASC Topic 805. AC measures the identifiable assets at $250, and the liabilities assumed at $50. AC engages an independent consultant who determines that the fair value of the 20% noncontrolling interest in TC is $42. AC also performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination. The amount of TC’s identifiable net assets ($200, calculated as $250 - $50) exceeds the fair value of the consideration transferred plus the fair value of the noncontrolling interest in TC, resulting in an initial indication of a gain on a bargain purchase. Therefore, AC reviews the procedures it used to identify and measure the assets acquired and liabilities assumed, to measure the fair value of both the noncontrolling interest in TC and the consideration transferred, and the process it used to identify transactions that were not part of the business combination. Following that review, AC concludes that the procedures followed and the resulting measurements were appropriate. AC measures the gain on its purchase of the 80% interest as follows:

Identifiable net assets acquired ($250 - $50)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable assets acquired</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>150</td>
</tr>
<tr>
<td>Liabilities assumed</td>
<td>50</td>
</tr>
<tr>
<td>Gain on a bargain purchase</td>
<td>8</td>
</tr>
<tr>
<td>Equity—noncontrolling interest in TC</td>
<td>42</td>
</tr>
</tbody>
</table>
Section 9 - Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations

Detailed Contents

Business Combinations Achieved in Stages (Step Acquisitions)
  Example 9.1: Step Acquisition

Business Combinations Achieved Without the Transfer of Consideration
  Measurement of Goodwill in a Business Combination Achieved without the Transfer of Consideration
  A Business Combination Resulting from the Reacquisition by an Acquiree of Its Own Shares
    Example 9.2: Control Obtained Through the Reacquisition of Shares by an Acquiree
  A Business Combination Achieved Through Lapse of Minority Approval or Veto Rights
    Example 9.3: Control Obtained on Lapse of Minority Veto Rights

A Business Combination Achieved by Contract Alone
  Example 9.4: Physician Practice Management Entity Enters into a Management Agreement with a Physician Practice

Reverse Acquisitions
  Reverse Acquisitions Involving a Shell Company
  Measuring the Consideration Transferred
  Preparation and Presentation of Consolidated Financial Statements
    Example 9.5: Financial Statement Presentation
    Example 9.6: Precombination Shareholdings of the Acquirer
    Example 9.7: Presentation of Share-Based Payment Information for Periods Prior to the Acquisition for a Reverse Acquisition

Noncontrolling Interest in a Reverse Acquisition
  Example 9.7a: Revision of Financial Statements for a Reverse Stock Split Occurring prior to a Reverse Acquisition
  Example 9.8: Reverse Acquisition
BUSINESS COMBINATIONS ACHIEVED IN STAGES (STEP ACQUISITIONS)

ASC Paragraph 805-10-25-9

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. [ASC Topic 805] refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition.

ASC Paragraph 805-10-25-10 (Pre-adoption of ASU 2016-01*)

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment was classified as available for sale). If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment in an investee that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

ASC Paragraph 805-10-25-10 (Post-adoption of ASU 2016-01*)

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

9.000 A business combination occurs on the date the acquirer obtains control of the acquiree (i.e., the acquisition date). In a business combination achieved in stages, this is the date on which the acquirer purchases an additional equity interest and gains control of
the acquiree. At that date, the acquirer applies the acquisition method to account for the combination. The acquirer remeasures its previously held equity interest in the acquiree at its acquisition-date fair value, and recognizes the resulting gain or loss in earnings (including changes in value that were previously recognized in accumulated other comprehensive income). Additionally, the consideration transferred is measured; the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree are recognized and measured; goodwill or, in some cases, a gain from a bargain purchase, is recognized and measured, and the accounting acquirer consolidates the acquiree. See the discussion of The Acquisition Method in Section 3. Refer to Appendix 4-1 in KPMG's Guide to Accounting for Foreign Currency for discussion of how to account for foreign currency translation adjustments in business combinations of foreign equity method investments achieved in stages.

9.001 The following example illustrates the accounting for a step acquisition.

**Example 9.1: Step Acquisition**

On December 31, 20X1 ABC Corp. acquires 30% of the outstanding shares of DEF Corp. for $1,000 cash. The fair value of the identifiable net assets of DEF is $2,500. DEF has a breakeven net income and other comprehensive income of $100 for the year ended December 31, 20X2.

On December 31, 20X2, ABC acquires an additional 50% of the outstanding shares of DEF for $2,000 cash. At that date, the fair value of the identifiable net assets of DEF is $3,000. ABC determines that the acquisition-date fair value of its original investment and the noncontrolling interest in DEF at December 31, 20X2 is $1,050 and $700, respectively. The determination of the fair value of ABC’s original investment does not reflect consideration of a control premium (i.e., control is associated only with ABC’s acquisition of an additional 50% interest on December 31, 20X2).

ABC accounts for its investment in DEF during 20X2 by the equity method, and recognizes $30 (30% × $100) in other comprehensive income, and amortization expense of $20 related to the fair value adjustments recognized as of December 31, 20X1.

As a result of the acquisition of an additional 50% interest in DEF on December 31, 20X2, ABC obtains control of DEF. Thus, a business combination occurs as of that date and ABC accounts for the acquisition of DEF by the acquisition method. ABC determines the goodwill resulting from the acquisition and the gain on its previously held interest in DEF at the acquisition date as follows:

**Goodwill:**

- Fair value of consideration transferred $2,000
- Fair value of the noncontrolling interest 700
- Fair value of ABC’s previously held equity interest 1,050
  - Subtotal (a) 3,750

Less: Identifiable assets acquired net of liabilities assumed measured under ASC Topic 805 (b) 3,000

Goodwill (a-b) $750
Gain on previously held equity interest in DEF:

Fair value at December 31, 20X2 (c) $ 1,050
Less basis of ABC’s investment:
  Investment at December 31, 20X1 1,000
  ABC’s equity in DEF’s earnings for 20X2, including amortization of fair value adjustments (20)
  ABC’s share of DEF’s other comprehensive income for 20X2 ($100 × 30%) 30

ABC’s basis of the previously held equity interest in DEF before the acquisition of the additional 50% equity interest (d) $ 1,010
Excess of fair value over ABC’s basis in DEF (e) (equal to (c)-(d)) 40
Recognize AOCI in earnings (f) 30
Gain on previously held equity interest in DEF recognized in earnings (e + f) $ 70

ABC records the following to reflect the gain on its previously held equity interest in DEF and its acquisition of DEF as of December 31, 20X2:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable net assets of DEF</td>
<td>3,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>750</td>
</tr>
<tr>
<td>AOCI</td>
<td>30</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Investment in DEF</td>
<td>1,010</td>
</tr>
<tr>
<td>Noncontrolling interest in DEF</td>
<td>700</td>
</tr>
<tr>
<td>Gain on previously held equity interest in DEF</td>
<td>70</td>
</tr>
</tbody>
</table>

9.002 We believe this guidance on business combinations achieved in stages would apply to transactions involving a previously held interest in an entity that is both a business and in-substance real estate such as a group of income-producing properties. In such a transaction, sale of the assets has not occurred (although the accounting for an acquisition achieved in stages treats the previously held interest as having been disposed and then reacquired) and therefore ASC Subtopic 360-20 (or ASC Subtopic 610-20 once that guidance is effective) would not apply. Additionally, the guidance in ASC Subtopic 810-10 addresses the accounting for a decrease in ownership interest, which also does not apply. As a consequence, the guidance in ASC paragraph 805-10-25-10 would be applicable and the previously held interest would be remeasured to fair value with a gain or loss recognized in income in the period the business combination occurs. However, a step acquisition of in-substance nonfinancial assets is not a business combination and therefore outside the scope of ASC paragraph 805-10-25-10.
BUSINESS COMBINATIONS ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

ASC Paragraph 805-10-25-11

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include any of the following:

a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.

c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

9.003 A business combination occurs when an acquirer obtains control of one or more businesses. When an entity obtains control of a business, even without the transfer of consideration, a business combination has occurred and is within the scope of ASC Topic 805, Business Combinations. The acquisition method applies to such transactions, which requires, among other things, recognizing and measuring the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. ASC Topic 805 provides special guidance for these types of transactions.

9.004 The application of the acquisition method in each of the situations identified in ASC paragraph 805-10-25-11 in which an acquiree obtains control of an acquiree without the transfer of consideration is illustrated below.

MEASUREMENT OF GOODWILL IN A BUSINESS COMBINATION ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

ASC Paragraph 805-30-30-3

To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer’s interest in the acquiree determined using a valuation technique in place of the acquisition-date fair value of the consideration transferred (see [ASC] paragraph 805-30-30-1(a)(1)). Paragraphs 805-30-55-3 through 55-5 provide additional guidance on applying the acquisition method to combinations of mutual entities, including measuring the acquisition-date fair value of the acquiree’s equity interests using a valuation technique.

ASC Paragraph 805-30-55-2

In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the
acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see [ASC] paragraphs 805-30-30-1 through 30-4). [ASC] Subtopic 820-10 provides guidance on using valuation techniques to measure fair value.

9.005 The determination of goodwill in a business combination achieved without the transfer of consideration requires the acquirer to substitute the acquisition-date fair value of its interest in the acquiree for the consideration transferred. The acquisition-date fair value of the acquirer’s interest is measured using one or more valuation techniques. The acquisition-date fair value of the acquirer’s interest in the acquiree should reflect, in our view, any control premium attributable to the acquirer’s controlling financial interest that will exist as a result of the acquirer obtaining control of the acquiree. The acquirer uses the fair value so determined as the consideration transferred to measure goodwill or a gain on a bargain purchase. This also requires the acquirer to:

- Adjust the carrying amount of its interest in the acquiree to fair value;
- Recognize in earnings any gain or loss equal to the difference between the carrying amount of its equity interest in the acquiree before gaining control of the acquiree and the fair value of its controlling interest in the acquiree as a result of the transaction; and
- To otherwise apply the acquisition method in accounting for the business combination.

A BUSINESS COMBINATION RESULTING FROM THE REACQUISITION BY AN ACQUIREE OF ITS OWN SHARES

9.006 If an investee (acquiree) buys back enough of its own shares such that an existing shareholder (acquirer) obtains control of the acquiree, a business combination has occurred and the acquirer would apply the acquisition method to account for the transaction.

Example 9.2: Control Obtained Through the Reacquisition of Shares by an Acquiree

ABC Corp. owns 45% of DEF Corp. DEF repurchases a number of its shares such that ABC’s ownership percentage increases to 55%. The repurchase transaction results in ABC obtaining control of DEF and, therefore, is a business combination under ASC Topic 805. ABC is the acquirer of DEF, and accounts for the business combination by the acquisition method. As of the acquisition date (i.e., the date ABC obtains control), ABC:

1. Remeasures its previously held interest in DEF (45%) at its acquisition-date fair value, and recognizes in earnings any gain or loss equal to the difference between the carrying amount of its equity interest in DEF before gaining control and the fair value of its controlling interest in DEF as a result of the transaction.
(2) Recognizes and measures the identifiable assets acquired, the liabilities assumed, and the noncontrolling interest in DEF based on the recognition and measurement principles of ASC Topic 805.

(3) Recognizes and measures goodwill or a gain from a bargain purchase, using the fair value of its controlling interest in DEF as a result of the transaction as a substitute for the consideration transferred.

See Section 3 for a discussion of The Acquisition Method.

A BUSINESS COMBINATION ACHIEVED THROUGH LAPSE OF MINORITY APPROVAL OR VETO RIGHTS

9.007 An entity (investor) may own a majority interest in another entity (investee), but not consolidate that entity, because the noncontrolling interests in the investee have substantive participating rights that overcome the usual presumption that the investor with a majority voting interest should consolidate the investee. See ASC paragraphs 810-10-25-2 through 25-14 and ASC Section 810-20-25. In such situations, if the substantive participating rights held by the noncontrolling interests expire and the investor holding the majority voting interest gains control of the investee, the investor has acquired the investee in a business combination, and therefore applies the acquisition method to account for the transaction.

Example 9.3: Control Obtained on Lapse of Minority Veto Rights

ABC Corp. owns 55% of DEF Corp. but does not consolidate DEF because of substantive participating rights held by the minority shareholders (see ASC paragraphs 810-10-25-2 through 25-14). On September 30, 20X9, the veto rights expire. The lapse of minority veto rights results in ABC obtaining control of DEF and, therefore, this event meets the definition of a business combination under ASC Topic 805. ABC is the acquirer of DEF, and accounts for the business combination by the acquisition method.

As of the acquisition date (i.e., September 30, 20X9), the carrying amount of ABC’s 55% interest in DEF is $42 million. ABC also determines, using one or more valuation techniques, that the acquisition-date fair value of DEF’s identifiable assets and liabilities is $90 million (determined in accordance with the recognition and measurement principles of ASC Topic 805), the acquisition-date fair value of ABC’s 55% interest in DEF (including a control premium) is $60 million, and the acquisition-date fair value of the 45% noncontrolling interest after the transaction is $45 million.

In applying the acquisition method to this transaction, ABC:

(1) Remeasures its previously held interest in DEF at its acquisition-date fair value ($60 million), adjusts the carrying amount of its interest in DEF to the fair value so determined, and recognizes in earnings the resulting gain of $18 million ($60 million fair value of its controlling interest as a result of the transaction less the $42 million historical carrying amount of ABC’s equity interest in DEF).
Recognizes and measures the identifiable assets acquired and the liabilities assumed in accordance with the recognition and measurement principles of ASC Topic 805 ($90 million), and the noncontrolling interest in DEF at its acquisition-date fair value ($45 million).

Recognizes goodwill of $15 million ($60 fair value of ABC’s controlling interest in DEF used as a substitute for the consideration transferred plus the $45 million acquisition-date fair value of the noncontrolling interest in DEF, less the $90 million fair value of DEF’s identifiable assets and liabilities).

ABC’s entries to record the acquisition of DEF are:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in DEF</td>
<td>18 million</td>
</tr>
<tr>
<td>Gain on previously held investment in DEF</td>
<td>18 million</td>
</tr>
<tr>
<td>Identifiable net assets</td>
<td>90 million</td>
</tr>
<tr>
<td>Goodwill</td>
<td>15 million</td>
</tr>
<tr>
<td>Investment in DEF</td>
<td>60 million</td>
</tr>
<tr>
<td>Noncontrolling interest in DEF</td>
<td>45 million</td>
</tr>
</tbody>
</table>

See discussion of *The Acquisition Method* in Section 3.

A BUSINESS COMBINATION ACHIEVED BY CONTRACT ALONE

**ASC Paragraph 805-10-25-12**

In a business combination achieved by contract alone, the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree’s net assets recognized in accordance with the requirements of [ASC] Topic [805]. In other words, the equity interests in the acquiree held by parties other than the acquirer are a noncontrolling interest in the acquirer’s postcombination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the noncontrolling interest.

**9.008** Business combinations achieved by contract alone are within the scope of ASC Topic 805 and are accounted for by the acquisition method. Thus, the acquirer recognizes the assets acquired and liabilities assumed in accordance with the recognition and measurement requirements of ASC Topic 805. This applies to such transactions even if the acquirer did not previously hold or acquire any equity interest in the acquiree. Equity interests held by parties other than the acquirer (i.e., the party that obtains control by contract) are noncontrolling interests and are presented as such in the acquirer’s postcombination financial statements.

**9.009** Business combinations achieved by contract alone often result in the formation of a variable interest entity. In such situations, the primary beneficiary of the variable interest entity is always the acquirer. See the discussion below and the discussion of *Variable Interest Entities* in Section 4.
Paragraph B78 of Statement 141(R) cites as an example of a business combination achieved by contract alone a transaction in which a physician practice management entity executes a management agreement with a physician practice, and notes that the EITF reached a consensus that these transactions should be accounted for as business combinations. ASC paragraphs 810-10-15-19 through 15-22, 25-61 through 25-81, and 55-206 through 55-209

Example 9.4: Physician Practice Management Entity Enters into a Management Agreement with a Physician Practice

Q. Should the acquisition method be applied in a transaction in which a physician practice management entity (PPM) executes a management agreement with a physician practice (assume the physician practice is a business)?

A. Many of the arrangements between a physician practice and a PPM arise when the PPM seeks to acquire the physician practice. Legal or business reasons often preclude the PPM from acquiring the physician practice’s outstanding equity instruments. As an alternative, the PPM often will acquire some or all of the net assets of the physician practice, assume some or all of its contractual rights and responsibilities, and execute a long-term management agreement to operate the physician practice with its owners (typically the physicians) receiving consideration in exchange. ASC paragraphs 810-10-25-61 through 25-81 provide guidance for determining when a controlling financial interest in a physician practice through a contractual management arrangement with a PPM is established.

A PPM can have a controlling financial interest, but not own the majority of the outstanding voting equity instruments of the physician practice. As a result, many PPMs will be variable interest entities.

If a PPM establishes a controlling financial interest in a physician practice through a contractual management arrangement, and the physician practice is not a variable interest entity, then the PPM should apply the acquisition method in accordance with ASC Topic 805. However, if the physician practice is a variable interest entity, the primary beneficiary is the acquirer and, accordingly, the primary beneficiary (which could be the PPM) would apply the acquisition method. See the discussion of Variable Interest Entities in Section 4.

While ASC paragraphs 810-10-25-61 through 25-81 relate to entities that operate in the health care industry, its guidance for establishing a controlling financial interest applies to similar arrangements in other industries. For example, this guidance might apply to research and development arrangements, franchise arrangements, hotel management contracts, and service corporations for real estate investment trusts. These arrangements may involve the transfer of significant rights from the legal owners of an entity to another entity via a management arrangement or similar contract. If an entity establishes a controlling financial interest in another entity (acquiree) that is a business as a result of entering into a management arrangement, the entity should first assess whether the acquiree is a variable interest entity. If the acquiree is a variable interest entity, the primary beneficiary of the acquiree is the acquirer, and should apply the acquisition
REVERSE ACQUISITIONS

ASC Master Glossary: 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 [ASC] 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.

ASC Paragraph 805-40-05-2 (Emphasis added)

As one example of a reverse acquisition, a private operating entity may want to become a public entity but not want to register its equity shares. To become a public entity, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this situation, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired. However, application of the guidance in [ASC] paragraphs 805-10-55-11 through 55-15 results in identifying:

a. The public entity as the acquiree for accounting purposes (the accounting acquiree)

b. The private entity as the acquirer for accounting purposes (the accounting acquirer).

ASC Paragraph 805-40-25-1

For a business combination transaction to be accounted for as a reverse acquisition, the accounting acquiree must meet the definition of a business. All of the recognition principles in [ASC] Subtopics 805-10, 805-20, and 805-30, including the requirement to recognize goodwill, apply to a reverse acquisition.

ASC Paragraph 805-40-30-1

All of the measurement principles applicable to business combinations in [ASC] Subtopics 805-10, 805-20, and 805-30 apply to a reverse acquisition.

9.012 The example of a reverse acquisition included in ASC Section 805-40-55 is comprehensive in nature. That example is presented below in its entirety as Example 9.8 in Paragraph 9.019 to illustrate the basic concepts that apply to the accounting for reverse acquisitions.

9.013 See Example 6.3, Transfer of a Subsidiary to an Acquiree, in Section 6 for an additional example of a reverse acquisition
REVERSE ACQUISITIONS INVOLVING A SHELL COMPANY

9.014 The SEC staff has taken the position that a transaction between a private operating company and a nonoperating public shell company, in which the shell company is the issuer of securities and the operating company is the acquirer for accounting purposes, should be treated for financial reporting purposes as an issuance of securities by the operating company. These transactions are not business combinations because the shell company is not a business. The operating company would credit equity for the fair value of the net monetary assets of the shell company (i.e., no goodwill or intangible assets would be recognized in this transaction). Costs directly related to this transaction should be charged to equity only to the extent of cash received, while all costs in excess of cash received should be charged to expense.

9.014a Whether a public company meets the SEC’s definition of a shell company is a legal determination that should be performed by the company’s SEC legal counsel.

9.014b In many instances, a reverse acquisition may involve a public company that no longer has future operating prospects (e.g. a life sciences company whose only drug candidate fails during clinical trials). The public company may find a merger partner in the form of a private company that wants to go public. A reverse acquisition may benefit both parties as it maximizes value for the shareholders of the public company and allows the private company to become public without incurring the cost and time associated with an IPO process. Often, the public company does not meet the SEC’s definition of a shell company because it had significant precombination assets and/or activities.

9.015 Even if a public company does not meet the SEC’s definition of a shell company, the public company may have little to no assets (other than cash or cash equivalents) or activities by the time the reverse acquisition is consummated. If the public company's assets or activities just prior to the reverse acquisition meet the definition of a business, and the private company is the acquirer for accounting purposes, the transaction constitutes a business combination. However, if the assets and activities of the public company are not sufficient to meet the definition of a business, and the private company is the acquirer for accounting purposes, the accounting acquirer would account for this transaction as the acquisition of a group of assets. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

MEASURING THE CONSIDERATION TRANSFERRED

ASC Paragraph 805-40-30-2

In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree. Instead, the accounting acquiree usually issues its equity shares to the owners of the accounting acquirer. Accordingly, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. Example 1, Case A (see [ASC] paragraph 805-40-55-8) illustrates
that calculation. The fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred in exchange for the acquiree.

PREPARATION AND PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS

ASC Paragraph 805-40-45-1

Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to retroactively adjust the accounting acquirer’s legal capital to reflect the legal capital of the accounting acquiree. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree). Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).

ASC Paragraph 805-40-45-2 (Emphasis added)

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

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

b. The assets and liabilities of the legal parent (the accounting acquiree) recognized and measured in accordance with [ASC] Topic [805] applicable to business combinations.

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

d. The amount recognized as issued equity interests in the consolidated financial statements determined by adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to the fair value of the legal parent (accounting acquiree) determined in accordance with the guidance in [ASC] Topic [805] applicable to business combinations. However, the equity structure (that is, the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.

e. The noncontrolling interest’s proportionate share of the legal subsidiary’s (accounting acquirer’s) precombination carrying amounts of retained earnings and other equity interests as discussed in [ASC] paragraphs 805-40-25-2 and
In a business combination, the acquirer recognizes the assets and liabilities of the acquiree in accordance with the recognition and measurement principles of ASC Topic 805. The acquirer includes the acquiree’s results of operations in its postcombination financial statements from the acquisition date. This guidance also applies to reverse acquisitions, in which the acquiree (for accounting purposes) is the surviving entity. The historical financial statements of the acquirer (for accounting purposes) are presented as the historical financial statements of the combined entity, and the assets and liabilities of the acquiree (the legal acquirer) are recognized and measured in accordance with the recognition and measurement principles of ASC Topic 805. Likewise, the results of operations of the acquired entity (the legal acquirer) are included in the financial statements of the combined entity only from the date of acquisition, even if the acquired entity (legal acquirer) is the surviving entity.

The equity of the acquirer is presented as the equity of the combined entity; however, the capital share account of the acquirer is adjusted to reflect the par value of the outstanding shares of the legal acquirer after considering the number of shares issued in the business combination. The difference between the capital share account of the acquirer and the capital share account of the legal acquirer (presented as the capital share account of the combined entity) is recorded as an adjustment to additional paid-in capital of the combined entity. For periods prior to the business combination, the equity of the combined entity is the historical equity of the acquirer prior to the merger, retroactively restated to reflect the number of shares received in the business combination. Retained earnings of the acquirer are carried forward after the acquisition. Earnings per share for periods prior to the business combination are restated to reflect the number of equivalent shares received by the acquirer.

Example 9.5: Financial Statement Presentation

ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. On consummation of the combination, DEF becomes a wholly owned subsidiary of ABC and the former shareholders of DEF own 60% of the outstanding common shares of ABC.

Because the former shareholders of DEF receive the larger portion of the voting interests in the combined entity, and assuming there is no evidence pointing to a different acquiring entity, DEF is the acquirer for accounting purposes.

For purposes of the consolidated financial statements of the surviving entity (ABC), DEF’s historical financial statements should be presented as the historical financial statements of the combined entity. The assets and liabilities of ABC should be recognized and measured in accordance with ASC Topic 805 as of the acquisition date. The results of operations of ABC are included in the financial statements of the combined entity only for periods subsequent to the acquisition.

Although the equity of DEF (the acquirer) is presented as the equity of the combined entity, the capital share account must be adjusted to reflect the outstanding shares of ABC.
(the surviving entity). That is, the retained earnings of DEF would be presented as the retained earnings of the combined entity; the capital share account of the combined entity would reflect the par value of ABC’s shares; and the additional paid-in capital account of DEF would be adjusted for the difference between the capital share account of DEF and the capital share account of ABC, and that adjusted amount would be presented as additional paid-in capital of the combined entity.

Example 9.6: Precombination Shareholdings of the Acquirer

Q. How should shares of a legal acquirer that had been held by the accounting acquirer prior to a reverse acquisition be considered in accounting for the business combination?

A. The transaction should be accounted for as a business combination achieved in stages (step acquisition). The accounting acquirer would recognize and measure the legal acquirer’s identifiable assets and liabilities, the previously held interest and noncontrolling interest at acquisition-date fair value. The accounting acquirer would recognize a gain or loss for the difference between the carrying amount of the previously held investment in the legal acquirer and the acquisition-date fair value (see Paragraph 9.005).

Example 9.7: Presentation of Share-Based Payment Information for Periods Prior to the Acquisition for a Reverse Acquisition

Q. Should the accounting acquirer in a transaction accounted for as a reverse acquisition retrospectively adjust its share-based payment disclosures for periods prior to the business combination when the equity of the accounting acquirer has been retrospectively adjusted to reflect the shares received in the business combination?

A. Yes, in our view it would be appropriate to adjust the share-based payment disclosures to reflect the impact of the business combination on a basis that is comparable to the retrospectively adjusted legal capital that is presented in shareholders’ equity.

NONCONTROLLING INTEREST IN A REVERSE ACQUISITION

ASC Paragraph 805-40-25-2

In a reverse acquisition, some of the owners of the legal acquiree (the accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (the accounting acquiree). Those owners are treated as a noncontrolling interest in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal acquiree that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal acquiree—not in the results and net assets of the combined entity. Conversely, even though the legal acquirer is the acquiree for accounting purposes, the owners of the legal acquirer have an interest in the results and net assets of the combined entity.
ASC Paragraph 805-40-30-3

The assets and liabilities of the legal acquiree are measured and recognized in the consolidated financial statements at their precombination carrying amounts (see [ASC] paragraph 805-40-45-2(a)). Therefore, in a reverse acquisition the noncontrolling interest reflects the noncontrolling shareholders’ proportionate interest in the precombination carrying amounts of the legal acquiree’s net assets even though the noncontrolling interests in other acquisitions are measured at their fair values at the acquisition date.

9.018 If, in a reverse acquisition the legal acquirer does not acquire all of the outstanding common shares of the accounting acquirer, the combined entity should reflect a noncontrolling interest in its postcombination financial statements. Other financial instruments that are classified as equity in the legal acquiree’s financial statements that remain outstanding after a reverse acquisition are also classified as a noncontrolling interest in the postcombination financial statements of the combined entity.

EARNINGS PER SHARE

ASC Paragraph 805-40-45-3

As noted in [ASC paragraph 805-40-45-2](d), the equity structure in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal acquirer (the accounting acquiree), including the equity interests issued by the legal acquirer to effect the business combination.

ASC Paragraph 805-40-45-4

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

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

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

ASC Paragraph 805-40-45-5

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

a. The income of the legal acquiree attributable to common shareholders in each of those periods
b. The legal acquiree’s historical weighted average number of common shares outstanding multiplied by the exchange ratio established in the acquisition agreement.

**Example 9.7a: Revision of Financial Statements for a Reverse Stock Split Occurring prior to a Reverse Acquisition**

On May 30, 20X2, Public Co., a publicly traded "fallen angel" whose research and development project was unsuccessful, agrees to acquire Private Corp., a private operating company that was considering going public. Both companies have a calendar year fiscal year. Private's shareholders will own 75% of the shares of the combined entity, and the transaction will be accounted for as a reverse acquisition.

On July 15, 20X2, 3 days prior to closing, Public effected a 1:3 reverse stock split of its common stock to reduce the number of shares outstanding to facilitate the share exchange. The deal closed on July 18, 20X2 and Public filed a related Form 8-K the same day. Public must file an amended Form 8-K/A within 71 days with Private's historical financial statements for fiscal 20X1 and for the interim period ended June 30, 20X2.

Because Private is the accounting acquirer, its financial statements will become the historical financial statements of the combined company for periods before the acquisition. In the combined company's interim financial statements for the period ending September 30, 20X2 filed on Form 10-Q, the capital structure and earnings per share of Private should be recast in prior periods to reflect Public's reverse stock split and the exchange ratio.

However, in the historical financial statements of Private through June 30, 20X2 to be filed on the Form 8-K/A, we believe that Private's capital structure and earnings per share should not be recast to reflect Public's reverse stock split and the exchange ratio. ASC Paragraph 805-40-45-4 specifically refers to "the period in which the reverse acquisition occurs" as the period for calculating the weighted average common shares outstanding in a reverse acquisition. We interpret this to mean that the effect of the stock split and exchange ratio is not included until the period in which the merger takes place, which is the third quarter.

9.019 The following example is included in ASC paragraphs 805-40-55-3 through 55-23. The example demonstrates the application of the guidance and concepts discussed in ASC paragraphs 805-40-25-2, 30-2 and 30-3, and 45-1 through 45-5.

**Example 9.8: Reverse Acquisition**

This example illustrates the accounting for a reverse acquisition in which Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity instruments and therefore the legal parent, on September 30, 20X6. This example ignores the accounting for any income tax effects.

The statements of financial position of Entity A and Entity B immediately before the business combination are:
<table>
<thead>
<tr>
<th>Entity A (Legal Parent, Accounting Acquiree)</th>
<th>$</th>
<th>Entity B (Legal Subsidiary, Accounting Acquirer)</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>500</td>
<td>Noncurrent assets</td>
<td>1,300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total assets</td>
<td>1,800</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>300</td>
<td>Noncurrent liabilities</td>
<td>400</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total liabilities</td>
<td>700</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>800</td>
<td>Retained earnings</td>
<td>1,400</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100 common shares</td>
<td>300</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>60 common shares</td>
<td>—</td>
<td></td>
<td>600</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>1,100</td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>Total liabilities and shareholders’ equity</td>
<td>1,800</td>
<td></td>
<td>3,700</td>
</tr>
</tbody>
</table>

This example also uses the following information:

(a) 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.

(b) The fair value of each common share of Entity B at September 30, 20X6, is $40. The quoted market price of Entity A’s common shares at that date is $16.

(c) 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.

**Calculating the Fair Value of the Consideration Transferred**

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 example, 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.

**Measuring Goodwill**

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration effectively transferred</td>
<td>1,600</td>
</tr>
<tr>
<td>Net recognized values of Entity A’s identifiable assets and liabilities</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>500</td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td>1,500</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(300)</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>(400)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
</tbody>
</table>

The consolidated statement of financial position immediately after the business combination is:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets ($700 + $500)</td>
<td>1,200</td>
</tr>
<tr>
<td>Noncurrent assets ($3,000 + $1,500)</td>
<td>4,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td>Total assets</td>
<td>6,000</td>
</tr>
<tr>
<td>Current liabilities ($600 + $300)</td>
<td>900</td>
</tr>
<tr>
<td>Noncurrent liabilities ($1,100 + $400)</td>
<td>1,500</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>2,400</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,400</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
</tr>
<tr>
<td>250 common shares ($600 + $1,600)</td>
<td>2,200</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>3,600</td>
</tr>
<tr>
<td>Total liabilities and shareholders’ equity</td>
<td>6,000</td>
</tr>
</tbody>
</table>

In accordance with ASC paragraphs 805-40-45-2(c) through 45-2(d), the amount recognized as issued equity interests in the consolidated financial statements ($2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination ($600) and the fair value of the
consideration effectively transferred, measured in accordance with ASC 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.

**Earnings per Share**

ASC paragraph 805-40-55-16. Entity B’s earnings for the annual period ending December 31, 20X5, was $600, and the consolidated earnings for the annual period ending December 31, 20X6, is $800. There was no change in the number of common shares issued by Entity B during the annual period ending December 31, 20X5, and during the period from January 1, 20X6, to the date of the reverse acquisition on September 30, 20X6. Earnings per share 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 × 9 ÷ 12] + [250 × 3 ÷ 12]) 175

Earnings per share (800 ÷ 175) $ 4.57

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).

**Noncontrolling Interest**

Assume the same facts as above, 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 ASC paragraphs 805-30-30-7 and 30-8 require the acquirer to measure the consideration exchanged for the accounting acquiree. 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.

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).

The consolidated statement of financial position at September 30, 20X6, reflecting the noncontrolling interest is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets ($700 + $500)</td>
<td>1,200</td>
</tr>
<tr>
<td>Noncurrent assets ($3,000 + $1,500)</td>
<td>4,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>6,000</strong></td>
</tr>
<tr>
<td>Current liabilities ($600 + $300)</td>
<td>900</td>
</tr>
<tr>
<td>Noncurrent liabilities ($1,100 + $400)</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>2,400</strong></td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Retained earnings ($1,400 × 93.3%)</td>
<td>1,306</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
</tr>
<tr>
<td>240 common shares ($560 + $1,600)</td>
<td>2,160</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>134</td>
</tr>
<tr>
<td><strong>Total shareholders’ equity</strong></td>
<td><strong>3,600</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders’ equity</strong></td>
<td><strong>6,000</strong></td>
</tr>
</tbody>
</table>

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).
ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, eliminates the use of available-for-sale accounting (fair value through OCI) for investments in marketable equity securities that is referred to in this paragraph. ASU 2016-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for nonpublic business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.
Section 10 - Measurement Period

Detailed Contents

Definition and Purpose of the Measurement Period
- The Measurement Period

Financial Reporting When the Initial Accounting for a Business Combination Is Incomplete
- Reporting of Provisional Amounts
- Disclosures

Adjustments to Provisional Amounts During the Measurement Period
- Identifying Adjustments to Provisional Amounts
  - Example 10.1: Use of Hindsight When Measuring the Fair Value of Contingent Consideration
  - Example 10.2: Information Becomes Available before and Shortly after the Measurement Period Ends

Adjustments to Provisional Amounts Are Reported in the Subsequent Period

Other Examples of Measurement Period Adjustments
- Incomplete Valuation Information at the Reporting Date
  - Example 10.3: Appraisal Received during the Measurement Period Identifies Decrease in Fair Value Occurring after the Acquisition Date
  - Example 10.4: Pension Plan Valuation Not Completed at the Acquisition Date

- Obligation for Defective Products
  - Example 10.5: New Information on Defective Product Liability Obtained during the Measurement Period

- Loans Acquired in an Acquisition
  - Example 10.6: New Information on the Fair Value of an Acquired Loan Obtained during the Measurement Period
  - Example 10.7: Decrease in Fair Value of Acquired Loan Resulting from an Event Occurring during the Measurement Period

New Information Obtained on a Contingency Identified Pre-Combination
- Example 10.8: Contingency Existed but Additional Information Identified after the Acquisition Date

After the Measurement Period Ends, the Acquisition Accounting Is Adjusted Only to Correct Errors
- Example 10.9: Error Discovered after the End of the Measurement Period

Adjustments to Provisional Amounts Related to Deferred Tax Assets and Liabilities
- During the Measurement Period
- Contingent Consideration
DEFINITION AND PURPOSE OF THE MEASUREMENT PERIOD

THE MEASUREMENT PERIOD

ASC Paragraph 805-10-25-13

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, in accordance with [ASC] paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.

ASC Paragraph 805-10-25-14

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

ASC Paragraph 805-10-25-15

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure any of the following as of the acquisition date in accordance with the requirements of [ASC] Topic [805]:

a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree (see [ASC] Subtopic 805-20)

b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill in accordance with [ASC] paragraphs 805-30-30-1 through 30-3)

c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer (see [ASC] paragraph 805-30-30-1(a)(3))

d. The resulting goodwill recognized in accordance with [ASC] paragraph 805-30-30-1 or the gain on a bargain purchase recognized in accordance with [ASC] paragraph 805-30-25-2.
10.000 The information necessary to enable an acquirer to complete the identification and measurement of these items often will be unavailable by the end of the first reporting period following the acquisition date. For example, appraisals may be required to determine fair value of plant and equipment acquired, a discovery period might be needed to identify and value intangible assets acquired, and an actuarial determination may be required to determine the pension liability (or asset) to be recorded. Additionally, if a business combination is consummated near the end of the acquirer’s reporting period or the acquiree’s operations are extensive or unusually complex, the acquirer may require additional time to obtain all of the data required to complete the acquisition accounting. The objective of the measurement period is to provide a reasonable period of time for the acquirer to obtain the information necessary to enable it to complete the accounting for a business combination. The acquirer determines whether it has obtained all the information it is seeking on an item-by-item basis, as it may be easier to obtain the information needed to determine the fair value of certain acquired items than others.

10.001 The FASB determined that a reasonable time ends when the acquirer receives the information it was seeking about facts and circumstances existing as of the acquisition date, but in any event cannot continue for more than one year from the acquisition date. In limiting the measurement period to a maximum of one year, the FASB concluded that extending the measurement period beyond one year would not be particularly helpful, because obtaining reliable information about circumstances and conditions that existed as of an acquisition date more than a year earlier is likely to become more difficult as time passes. The FASB also noted that, while the outcome of some contingencies and similar items may not be known within a year, the purpose of the measurement period is to provide time to obtain the information necessary to measure the items as of the acquisition date, and that determining the ultimate settlement amount of a contingency is not part of the acquisition accounting. Statement 141(R), par. B392

FINANCIAL REPORTING WHEN THE INITIAL ACCOUNTING FOR A BUSINESS COMBINATION IS INCOMPLETE

REPORTING OF PROVISIONAL AMOUNTS

10.002 If the initial accounting for a business combination is not complete at the end of the financial reporting period following the acquisition date, the acquirer reports provisional amounts for the assets, liabilities, equity interests, or items of consideration for which the accounting is incomplete. Because the acquirer evaluates whether it has the information it seeks on an item-by-item basis, the amounts reported may be final for certain items and provisional for others. ASC Topic 805, Business Combinations, does not provide specific guidance on determining provisional amounts. We believe that those amounts should be determined based on the available information at the acquisition date, consistent with the recognition and measurement requirements of ASC Topic 805. We do not believe it is appropriate to assign only nominal amounts, or no amounts, simply because the acquirer anticipates receiving additional information about facts and circumstances that existed as of the acquisition date.
10.003 Until the accounting for a business combination is complete, the acquirer is required to include additional disclosures in its financial statements. ASC paragraph 805-20-50-4A specifies these disclosure requirements, which include, for particular assets, liabilities, noncontrolling interests, or items of consideration for which the initial accounting is incomplete and for which the amounts recognized in the financial statements have been determined only provisionally:

1. The reasons why the initial accounting is incomplete;
2. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete; and
3. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with ASC paragraph 805-10-25-17.

10.004 The disclosures in an acquirer’s postcombination financial statements, when the initial accounting for an acquisition is incomplete, should clearly identify the status of the acquisition accounting, consistent with the level of detail required by ASC Topic 805. The disclosures in the acquirer’s initial postcombination financial statements following an acquisition should describe why the initial accounting is incomplete, and the items in its financial statements for which the initial accounting is incomplete. Postcombination financial statements issued during the measurement period should describe the adjustments to the acquisition accounting during the most recent reporting period, and update the other disclosures with respect to the status of the acquisition accounting, including the items for which the initial accounting remains incomplete. In making these disclosures, the acquirer should give consideration to the following:

- The measurement period does not provide an open one-year period following the acquisition date to complete the acquisition accounting. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date, or learns that more information is not available. “However, in no circumstances may the measurement period exceed one year from the acquisition date.” Statement 141(R), par. B392; ASC paragraph 805-10-25-14
- The required disclosures under ASC paragraph 805-20-50-4A should be sufficiently detailed to identify the nature of the items for which the acquisition accounting has not been completed. Thus, it would generally be expected that subsequent adjustments to the acquisition accounting during the measurement period would have been included in the ASC paragraph 805-20-50-4A disclosures as an area of potential adjustment to the acquisition accounting in any postcombination financial statements of the acquirer.

Additional assets acquired or liabilities assumed in an acquisition that were not recognized at the acquisition date might be identified during the measurement period. For example, new information obtained about facts and circumstances that existed at the acquisition date might indicate that an
income tax uncertainty that was not recognized by the acquirer in the initial accounting for an acquisition because it did not meet the more-likely-than-not criterion for recognition at the acquisition date did, in fact, meet that criterion at the acquisition date. Similarly, new information might be obtained about facts and circumstances that existed at the acquisition date, but that were unknown at that date, that indicate additional assets or liabilities (including those arising from contingencies) not recognized in the initial accounting for an acquisition should be recognized as part of the accounting for the acquisition. ASC paragraphs 805-10-25-13 and 25-14 require an acquirer to recognize additional assets or liabilities during the measurement period if it obtains new information about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities at that date. Thus, an acquirer should assess the potential for identifying additional assets or liabilities not recognized at the acquisition date in making the disclosures required by ASC paragraph 805-20-50-4A about provisional amounts. For example, unless an acquirer has a high level of confidence that it has identified all liabilities assumed due to legal and regulatory matters, including but not limited to those related to environmental regulation and taxation arising from an acquisition, it should disclose the status of its review and disclose the potential for adjustments to the provisional amounts initially recognized. Such disclosure might be along the following lines:

“[Acquiree] is subject to the legal and regulatory requirements, including but not limited to those related to environmental matters and taxation, in each of the jurisdictions in the 12 countries in which it operates. [Acquirer] has conducted a preliminary assessment of liabilities arising from these matters in each of these jurisdictions, and has recognized provisional amounts in its initial accounting for the acquisition of [Acquiree] for all identified liabilities in accordance with the requirements of ASC Topic 805. However, [Acquirer] is continuing its review of these matters during the measurement period, and if new information obtained about facts and circumstances that existed at the acquisition date identifies adjustments to the liabilities initially recognized, as well as any additional liabilities that existed at the acquisition date, the acquisition accounting will be revised to reflect the resulting adjustments to the provisional amounts initially recognized.”

- Adjustments to provisional amounts, or recognition of additional assets acquired or liabilities assumed, identified during the measurement period, should be recognized as they are identified, even if the acquirer expects that further adjustments might be needed during the measurement period. Thus, for example, if an acquirer issues quarterly financial statements during the period following an acquisition, those financial statements should reflect, on a cumulative basis, any measurement period adjustments identified since the issuance of financial statements for the previous reporting period(s). Additionally, the disclosures required by ASC Topic 805, including those required by ASC paragraph 805-20-50-4A for business combinations for
which the initial accounting is incomplete, are required to be included in interim financial statements.

The SEC staff has challenged measurement period adjustments when there were no prior disclosures by the acquirer about the reported amounts being provisional and why the initial accounting was incomplete. Absent sufficient prior disclosures about the reported amounts being provisional, the SEC staff ordinarily expects the accounting for those items to be final. See the discussion of Disclosures in Section 13.

ADJUSTMENTS TO PROVISIONAL AMOUNTS DURING THE MEASUREMENT PERIOD

IDENTIFYING ADJUSTMENTS TO PROVISIONAL AMOUNTS

ASC Paragraph 805-10-30-2
The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the time at which additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts.

ASC Paragraph 805-10-30-3
Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

10.005 In many instances, it will be clear whether information obtained after the acquisition date (but within the measurement period) relates to facts and circumstances that existed at the acquisition date and should, therefore, result in an adjustment to the provisional amounts recognized, or whether the additional information relates to events that occurred after the acquisition date and should, therefore, be accounted for as events of the postcombination period. However, in other instances, whether an event should be recognized as an adjustment to a provisional amount or as a postcombination event will be less clear, and will require analysis and judgment. See the discussion in Paragraph 10.007 about the analogy of measurement period adjustments to recognized subsequent events under ASC Subtopic 855-10, Subsequent Events - Overall.

10.006 Even if additional information related to circumstances and conditions that existed as of the acquisition date comes to light during the measurement period, such information results in adjustments to the provisional amounts recognized at the acquisition date only if:
• The additional information affects the measurement of items that were initially recognized at the acquisition date;

• The additional information establishes that an additional asset was acquired or a liability was assumed that was not recognized in the initial accounting for the acquisition; or

• An asset or a liability was recognized at the acquisition date, and the subsequent information establishes that such asset or liability did not meet the recognition requirements of ASC Topic 805 at that date.

10.007 In considering the nature of postcombination adjustments, the FASB concluded that adjustments to provisional amounts during the measurement period are analogous to recognized subsequent events in ASC Subtopic 855-10. Recognized subsequent events are events that occur after the balance sheet date but before financial statements are issued or are available to be issued, that provide additional evidence about conditions that existed at the financial statements balance sheet date (including the estimates inherent in the process of preparing financial statements) and, thus, are reflected in the financial statements as if they had been initially recognized at that date. Similarly, the effects of information that first becomes available during the measurement period and provides evidence of conditions or circumstances that existed at the acquisition date should be reflected in the accounting as of the acquisition date. Statement 141(R), par. B399 (revised to reflect changes in accounting guidance and terminology in ASC Subtopic 855-10); ASC paragraphs 805-10-30-2 and 30-3

Example 10.1: Use of Hindsight When Measuring the Fair Value of Contingent Consideration

ABC Corp. acquires DEF Corp. on February 28, 20X4. The acquisition agreement calls for ABC to pay the former shareholders of DEF additional consideration based on the performance of DEF’s business for the two years after the acquisition date. Based on the due diligence performed at the acquisition date, the fair value of the contingent consideration is estimated to be $20 million.

DEF’s performance in the 10 months after the acquisition date has been significantly better than anticipated, in part because of better synergies in integrating DEF’s operations into ABC’s existing distribution channels. As a consequence, at December 31, 20X4 (which is within the measurement period), the fair value of the contingent consideration is estimated to be $50 million.

The adjustment to the contingent consideration would not constitute a measurement period adjustment because it reflects new conditions (i.e., improved performance of DEF) rather than more information about conditions that existed at the acquisition date. Therefore, the $30 million adjustment to the fair value of the contingent consideration is included in income for the year ended December 31, 20X4.
Example 10.2: Information Becomes Available before and Shortly after the Measurement Period Ends

ABC Corp. acquires DEF Corp. on April 30, 20X8. Provisional amounts are recognized for certain of the assets acquired and liabilities assumed, including a liability related to a contractual dispute between DEF and one of its customers. DEF completed the contract before the acquisition date, but its customer claimed, shortly before the acquisition date, that certain amounts were due to the customer from DEF under penalty clauses for completion delays included in the contract. ABC evaluated the dispute based on the information available at the acquisition date, and concluded that DEF was responsible for at least some of the delays in completing the contract. ABC recognized a provisional amount for this liability in its acquisition accounting of $1 million, which was its best estimate of the fair value of the liability to the customer based on the information available at the acquisition date.

ABC obtained no new information about the possible outcome of the dispute until September 20X8 and it continued to reflect the liability at the provisional amount of $1 million. However, in September 20X8, based on its evaluation of additional information presented by the customer in support of its claim, ABC concluded that the fair value of the liability for the customer’s claim at the acquisition date was $2 million.

ABC continued to receive and evaluate information related to the claim after September 20X8, but its evaluation did not change until May 15, 20X9, when it concluded, based on additional information and responses received from the customer to inquiries made by ABC, that the liability for the claim at the acquisition date was $1.9 million. ABC determined that the amount that would otherwise be recognized with respect to the claim under ASC Topic 450, Contingencies (i.e., if the claim had not arisen from a contingency existing at the acquisition date) as of May 15, 20X9, would be $2.2 million.

ABC’s accounting for changes to the liability provisionally recognized for this dispute at the acquisition date is:

- ABC increases the provisional amount of $1 million recognized as a liability at the acquisition date to $2 million in September 20X8, because this adjustment results from new information about facts and circumstances that existed at the acquisition date and falls within the measurement period.

The decrease in the estimated fair value of the liability for the claim (from $2 million to $1.9 million) in May 20X9 occurred after the measurement period (i.e., more than one year after the acquisition date), and would therefore not be recognized as an adjustment to the acquisition accounting. However, because the amount determined in accordance with ASC Topic 450 ($2.2 million) now exceeds the fair value of the liability recognized under ASC Topic 450 ($2 million), and because the information resulting in this change was obtained after the end of the measurement period, ABC would recognize an increase in the liability of $0.2 million, and an offsetting charge to earnings. See discussion of the subsequent measurement and accounting for Assets and Liabilities Arising from Contingencies, in Section 12.
ADJUSTMENTS TO PROVISIONAL AMOUNTS ARE REPORTED IN THE SUBSEQUENT PERIOD

ASC Paragraph 805-10-25-16

The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree’s facilities, part or all of which are covered by the acquiree’s liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

ASC Paragraph 805-10-25-17

During the measurement period, the acquirer shall recognize adjustments to the provisional amounts with a corresponding adjustment to goodwill in the reporting period in which the adjustments to the provision amounts are determined. Thus, the acquirer shall adjust its financial statements as needed, including recognizing in its current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, if any, as a result of the change to the provisional amounts calculated as if the accounting had been completed at the acquisition date. Paragraph 805-10-55-16 and Example 1 (see paragraph 805-10-55-27) provide additional guidance.

10.008 An acquirer is required to recognize adjustments to provisional amounts identified during the measurement period in the period they are identified, and to recognize such adjustments in the current period as if the accounting for the business combination had been completed at the acquisition date (i.e., on a cumulative basis in the period of the adjustment). These adjustments may relate to the measurement of initially recognized assets acquired or liabilities assumed, identification of additional assets acquired or liabilities assumed, and previously recognized assets or liabilities that do not meet the recognition criteria of ASC Topic 805, based on new information about the facts and circumstances that existed at the acquisition date. The current financial statements would reflect the cumulative adjustments to provisional amounts identified during the measurement period, including any adjustments to the assets acquired (including indemnification assets), the liabilities assumed, related deferred taxes, goodwill, and any change in depreciation, amortization, or other income effects as a result of the adjustments.
OTHER EXAMPLES OF MEASUREMENT PERIOD ADJUSTMENTS

10.009 Examples 10.3 through 10.9 illustrate the accounting for adjustments to assets acquired and liabilities assumed in an acquisition that are identified during the measurement period. All adjustments in the examples are deemed to be material for purposes of illustration. Income tax considerations are not addressed in the examples. It is assumed for purposes of each of these examples that, when amounts recognized in the financial statements for the first reporting period following the acquisition are based on provisionally determined amounts, the disclosures required by ASC paragraph 805-20-50-4A were included in those financial statements.

INCOMPLETE VALUATION INFORMATION AT THE REPORTING DATE

10.010 An acquirer may not have obtained the valuation information required to finalize the accounting for certain assets acquired and liabilities assumed in an acquisition by the time it issues its financial statements for the first reporting period following an acquisition. In such instances, the acquiree assigns provisional amounts to the acquired asset or liability assumed, based on an evaluation of the information available at that time.

ASC Paragraph 805-10-55-27
This Example illustrates the measurement period guidance in paragraph 805-10-55-16. Acquirer acquires Target on September 30, 20X7. Acquirer seeks an independent appraisal for an item of property, plant, and equipment acquired in the combination, and the appraisal was not complete by the time Acquirer issued its financial statements for the year ending December 31, 20X7. In its 20X7 annual financial statements, Acquirer recognized a provisional fair value for the asset of $30,000. At the acquisition date, the item of property, plant, and equipment had a remaining useful life of five years. Six months after the acquisition date, Acquirer received the independent appraisal, which estimated the asset’s acquisition-date fair value as $40,000.

ASC Paragraph 805-10-55-28
In its interim financial statements for the quarter ending March 31, 20X8, Acquirer adjusts the provisional amounts recorded and the related effects on that period’s earnings as follows:

a. The carrying amount of property, plant, and equipment as of March 31, 20X8, is increased by $9,000. That adjustment is measured as the fair value adjustment at the acquisition date of $10,000 less the additional depreciation that would have been recognized had the asset’s fair value at the acquisition date been recognized from that date ($1,000 for 6 months’ depreciation).

b. The carrying amount of goodwill as of March 31, 20X8, is decreased by $10,000.
c. Depreciation expense for the quarter ended March 31, 20X8 is increased by $1,000 to reflect the effect on earnings as a result of the change to the provisional amount recognized.

**ASC Paragraph 805-10-55-29**

In accordance with ASC paragraph 805-20-50-4A, Acquirer discloses both of the following:

a. In its 20X7 financial statements, that the initial accounting for the business combination has not been completed because the appraisal of property, plant, and equipment has not yet been received

b. In its March 31, 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, Acquirer discloses that the increase to the fair value of the item of property, plant, and equipment was $10,000 with a corresponding decrease to goodwill. Additionally, the change to the provisional amount resulted in an increase in depreciation expense and accumulated depreciation of $1,000, of which $500 relates to the previous quarter.

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**Example 10.3: Appraisal Received during the Measurement Period Identifies Decrease in Fair Value Occurring after the Acquisition Date**

ABC Corp. acquires DEF Corp. in December 20X8. The fair value of DEF’s headquarters and surrounding property was estimated to be $10 million. In May 20X9, ABC obtained an appraisal for the property that indicated a current fair value of $8 million. The appraisal also confirmed the property’s acquisition-date fair value of $10 million, and indicated that the subsequent decline in fair value was due to an unexpected change in zoning and land-use laws proposed three months after the acquisition date. Comparable real estate in the same market area also declined significantly as a result of the proposed changes in zoning and land-use laws. ABC concluded that there were no other factors that may have affected the acquisition-date fair value of the property.

In this case, the decline in fair value of the property would not be a measurement period adjustment, because an event after the acquisition (the proposed change in zoning and land-use laws) caused the property value decline. Accordingly, ABC would not adjust the provisionally determined amount recognized in the initial accounting for the acquisition. ABC would perform an impairment test under ASC paragraphs 360-10-35-15 through 35-42, to determine if recognition of an impairment loss is required.
Example 10.4: Pension Plan Valuation Not Completed at the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination in August 20X7. At the acquisition date, ABC provisionally recognized a liability of $200 related to DEF’s pension plan, based on an actuarial valuation report as of December 20X6 with a rollforward adjustment for the period from the measurement date of the valuation report to the acquisition date, because the calculation of the projected benefit obligation and the information concerning the fair value of the plan assets as of the acquisition date was not available. The remeasurement of the projected benefit obligation and the fair value of plan assets related to DEF’s pension plan as of the acquisition date was not completed until November 20X7. This remeasurement reflected an excess of the projected benefit obligation over plan assets of $300 as of the acquisition date. ABC evaluated the reasons for the difference between the provisionally recognized and the finally determined projected benefit obligation, and determined that the differences did not result from an error in the calculation of the provisionally recognized amount, but rather resulted from using the updated information that was not available until November 20X7.

ABC should recognize the additional $100 excess of the projected benefit obligation over plan assets as a $100 increase in the provisional liability recognized at the acquisition date, with an offsetting adjustment recognized as an increase in goodwill or a reduction in the gain on a bargain purchase, as applicable. These adjustments would be included in the quarter that includes November 20X7. The impact on net pension cost for the period August 20X7 - November 20X7 would be included in the net pension cost recognized for the quarter that included November 20X7. Net pension cost for periods subsequent November 20X7 would be determined based on the unfunded projected benefit obligation of $300, which includes the effect of the measurement period adjustment identified subsequent to the acquisition.

OBLIGATION FOR DEFECTIVE PRODUCTS

Example 10.5: New Information on Defective Product Liability Obtained during the Measurement Period

ABC Corp. acquired DEF Corp. in a business combination in December 20X8. As of the acquisition date, DEF had established a liability for its warranty obligation for product defects on products sold to 25 customers. DEF had reviewed the customers’ claims and concluded, pending actual product testing, that it was obliged under its product warranty to either make repairs or replace certain product components. ABC agreed with DEF’s assessment and recognized a liability in the provisional amount of $1,000 (25 × $40), the estimated fair value of the liability, as part of its accounting for the acquisition of DEF. In April 20X9, on completion of product testing, ABC concluded that it would be required to replace the defective products in their entirety, and estimated the fair value of the liability for total product replacement as of the acquisition date to be $5,000 (25 × $200).
DEF’s liability for defective products existed as of the acquisition date. The new information received in April 20X9 related to facts and circumstances that existed at the acquisition date. Accordingly, ABC would therefore recognize an increase of $4,000 (25 \times ($200 - $40)) in the provisional amount of the liability recognized at the acquisition date, and a corresponding increase in goodwill (or as an adjustment to the gain from a bargain purchase, if applicable) in the quarter that includes April 20X9.

LOANS ACQUIRED IN AN ACQUISITION

Example 10.6: New Information on the Fair Value of an Acquired Loan Obtained during the Measurement Period

Bank X acquired Bank Y in a business combination. In measuring the fair value of Bank Y’s loan portfolio, Bank X recognizes a loan to one of the Bank’s customers, Borrower Z, at its provisionally determined fair value. Subsequent to the acquisition date, Bank Y received financial statements from Borrower Z as of Borrower Z’s most recent year-end (which preceded the acquisition date), which indicated that the income from operations of Borrower Z had declined significantly during the past year. Based on this new information, Bank X concluded that the fair value of Borrower Z’s loan at the acquisition date was less than the provisional amount recognized at that date.

The new information obtained by Bank X subsequent to the acquisition related to facts and circumstances that existed at the acquisition date. Accordingly, Bank X should recognize a decrease in the provisional amount recognized for Borrower Z’s loan to the fair value of the loan determined based on the new information, and a corresponding increase in goodwill (or a decrease in the gain from a bargain purchase, if applicable) in the quarter in which the updated information is obtained.

Example 10.7: Decrease in Fair Value of Acquired Loan Resulting from an Event Occurring during the Measurement Period

Bank X acquired Bank Y in a business combination. In measuring the fair value of Bank Y’s loan portfolio, Bank X recognizes a loan to one of Bank Y’s customers, Borrower Z, at its provisionally determined fair value. Subsequent to the acquisition date, Bank X learned that Borrower Z had lost its major customer (the loss of its major customer occurred after the acquisition date), which is expected to have a significant negative effect on the operations of Borrower Z. Based on this new information, Bank X determined that the fair value of the loan to Borrower Z was significantly less than the amount that had been provisionally determined at the acquisition date.

The new information resulting in the change in the estimated fair value of the loan was not due to facts and circumstances that existed at the acquisition date, but rather was due to an event (the loss of a major customer by Borrower Z) that occurred subsequent
NEW INFORMATION OBTAINED ON A CONTINGENCY IDENTIFIED PRE-COMBINATION

Example 10.8: Contingency Existed but Additional Information Identified after the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination in April 20X8. ABC identified a contingency during due diligence related to the trade practices of a subsidiary of DEF. ABC was still in the process of obtaining information related to the contingency at the acquisition date and disclosed this as an item subject to potential adjustment during the measurement period. As sufficient information was not available, ABC did not record a liability at the acquisition date. The acquisition agreement included a $20 million indemnification of potentially identified contingencies. ABC caused DEF to discontinue such trading practices immediately following the acquisition.

In February 20X9, before ABC obtained all relevant information about the facts related to the contingency that existed at the acquisition date, the Department of Justice publicly announced the start of a formal investigation into the trade practices of a subsidiary of DEF related to activities that occurred during a three-year period that ended prior to the acquisition date. Based on the subsequent announcement of the investigation into the trade practices of DEF and on the records available related to the period under investigation, ABC concludes that, while the acquisition-date fair value of the liability is not determinable, it is probable that DEF’s trade practices during the period under investigation violated the applicable laws and estimates the amount of the unasserted claim at the acquisition date to be $30 million. In addition, after seeking advice from legal counsel, ABC concludes that it has recourse against the previous shareholders of DEF up to the $20 million from the indemnification clause in the acquisition agreement, and has responsibility for any remaining loss arising from claims related to the investigation.

The contingency existed as of the acquisition date; however, ABC did not obtain the additional information until after the acquisition date but before the end of the measurement period. If ABC had been aware of this information at the acquisition date, it would have recognized a liability as of that date. Therefore, ABC should record a measurement period adjustment to reflect the $30 million estimated amount of the liability related to the contingency, consistent with ASC paragraph 805-10-25-16, offset by the indemnification asset of $20 million, as well as a corresponding increase in goodwill.
After the measurement period ends, the acquisition accounting is adjusted only to correct errors.

**ASC Paragraph 805-10-25-19**

After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with [ASC] Topic 250.

**10.011** Because the measurement period extends for a maximum period of one year following the acquisition date, no further adjustments are made to the acquisition accounting thereafter except to correct an error. If errors in the acquisition accounting are discovered during the measurement period, but after postcombination financial statements have been issued, adjustments to the postcombination financial statements to correct the error should also be accounted for as the correction of an error under ASC Topic 250, *Accounting Changes and Error Corrections*.

**10.012 – 10.015** Paragraphs not used.

### Example 10.9: Error Discovered after the End of the Measurement Period

**Case 1: New Information Obtained after the End of the Measurement Period**

ABC Corp., a calendar-year-end nonpublic entity, acquired DEF Corp. in a business combination in November 20X8. The measurement period ended in November 20X9. In January 20Y0, before issuance of its 20X9 financial statements, ABC obtained new information about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of an additional liability at that date.

In this case, because the measurement period has ended and the adjustment resulting from the new information is not the result of an error, ABC would not adjust the acquisition accounting. Instead, it would treat the new information as a recognized subsequent event with respect to its 20X9 financial statements and, accordingly, would reflect the effect of the adjustment resulting from the new information in its 20X9 financial statements by recognizing the additional liability through a charge to earnings.

**Case 2: Error Discovered after the End of Measurement Period**

Assume the same facts as in Case 1, except that ABC concluded that the new information it obtained in January 20Y0 indicated that it had made an error in the acquisition accounting due to the misuse of facts that existed at the acquisition date.

In this case, if the effects were material, ABC would restate its financial statements as of the date the information was deemed to be initially available (which could be the period that includes the acquisition date or any of the subsequent interim periods until the end of the measurement period and any subsequent interim period financial statements after that date) to correct the error in the acquisition accounting by recognizing the liability as of the acquisition date and adjusting goodwill (or the gain on a bargain purchase) by the
corresponding amount, and making any cumulative adjustments needed to its results of operations resulting from the error. ABC also would determine whether any other actions were necessary as a result of the restatement of such financial statements.

ADJUSTMENTS TO PROVISIONAL AMOUNTS RELATED TO DEFERRED TAX ASSETS AND LIABILITIES DURING THE MEASUREMENT PERIOD

ASC Paragraph 805-740-25-2

An acquirer shall recognize a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination and shall account for the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, in accordance with the guidance in [ASC] Subtopic 740-10 [Income Taxes - Overall] together with the incremental guidance provided in [ASC] Subtopic [805-740].

10.016 Prior to the issuance of ASC Topic 805 and the related amendments to ASC Subtopic 740-10, Income Taxes - Overall, ASC Subtopic 740-10 required that the tax benefits arising subsequent to an acquisition (as a result of the initial elimination of a valuation allowance recognized at the acquisition date for an acquiree’s deductible temporary differences or operating loss or tax credit carryforwards) be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

10.017 In deliberating ASC Topic 805, the FASB concluded that an acquirer should recognize changes in amounts recognized for acquired deferred tax benefits of an acquiree (both increases and decreases) in the same manner as revisions to other amounts recognized at the acquisition date.

ASC Paragraph 805-740-45-2

The effect of a change in a valuation allowance for an acquired entity’s deferred tax asset shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, an acquirer shall recognize any additional decrease in the valuation allowance as a bargain purchase in accordance with [ASC] paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a business combination.
b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by [ASC] paragraphs 740-10-45-20 through 45-21).

10.018 The FASB also revised ASC Subtopic 740-10 to provide similar guidance for the subsequent accounting for adjustments to amounts recognized for acquired income tax uncertainties. Therefore, the same approach is used in accounting for such adjustments as is required for subsequent adjustments to acquired deferred tax benefits:

**ASC Paragraph 805-740-45-4**

The effect of a change to an acquired tax position, or those that arise as a result of the acquisition, shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed as of the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, the remaining portion of that adjustment shall be recognized as a gain on a bargain purchase in accordance with [ASC] paragraphs 805-30-25-2 through 25-4.

b. All other changes in acquired income tax positions shall be accounted for in accordance with the accounting requirements for tax positions established in [ASC] Subtopic 740-10.

10.019 As a result of these requirements, the accounting for subsequent adjustments to amounts recognized at the acquisition date for acquired deferred tax benefits and acquired income tax uncertainties is the same. That is, retrospective adjustments to amounts recognized at the acquisition date are limited to adjustments that result from new information obtained during the measurement period about facts and circumstances that existed as of the acquisition date. All other changes in amounts recognized at the acquisition date are recognized and measured in accordance with ASC Subtopic 740-10. Additionally, because of ASC Topic 805’s transition provisions related to income taxes, this accounting applies to all adjustments to acquired deferred tax benefits and acquired income tax uncertainties, including adjustments related to amounts recognized in business combinations consummated before the effective date of ASC Topic 805. See the discussion of the subsequent accounting for income taxes following a business combination in KPMG’s handbook, *Accounting for Income Taxes* Section 6.

**CONTINGENT CONSIDERATION**

10.020 The consideration issued by the acquirer in exchange for the acquiree includes a liability (or an asset) arising from a contingent consideration arrangement, measured and recognized at its acquisition-date fair value. Provisional amounts for contingent consideration recognized at the acquisition date are adjusted only for adjustments identified during the measurement period that result from new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized at the acquisition date. All other changes in fair value after the acquisition date, including those occurring within the measurement period, do not affect the acquisition date accounting. See the discussions of
the initial recognition and measurement of contingent consideration, and the subsequent accounting for contingent consideration under *Contingent Consideration*, in Sections 6 and 12, respectively.
Section 11 - Determining What Is Part of the Business Combination Transaction

Detailed Contents

Example 11.0: Costs of Introducing New Processes to an Acquiree before a Business Combination

Preexisting Relationships

Settlement of Preexisting Relationships

Preexisting Noncontractual Relationships
Example 11.1: Preexisting Noncontractual Relationship

Preexisting Contractual Relationships
Example 11.2: Effective Settlement of a Supply Contract as a Result of a Business Combination
Example 11.3: Effective Settlement of a Contract between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability before the Business Combination
Example 11.4 Effective Settlement of a License Contract between the Acquirer and Acquiree
Example 11.5: Reacquired Rights with Off-Market Terms

Transactions That Compensate Employees or Former Owners of the Acquiree for Services

Example 11.6: Arrangement for Contingent Payment to an Employee
Example 11.7: Arrangement for Contingent Payment to an Employee at the Suggestion of the Acquirer
Example 11.7a: Arrangement for Bonuses to Be Paid by the Acquirer to Employees

Additional Indicators for Evaluating Arrangements for Contingent Payments to Employees or Selling Shareholders

Arrangements for Contingent Payments to Employees or Selling Shareholders That Are Forfeited if Employment Terminates

Example 11.8: Stay Bonuses - Scenario 1
Example 11.9: Stay Bonuses - Scenario 2
Example 11.10: Shareholders/Executive Officers - Scenario 1
Example 11.11: Shareholders/Executive Officers - Scenario 2
Example 11.12: Executive Officers - Double Trigger Awards

Forgiveness of Full-Recourse Loans
Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree

Attribution of Replacement Awards to Consideration Transferred and Post-combination Vesting

Measurement

Attribution - Employee Awards

Example 11.13: Acquirer Replacement Awards That Require No Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Required Services as of the Acquisition Date

Example 11.14: Recording Replacement Awards that Provide Additional Fair Value if Post-combination Vesting Is Rendered

Example 11.15: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Requisite Service as of the Acquisition Date

Example 11.16: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

Example 11.17: Acquirer Replacement Awards for Which No Post-combination Vesting Is Required Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

(Pre-ASU 2018-07) Attribution - Nonemployees

Example 11.17a: Share Options Granted to Nonemployees in a Business Combination

(Post-ASU 2018-07) Attribution - Nonemployees

Example 11.17b: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Nonemployees Have Not Delivered all of the Goods or Services as of the Acquisition Date

Accounting for Forfeitures of Replacement Awards in a Business Combination

Example 11.17c: Effect of Acquirer’s Forfeiture Accounting Policy on Post-Acquisition Accounting for Replacement Share-Based Payment Awards

Awards with Graded Vesting - Employee Awards

Example 11.18: Graded Vesting Replacement Awards

Example 11.18a: Graded Vesting Replacement Awards – Part II

Settlement of Share-Based Awards

Example 11.19: Acquirer Cash Settles an Acquiree's Award

Change-in-Control Provisions

Example 11.19a Settlement of Share Awards on Consummation of a Business Combination
Example 11.20: Original Share-Based Payment Award Provides for Accelerated Vesting on Change in Control
Example 11.21: Acquiree Initiates Modification of Share-Based Compensation Awards in Contemplation of a Change in Control
Example 11.22: Modifications of Acquiree Share-Based Compensation Award at the Request of the Acquirer in Contemplation of a Change in Control

Awards with Performance Conditions
Awards with Market Conditions
Post-Acquisition Changes in Estimates
Last-Man-Standing Plans
   Example 11.23: Last-Man-Standing Plans
Acquisition of Noncontrolling Interest
   Example 11.23a: Treatment of the Exchange of Awards in the Acquisition of Noncontrolling Interest
   Example 11.23b: Accounting for the Exchange of Partially Vested Awards at the Acquisition Date of the Subsidiary
   Example 11.23c: Accounting for the Exchange of Fully Vested Awards Issued after the Acquisition Date of the Subsidiary

Acquirer’s Accounting for Unreplaced Awards
   Acquirer’s Subsequent Grant of Awards When Acquirer Did Not Exchange Acquiree’s Awards in the Business Combination Transaction
      Example 11.23a: Employee Share Options of Acquiree That Are Not Assumed by the Acquirer

Payroll Taxes on Share-Based Awards
Accounting for the Income Tax Effects of Replacement Awards Classified as Equity Issued in a Business Combination

Acquisition-Related Costs
   Acquisition-Related Costs Incurred by the Acquirer
      Example 11.26: Acquisition-Related Costs
   Q&A 11.1: Costs Related to Directors and Officers Liability Insurance
   Costs Related to the Issuance of Equity Securities
   Costs Related to the Issuance of Debt
   Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred
      Example 11.27: Acquisition-Related Payments Made by an Acquiree

Other Transactions
   Changes in Interest Rate on Acquirer's Debt Resulting from a Change in Control
Costs Contingent on a Business Combination

Hedging a Forecasted Transaction Contingent on Consummation of a Business Combination

Example 11.28: Derivative Transaction That Will Lock In the Interest Rate Today on the Forecasted Issuance of Debt Expected to Occur in Six Months
The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

- A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see [ASC] paragraphs 805-10-55-20 through 55-23)
- A transaction that compensates employees or former owners of the acquiree for future services (see [ASC] paragraphs 805-10-55-24 through 55-26)
- A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see [ASC] paragraph 805-10-25-23).

An acquirer is required to identify amounts that are not part of the exchange for the acquiree. Such amounts are not included in the accounting for the business combination, but rather are accounted for as separate transactions in accordance with other relevant GAAP. If a method of allocating consideration is not specifically addressed by other relevant GAAP, we believe allocating amounts based on relative fair value is a reasonable approach.

Determining what is part of the business combination involves an analysis of the relevant factors of the arrangement. The FASB observed that parties directly involved in the negotiations of a business combination may take on the characteristics of related parties, and thus may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity (for example, to achieve more favorable financial reporting outcomes after the business combination). ASC paragraph 805-10-25-21 provides three examples of transactions that are not part of a business combination and which should therefore be accounted for separately in accordance with other relevant GAAP. The determination as to whether an asset or liability is part of a business combination transaction rather than an asset or a liability resulting from a separate transaction requires an acquirer to identify the components of a transaction in which it
obtains control over an acquiree. The objective of making the distinction is to ensure that each component is accounted for in accordance with its economic substance. ASC paragraphs 805-10-25-20 through 25-22 and 55-18.

11.002 The implementation guidance in ASC paragraph 805-10-55-18 provides factors (which are not mutually exclusive or individually conclusive) to be considered in assessing whether a transaction is part of a business combination or is a separate transaction and should be accounted for separately in accordance with other relevant GAAP.

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

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

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

11.003 In many instances, it will be readily apparent, giving consideration to the specific circumstances including the above factors, whether a transaction or arrangement is part of the business combination or relates to events or transactions that are not a part of the business combination and should therefore be accounted for in accordance with other relevant GAAP. For example, the settlement of matters that arose prior to the consideration of a business combination between the acquirer and the acquiree, such as a
preexisting lawsuit between the acquirer and the acquiree, or a long-term supply contract or an operating lease agreement between the acquirer and the acquiree with terms that are favorable or unfavorable relative to market terms at the acquisition date, would not be part of the business combination, and would therefore be accounted for in accordance with other relevant GAAP.

11.004 In other instances, it may be less clear whether an amount relates to a transaction or arrangement that is or is not part of the business combination, and a more detailed analysis based on the above factors and other relevant information may be required in making this determination.

11.005 ASC paragraphs 805-10-25-20 through 25-23 provide additional guidance in assessing transactions entered into with an acquiree or by an acquiree on behalf of an acquirer. See Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred beginning at Paragraph 11.066.

Example 11.0: Costs of Introducing New Processes to an Acquiree before a Business Combination

Background

An entity (Acquirer) entered into an agreement to purchase a manufacturing operation (Target) from a third party (Seller). Target meets the definition of a business under ASC paragraph 805-10-55-3A. Seller agreed to incur costs to introduce certain new processes into the facility to allow Acquirer to manufacture product not currently manufactured by Target. If the new processes do not meet the specifications agreed by the two parties, Acquirer can withdraw from the acquisition but must pay a penalty, calculated by reference to the costs that Seller will incur to introduce the new processes. The costs are business process reengineering expenses in the scope of ASC Subtopic 720-45.

Acquirer considers the guidance in ASC paragraph 805-10-55-18 to determine whether it should account for the new processes as part of the business combination.

(a) The reasons for the transaction – The introduction of the new processes into the facility, although they could benefit both Target and Acquirer, are primarily for the benefit of Acquirer and the combined entity to allow the facility to manufacture a product not currently manufactured by Target.

(b) Who initiated the transaction – Acquirer initiated the transaction as part of the negotiations of the business combination.

(c) The timing of the transaction – The parties agreed to introduce the new processes during the negotiations for and in contemplation of the business combination to provide future economic benefits to Acquirer and the combined entity.

Based on the analysis above, Acquirer concludes that introducing new processes just before the business combination is primarily for its own benefit, and therefore not part of
consideration transferred in a business combination. As Target is incurring the reengineering costs, Acquirer should record the expense and a payable (that will be paid to either Seller or Target, depending on whether the transaction closes).

At closing, Acquirer applies the portion of the consideration paid to Seller representing the reimbursement of business process reengineering expense as a reduction to the payable it previously recorded. If the acquisition does not proceed, Acquirer will pay the Target or Seller the penalty and reduce the payable.

PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-55-20

The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a preexisting relationship. A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or noncontractual (for example, plaintiff and defendant).

11.006 Preexisting relationships between the acquirer and the acquiree, including contractual and noncontractual relationships, should be identified and assessed to determine whether they have been effectively settled as a result of the business combination transaction and should therefore be accounted for separately from the business combination in accordance with other relevant GAAP. Because the acquirer usually consolidates the acquiree following a business combination, preexisting relationships are generally effectively settled as a result of the combination (i.e., following the business combination, such transactions are eliminated in the post-combination consolidated financial statements). Prior to the issuance of ASC Topic 805, EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination" provided guidance for the effective settlement of preexisting relationships between the parties to a business combination. EITF 04-1 was nullified by ASC Topic 805. However, the guidance in EITF 04-1 was generally incorporated into ASC Topic 805.

SETTLEMENT OF PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-55-21

If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

a. For a preexisting noncontractual relationship, such as a lawsuit, fair value

b. For a preexisting contractual relationship, the lesser of the following:

   1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not
necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

11.007 The measurement of the gain or loss arising from a preexisting relationship that is effectively settled as the result of a business combination depends on whether that preexisting relationship was contractual or noncontractual in nature. The difference between the amount of the gain or loss measured in accordance with ASC paragraph 805-10-55-21 and the amount previously recognized by the acquirer, if any, is recognized in earnings at the acquisition date. See KPMG’s Accounting for Income Taxes, Section 6 The Tax Effects of Business Combinations for discussion of Recognizing the Tax Effects of the Effective Settlement of a Preexisting Relationship in a Business Combination.

Preexisting Noncontractual Relationships

11.008 An example of a preexisting noncontractual relationship between the acquirer and acquiree would be a lawsuit relating to a noncontractual matter in which the two parties had a relationship as plaintiff and defendant. If the lawsuit is effectively settled as a result of a business combination, it would be measured at fair value, and the difference between the amount measured and amounts previously recognized by the acquirer (in accordance with applicable GAAP) would be recognized as a gain or loss at the acquisition date.

Example 11.1: Preexisting Noncontractual Relationship

ABC Corp. is the defendant in a lawsuit in which DEF Corp. is the plaintiff. ABC has recognized a liability in the amount of $8 million related to this lawsuit in accordance with ASC Topic 450, Contingencies. On January 1, 20Y0, ABC acquires DEF in a business combination, and pays cash consideration of $100 million to DEF's shareholders. ABC’s acquisition of DEF effectively settles the lawsuit. ABC concludes that the lawsuit should be evaluated as a preexisting noncontractual relationship. The fair value of the lawsuit at January 1, 20Y0 is determined to be $5 million. ABC recognizes a $3 million gain on the effective settlement of the lawsuit in earnings at the acquisition date (the $8 million liability previously recognized under ASC Topic 450 less the $5 million fair value of the lawsuit at the acquisition date).

ABC records the following entry to recognize the acquisition of DEF and the effective settlement of the lawsuit with DEF on the acquisition date:
### Debit | Credit
---|---
Net assets of DEF (including goodwill) | $95 million
Litigation liability | $8 million
Gain on settlement of litigation | $3 million
Cash | $100 million

In accounting for the acquisition, the consideration transferred to acquire DEF is $95 million (the $100 million paid to the shareholders of DEF less the $5 million recognized in connection with the effective settlement of the lawsuit).

### Preexisting Contractual Relationships

**11.009** Examples of preexisting contractual relationships between the acquirer and acquiree include a vendor and customer relationship, a lessor and lessee relationship, a licensor and licensee relationship, or a lender and a borrower relationship. A preexisting contractual relationship that is effectively settled as a result of a business combination is measured at 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 (zero for contracts without a termination penalty). The difference between the amount so measured and any amounts previously recognized by the acquirer (in accordance with applicable GAAP) is recognized as a gain or loss at the acquisition date.

**11.010** The following example, which is taken from ASC paragraphs 805-10-55-30 through 55-32, illustrates the accounting for the effective settlement of a supply contract as a result of a business combination.

### Example 11.2: Effective Settlement of a Supply Contract as a Result of a Business Combination

AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates in the contract are higher than rates at which AC could purchase similar electronic components from other suppliers. The supply contract allows AC to terminate the contract before the end of the initial 5-year term by paying a $6 million penalty. With 3 years remaining under the supply contract, AC pays $50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.

Included in the total fair value of TC is $8 million related to the fair value of the supply contract with AC. The $8 million represents a $3 million component that is "at-market" because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a $5 million component for pricing that is unfavorable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognized any assets or liabilities related to the supply contract before the business combination.
In this example, AC recognizes a loss of $5 million (the lesser of the $6 million settlement provision stated in the contract and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The $3 million at-market component of the contract is subsumed into goodwill in the acquisition accounting. The consideration transferred by AC to acquire TC is $45 million (the $50 million paid less the $5 million attributable to the effective settlement of the unfavorable supply contract). ASC paragraphs 805-10-55-30 through 55-32

11.011 The following example, which is taken from ASC paragraph 805-10-55-33, illustrates the accounting for the effective settlement of a supply contract when the acquirer had previously recognized a liability prior to the business combination.

Example 11.3: Effective Settlement of a Contract between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability before the Business Combination

Whether AC had previously recognized an amount in its financial statements related to a preexisting relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. In Example 11.2, GAAP might have required AC to recognize a $6 million liability for the supply contract before the business combination. In that situation, AC recognizes a $1 million settlement gain on the contract in earnings at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, AC has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million. ASC paragraph 805-10-55-33

11.012 The following example illustrates the accounting for the settlement of a license agreement as a result of a business combination.

Example 11.4 Effective Settlement of a License Contract between the Acquirer and Acquiree

ABC Corp. licensed spectrum capacity to DEF Corp. After the original agreement, the market price of spectrum capacity changed substantially such that the contract is now favorable to DEF. ABC acquired DEF while the spectrum license was favorable to DEF and unfavorable to ABC. The fair value of DEF, including the favorable contract is $102, whereas the fair value of DEF if the contract were instead at market value is $100.

ABC pays the same amount as a market participant to acquire DEF ($102), but as the acquisition effectively settles the preexisting relationship, ABC would recognize a loss on settlement of the preexisting relationship separate from the acquisition accounting. Assuming ABC did not have a provision previously recognized for the unfavorable contract, it would record the following:
**Effective Extinguishment of Debt between the Acquirer and the Acquiree**

**11.013** A business combination may result in the effective extinguishment of debt issued by the acquirer. When a business combination results in the extinguishment of debt issued by the acquirer to the acquiree, the acquirer should apply ASC Subtopic 470-50, *Debt - Modifications and Extinguishments*, to account for the debt extinguishment. Any settlement gain or loss that the acquirer recognizes in connection with the debt extinguishment is recognized outside of the accounting for the acquisition.

**11.014** If the preexisting relationship that is settled is debt issued by the acquiree to the acquirer, then the acquirer applies the guidance in ASC paragraph 805-10-55-21(b) related to the settlement of preexisting relationships in a business combination.

**Reacquired Rights**

**11.015** An acquirer may have a preexisting relationship with an acquiree in the form of a previously granted right such as a right to use intellectual property such as a brand or trademark. As a result of a business combination, the acquirer essentially reacquires that previously granted right. For example, an acquirer may have previously granted the acquiree the right to use the acquirer's trade name under a franchise agreement. ASC Topic 805 specifies that rights reacquired by an acquirer in a business combination are identifiable intangible assets that the acquirer recognizes separately from goodwill. See Section 7 for guidance on the measurement of rights that are reacquired in a business combination.

**11.016** Additionally, if the terms of the reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer recognizes a settlement gain or loss separate from the business combination, measured using the guidance for settling preexisting relationships provided in ASC paragraphs 805-20-25-14 through 25-15 and 805-10-55-21.

**Example 11.5: Reacquired Rights with Off-Market Terms**

Franchisor ABC Corp. acquires the business of operating Franchisee DEF Corp. In connection with the acquisition, Franchisor ABC reacquires previously granted franchise rights. Franchisor ABC pays $30 million to acquire Franchisee DEF. The reacquired franchise right is valued at $3 million in accordance with the measurement guidance in...
ASC Topic 805. The terms of the contract covering the rights are unfavorable (from the perspective of the ABC, the acquirer) by $4 million relative to the terms of current market transactions for the same or similar items, and the contract does not include any cancellation or settlement provisions. The amount of the identifiable net assets of Franchisee DEF, measured in accordance with ASC Topic 805, is $17 million (excluding the franchise right). Franchisor ABC records the reacquisition of the franchise right and the acquisition of Franchisee DEF as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on reacquired franchisee right</td>
<td>$4 million</td>
</tr>
<tr>
<td>Reacquired franchise right (intangible asset)</td>
<td>$3 million</td>
</tr>
<tr>
<td>Identifiable net assets of Franchisee DEF (excluding the reacquired franchise right)</td>
<td>$17 million</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$6 million</td>
</tr>
<tr>
<td>Cash</td>
<td>$30 million</td>
</tr>
</tbody>
</table>

TRANSACTIONS THAT COMPENSATE EMPLOYEES OR FORMER OWNERS OF THE ACQUIREE FOR SERVICES

11.017 Arrangements for Contingent Payments to Employees or Selling Shareholders (Application of ASC paragraph 805-10-25-21(b)).

ASC Paragraph 805-10-55-24

Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

11.018 In a business combination an acquirer may enter into an arrangement for contingent payments to employees or selling shareholders of the acquiree. The accounting for such arrangements depends on whether they represent contingent consideration issued in the business combination and are included in the accounting for the acquisition, or are separate transactions and are accounted for in accordance with other relevant GAAP.

- Contingent consideration issued in a business combination is 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 or fail to be met. (ASC Section 805-10-20) See the discussion of Contingent Consideration in Section 6.
Arrangements for contingent payments to employees or selling shareholders that do not meet the definition of contingent consideration are not part of the accounting for the business combination, and are therefore accounted for separately in accordance with other relevant GAAP.

11.019 An understanding of the factors in ASC paragraph 805-10-55-18 (i.e., the reasons why the acquisition agreement includes a provision for such payments, who initiated the arrangement, and the timing of when the parties entered into the arrangement), as well as the conditions that trigger payment of the consideration, may be helpful in assessing whether the arrangement represents contingent consideration issued in the business combination or is a transaction to be accounted for separately from the business combination.

11.020 The following two examples, which are included as ASC paragraphs 805-10-55-34 through 55-36, illustrate the consideration of ASC paragraph 805-10-55-18 factors on the determination of whether an arrangement for contingent payments represents contingent consideration issued in a business combination or is a transaction to be accounted for separately from the business combination.

**Example 11.6: Arrangement for Contingent Payment to an Employee**

TC hired a candidate as its new CEO under a 10-year contract. The contract required TC to pay the candidate $5 million if TC is acquired before the contract expires. AC acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay $5 million is included in the application of the acquisition method. ASC paragraphs 805-10-55-34 through 55-35.

**Example 11.7: Arrangement for Contingent Payment to an Employee at the Suggestion of the Acquirer**

In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method. ASC paragraph 805-10-55-36.
Contingent payments to employees may also be similar to sign on bonuses if they are paid by the acquirer on the acquisition date without any requirement to perform post-acquisition services. The following example illustrates the consideration of ASC paragraph 805-10-55-18 in those arrangements.

**Example 11.7a: Arrangement for Bonuses to Be Paid by the Acquirer to Employees**

Similar to Example 11.7, during the negotiations for the business combination, TC enters into an agreement whereby employees that will become employed by AC will receive cash bonuses as of the acquisition date if they continue to be employed on that date. If the agreement was entered into in contemplation of the business combination, it may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay the employees in its post-combination financial statements as an expense separately from application of the acquisition method.

**ADDITIONAL INDICATORS FOR EVALUATING ARRANGEMENTS FOR CONTINGENT PAYMENTS TO EMPLOYEES OR SELLING SHAREHOLDERS**

**ASC Paragraph 805-10-55-25**

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.

b. Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.

c. Level of compensation. Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.

d. Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the
selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

e. Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

f. Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. Other agreements and issues. The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for
contingent payments to the selling shareholder may be contingent consideration in the business combination.

ARRANGEMENTS FOR CONTINGENT PAYMENTS TO EMPLOYEES OR SELLING SHAREHOLDERS THAT ARE FORFEITED IF EMPLOYMENT TERMINATES

11.021 ASC paragraph 805-10-55-25 states that a contingent consideration arrangement in which the contingent payments are forfeited if employment terminates is compensation for post-combination services. Before the effective date of ASC Topic 805, EITF Issue No. 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination," which was nullified by ASC Topic 805, indicated that a contingent consideration arrangement in which payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is compensation for post-combination service. Discussion with the FASB staff indicated that the removal of the words strong indicator from the guidance in ASC paragraph 805-10-55-25 was intentional and intended to require contingent consideration arrangements in which payments are forfeited if employment terminates to be accounted for as compensation for post-combination services. We believe that an arrangement in which contingent payments to employees or selling shareholders are payable only if the recipients remain in the employment of the combined entity following an acquisition, represents compensation for post-combination service, even if evaluation of some (or even all) of the other indicators in ASC paragraph 805-10-55-25 indicate that the payments would otherwise be considered to be additional consideration transferred in exchange for the acquiree. If a contingent consideration arrangement is not affected by employment termination, the other indicators in ASC paragraph 805-10-55-25 should be considered in determining whether the arrangement is part of the exchange for the acquiree or a separate transaction.

Example 11.8: Stay Bonuses - Scenario 1

ABC Corp. acquires all of the outstanding equity shares of DEF Corp. in a business combination. In connection with the acquisition, ABC offers bonuses (to be paid in cash) to certain senior-level employees of DEF (the offerees). All of the offerees are shareholders of DEF and, collectively, owned all of the outstanding shares of DEF before its acquisition by ABC. The payment of bonuses to an individual offeree is contingent on the offeree remaining employed by the combined entity for a two-year period after the acquisition (i.e., an offeree’s right to receive a bonus is forfeited in the event the offeree does not remain with ABC during the two-year period). The amount of the bonuses to be paid to each offeree will be determined based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition.

The bonuses represent compensation for post-combination services, as the right to a bonus is forfeited if an offeree does not remain with the combined entity for the two-year period following the acquisition. Evaluation of the other factors related to the arrangement would not overcome this conclusion. Thus, the combined entity should recognize compensation cost in a systematic and rational manner during the two-year period the offerees' bonuses are earned.
Example 11.9: Stay Bonuses - Scenario 2

Assume the same facts as in Example 11.8, except that the arrangement provides for contingent payments to each of the offerees (i.e., the former shareholders of DEF) as follows:

(1) Regardless of whether an offeree remains employed by the combined entity, the offeree is entitled to a contingent payment based on a multiple of earnings during the two-year period following the acquisition and the number of shares of DEF held by the offeree and acquired by ABC in the acquisition.

(2) If an offeree remains employed by the combined entity for the two-year period following the acquisition, the offeree is entitled to a contingent payment equal to the higher of the amount determined under (1), or an amount determined based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition.

In this example, each of the offerees are entitled to a contingent payment based on a multiple of earnings and the number of DEF shares they held at the acquisition date (i.e., as determined under (1) above), regardless of whether they remain with the combined entity during the two-year post-combination period. Thus, because all shareholders are participating in the arrangement in proportion to their ownership interest in DEF before ABC acquires it, and because the contingent payment is not tied to employment following the acquisition date, this portion of the contingent consideration arrangement constitutes part of the consideration transferred by ABC in exchange for control of DEF. The contingent consideration obligation is measured at its fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings (even if the arrangement was a derivative, it is not subject to the requirements of ASC Topic 815, Derivatives and Hedging, as it falls under the scope exclusion of ASC paragraphs 815-10-15-59 through 15-61, and therefore could not be designated as a hedging instrument).

See the discussion of Contingent Consideration in Section 6, Recognizing and Measuring the Consideration Transferred.

If an offeree remains with the combined entity during the two-year post-combination period, the offeree will be entitled to an additional payment if the amount determined under (2) above (i.e., based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition) exceeds the amount determined under (1) above. Because any such additional payment is contingent on the offeree's continuing employment with the combined entity, the additional payment is compensation, is recognized by ABC for post-combination services, and is therefore recognized by the combined entity as compensation cost in a systematic and rational manner during the two-year period the offeree's bonuses are earned.
Example 11.10: Shareholders/Executive Officers - Scenario 1

ABC Corp. purchases DEF, a small brokerage firm in which all of the shareholders are executive officers of the firm. The terms of the purchase transaction provide for future payments to the DEF shareholders based on future operating results and the continued employment of the executive officers/shareholders for three years following the acquisition. The potential additional payments to each of the shareholders based on future operating results would be ratable based on their pre-combination shareholdings, would exceed by a significant amount the consideration transferred to them at the acquisition date and, if earned, will exceed by a significant amount what would generally be considered to be reasonable compensation. However, if an executive officer/shareholder does not remain with the entity for the full three-year period, that individual's rights to future payments are forfeited.

Because the future payments are contingent on the officers'/shareholders' continuing employment with the combined entity following the acquisition, ABC should recognize the future payments as compensation cost over the post-combination service period.

Example 11.11: Shareholders/Executive Officers - Scenario 2

ABC Corp. purchases Target from its four shareholders, consisting of Target's CEO and spouse, and two unrelated parties. The Target CEO is the only shareholder who will be employed by ABC. ABC offers each of the four shareholders additional cash consideration contingent on the Target CEO's continuing employment for two years subsequent to the business combination.

ABC should recognize the additional consideration payable to the Target CEO as compensation cost during the two-year post-combination period, because the CEO's right to the additional payment is conditioned on the CEO's continued employment during that period. In addition, the portion of the contingent consideration paid to the spouse is also compensation cost over the two-year post-combination period, due to the nature of a spousal relationship unless it is clear that the shares held by the spouse are unrelated to the spousal relationship.

The two unrelated shareholders do not have any future employment requirements. Accordingly, the fair value of the portion of the additional consideration payable to the two unrelated shareholders is contingent on the CEO remaining in the employment of ABC for the two-year post-combination, and thus constitutes part of the consideration transferred by ABC in exchange for control of Target. Thus, the contingent consideration is measured at fair value at the acquisition date, and is included in the acquisition accounting. Additionally, because the contingent consideration is payable in cash, it is classified as a liability and remeasured to fair value each reporting period until the contingency is resolved. Changes in fair value are recognized in earnings (unless the arrangement qualifies as a hedging instrument for which ASC Topic 815 requires the changes to be initially recognized in other comprehensive income, which seems to be an unlikely scenario in this example).
See discussion of Contingent Consideration in Section 6, Recognizing and Measuring the Consideration Transferred.

Example 11.12: Executive Officers - Double Trigger Awards

Scenario 1

ABC Corp. purchases Target. Target's COO has an employment agreement that requires her to receive a $5 million cash severance payment upon a change in control of the company and severance by the combined company. In this situation, if Target's COO is terminated after the acquisition is consummated, the $5 million severance payment would be treated as a post-combination expense, because the ultimate trigger for the payment is the decision to terminate the former COO, which is made by the acquirer after the acquisition date. This would be the case even if ABC plans, as part of its acquisition decisions, to terminate Target's COO after the acquisition is consummated.

Scenario 2

Contrary to Scenario 1, the double trigger in the COO's employment contract states that she is entitled to the payment upon change in control and a Good Reason. Specifically, the Good Reason clause states that she is entitled to the payment if after the combination, her responsibilities in the combined company are significantly reduced from her responsibilities before the acquisition. ABC plans to offer Target COO a position as marketing director of the combined company in which she will report to ABC's COO.

In our experience, entities normally view Scenario 2 as similar to Scenario 1 because ABC has the ability to decide what the role and responsibilities of Target's former COO will be after the acquisition and can, in effect, determine whether the second trigger is invoked.

We are aware, however, that some Good Reason clauses may provide the acquirer with no reasonable alternative and therefore would be the equivalent of a single trigger provision (see Example 11.6). This alternative view would depend on the specific facts and circumstances of the Good Reason clause and an SEC registrant may want to consider consultation with the SEC staff before applying this approach.

FORGIVENESS OF FULL-RECOURSE LOANS

11.022 Full-recourse loans previously granted to employees of an acquiree may be forgiven in connection with a business combination. This could include loans granted to employees in connection with the exercise of stock options, as well as loans granted for other purposes. If it is not clear whether the forgiveness of the loans is part of the exchange for the acquiree or is a transaction separate from the business combination, all
relevant facts and circumstances, including those identified in ASC paragraph 805-10-55-25, should be considered in making the determination. For example:

- If the loans were entered into prior to the commencement of negotiations for the business combination, and the original terms of the notes require forgiveness in the event of a change-in-control, such forgiveness would generally not be accounted for by the acquirer as a transaction separate from the business combination, as long as the forgiveness does not include any post-combination service requirements and is not tied to another agreement (entered into in connection with the loan agreement) that includes post-combination service requirements.

- If the acquisition agreement includes a provision requiring forgiveness of loans, a determination as to why the provision was included, as well as a review of other arrangements entered into with the participating employees, will be helpful in making the determination. For example, if the provision was included at the request of the acquirer, and a termination agreement was also entered into with the employee before the combination, the forgiveness might constitute what is, in effect, a severance payment to the employee that should be accounted for as a transaction separate from the business combination. An acquirer cannot avoid the recognition of a severance cost that it would otherwise expect to incur immediately following a business combination by arranging for the acquiree to make the payment before the business combination or by putting provisions in an acquisition agreement that effectively provide for the payments.

11.023 In reviewing arrangements such as those discussed above, all arrangements with the participating employees should be considered. For example, if two arrangements are entered into at or about the same time, such as an arrangement providing for the forgiveness of a loan with no service requirement, and a second arrangement that includes a service requirement, consideration should be given as to whether the service requirement included in the second arrangement should impact the determination of whether the first arrangement is part of the exchange for the acquiree or is a transaction separate from the business combination.

**ACQUIRER SHARE-BASED PAYMENT AWARDS EXCHANGED FOR AWARDS HELD BY THE GRANTEES OF THE ACQUIREE**

11.023a This section has been updated for ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting*, which requires companies to account for share-based payment transactions with nonemployees in the same manner as share-based payment transactions with employees, with differences remaining in the accounting for attribution and an award-by-award election to use the contractual term as the expected term to value nonemployee equity share options. The ASU also provides guidance on the accounting for acquirer nonemployee share-based payment awards exchanged for awards held by grantees of the acquiree. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in
fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity’s adoption of Topic 606.

**ASC Paragraph 805-30-30-9**

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. [ASC] Topic [805] refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with [ASC] Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquiree's replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree's awards if replacement is required by any of the following:

a. The terms of the acquisition agreement

b. The terms of the acquiree's awards

c. Applicable laws or regulations.

**ASC Paragraph 805-30-30-10**

In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the post-combination financial statements. That is, none of the fair value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

**ASC Paragraph 805-30-30-11**

To determine the portion of a replacement award that is part of the consideration transferred for the acquiree, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with [ASC] Topic 718. The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting.

**ASC Paragraph 805-30-30-12**

The acquirer shall attribute a portion of a replacement award to postcombination vesting if it requires postcombination vesting, regardless of whether grantees had rendered all of the service or delivered all of the goods required in exchange for their acquiree awards before the acquisition date. The portion of a nonvested replacement award attributable to post-combination vesting equals the total fair-
value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting.

ASC Paragraph 805-30-30-13

[ASC] paragraphs 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see [ASC] paragraph 805-30-55-17) provide additional guidance and illustrations on distinguishing between the portion of a replacement award that is attributable to precombination vesting, which the acquirer includes in the consideration transferred in the business combination, and the portion that is attributed to postcombination vesting, which the acquirer recognizes as compensation cost in its postcombination financial statements.

11.024 An acquirer may issue share-based payment awards (replacement awards) to employees or nonemployees of an acquiree in exchange for share options or other share-based payment awards previously issued by the acquiree. Such exchanges are modifications of share-based payment awards under ASC Topic 718, Compensation-Stock Compensation.

ATTRIBUTION OF REPLACEMENT AWARDS TO CONSIDERATION TRANSFERRED AND POST-COMBINATION VESTING

11.025 If the acquirer is obligated to replace the acquiree awards, all or a portion of the fair-value-based measure of the acquirer's replacement awards is included in measuring the consideration transferred in the business combination. If the acquirer is not obligated to replace the acquiree awards, but chooses to do so voluntarily, all of the fair-value-based measure of the replacement awards is recognized as compensation cost in the acquirer's post-combination financial statements (and thus none of the fair-value-based measure of the replacement awards is included in measuring the consideration transferred in the business combination). Therefore, an acquirer would make a determination as to whether it is obligated to replace the acquiree awards. This determination is based on whether the acquiree or its grantees have the ability to enforce replacement. ASC paragraph 805-30-30-9 indicates, for example, that the acquirer would be obligated to issue replacement awards if replacement is required by:

a. The terms of the acquisition agreement
b. The terms of the acquiree's awards
c. Applicable laws or regulations.

MEASUREMENT

ASC Paragraph 805-20-30-21

The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based...
payment awards of the acquirer in accordance with the method in [ASC] Topic 718. [ASC] Topic [805] refers to the result of that method as the fair-value-based measure of the award. Paragraphs 805-30-30-9 through 30-13 and 805-30-55-6 through 55-13 provide additional guidance.

11.026 Share-based payment awards are an exception to the fair value measurement principle of ASC Topic 805. This exception requires that replacement awards be measured at the acquisition date in accordance with ASC Topic 718, and refers to the amounts so determined as the fair-value-based measure of the award. This applies regardless of whether the fair-value-based measurement of a replacement award is included in measuring the consideration transferred in a business combination, or is recognized as compensation cost in the post-combination financial statements.

11.027 Generally, share-based payments are measured using the fair-value-based measurement method, and the discussion and examples in this Section focus on that method. However, ASC Topic 718 permits nonpublic companies, as a policy election, to use intrinsic value for liability-classified awards. Some nonpublic companies however, did not originally elect this policy when adopting FASB Statement No. 123R (now ASC Topic 718) and, consequently, measured liability-classified awards using fair value rather than intrinsic value. In recognition of this scenario, the FASB allowed a nonpublic company to change its accounting policy for measuring liability-classified awards when adopting the guidance in ASU 2016-091, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, without needing to evaluate whether the change in accounting policy is preferable.

11.027a For additional discussion on the use of intrinsic value by nonpublic companies for liability-classified awards, see KPMG's Share-Based Payment handbook. For example, an acquirer that is a nonpublic entity under ASC Topic 718 should measure replacement awards using intrinsic value if the awards are liability-classified replacement awards and that is the acquirer's ASC Topic 718 policy. Although this discussion focuses on the fair-value-based method, the guidance in ASC Topic 805 and in this discussion applies in situations where ASC Topic 718 permits the use of intrinsic value for the replacement awards.

11.028 ASC Topic 805 sets two limits on the amount of the replacement awards' value that can be included in the consideration transferred. The amount included in the consideration transferred cannot exceed the fair-value-based measure of the replaced awards. Any excess fair value is charged to post-combination expense (even if fully vested at the acquisition date). In addition, the amount included in the consideration transferred can only include the value attributable to pre-combination vesting.

ATTRIBUTION - EMPLOYEE AWARDS

11.029 If the acquiree's employees must render post-combination service under the acquirer's replacement awards, the acquirer determines the portion of the award attributable to pre-combination vesting (and therefore include in the measurement of the consideration transferred in the business combination), and the portion of the award...
attributable to post-combination vesting (and therefore recognized as compensation cost in the post-combination financial statements). Entities should do so following the framework described below, rather than assuming that vested awards are part of the consideration transferred and unvested awards are allocated between pre-combination vesting and post-combination vesting. The approach is the same, regardless of whether the replacement award is classified as a liability or equity.

11.030 The attribution of a replacement award (between pre-combination and post-combination vesting) is a multi-step process:

1. The first step requires the measurement at the acquisition date, in accordance with the fair-value-based measurement method (unless the calculated value method or intrinsic value method is appropriate in accordance with ASC Topic 718), of:
   a. The acquiree award, and
   b. The replacement award.

2. The next step requires the determination of the following:
   a. The requisite service period for the acquiree award (the original service period)*
   b. The portion of the requisite service period that was completed prior to the acquisition date*
   c. The post-combination requisite service period, if any, for the replacement award*
   d. The total service period (i.e., the sum of 2(b) and 2(c)).

* As specified in ASC Topic 718, the requisite service period includes explicit, implicit, or derived service periods during which employees are required to provide service in exchange for the award.

3. The portion of the replacement award attributable to pre-combination vesting is then calculated by multiplying the fair-value-based measure of the acquiree award (determined in 1(a)) by the ratio of the pre-combination vesting period (determined in 2(b)) to the greater of the total service period (determined in 2(d)) or the original service period (determined in 2(a)).

4. The portion of the replacement award attributable to post-combination vesting is then calculated as the difference between the fair-value-based measure of the replacement award (determined in 1(b)) and the amount attributed to pre-combination vesting (determined in 3).

11.031 This process is illustrated in Examples throughout this Section.

11.032 The above process results in the following:

- Even if an acquiree award is fully vested at the time of a business combination, a portion of the replacement award is allocated to post-
combination vesting if the acquiree's employee is required to render service in the post-combination period.

- The acquirer measures both the replacement award given to employees by the acquirer as well as the original acquiree award as of the acquisition date. The excess value of the replacement award over the measure of the acquiree award is attributed to post-combination vesting and is not part of the consideration transferred for the acquiree, even if all services have been rendered as of the acquisition date. If the acquirer does not require the acquiree's employees to perform additional services after the acquisition date, the excess value is recognized immediately as compensation cost in the post-combination financial statements of the combined entity. If additional services are required, then the compensation cost is recognized in the post-combination financial statements under ASC Topic 718.

The following examples, which are based on the examples in ASC paragraphs 805-30-55-17 through 55-24, illustrate the concepts discussed above. Example 11.17c illustrates the difference in accounting for a replacement award if the acquirer elects to estimate forfeitures rather than accounting for forfeitures as they occur under the policy election in ASC paragraph 718-10-35-3.

Example 11.13: Acquirer Replacement Awards That Require No Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Required Services as of the Acquisition Date

AC issues replacement awards of $110 (fair-value-based measure) at the acquisition date for TC awards of $100 (fair-value-based measure) at the acquisition date. No post-combination vesting is required for the replacement awards, and TC's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to pre-combination vesting is the fair-value-based measure of TC's awards ($100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to post-combination vesting is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to pre-combination vesting ($100). Because no post-combination vesting is required for the replacement awards, AC immediately recognizes $10 as compensation cost in its post-combination financial statements. ASC paragraphs 805-30-55-18 and 55-19

Example 11.14: Recording Replacement Awards that Provide Additional Fair Value if Post-combination Vesting Is Rendered

ABC Corp. acquires DEF Corp. At the acquisition date, the share based awards held by DEF Corp. employees were fully vested and therefore no additional service is required of the employees. The terms of the business combination require ABC to provide
replacement awards for the DEF awards. The replacement awards are fully vested but subject to a 7-year transferability restriction. Earlier transfer is permitted if the employee remains continuously employed for two years during the post-combination period.

The fair value of the DEF awards is $50,000 at the acquisition date. The replacement awards subject to the 7-year transferability restriction have a fair value of $150,000 at the acquisition date. If the post-combination vesting requirement of 2 years is completed, the replacement awards have a fair value of $166,000 at acquisition. ABC Management expects that all of the employees will complete the 2-year post-combination vesting.

It is appropriate to analogize to the guidance on a tandem award as discussed in ASC paragraph 718-10-55-116. A tandem award is an award with 2 or more components in which the exercise of one award cancels out the other.

Under ASC Section 805-30-55, ABC includes $50,000 (the fair value-based measure of the acquiree awards) in consideration transferred in the acquisition of DEF. The remaining fair value-based measure of the replacement awards ($150,000 - $50,000) is recognized as compensation cost by ABC immediately following the consummation of the business combination because the employees are not required to perform additional service. The incremental fair value of $16,000 ($166,000 - $150,000) associated with the 2-year post combination service period that would eliminate the 7-year transferability restriction is recorded as compensation cost over the 2-year service period.

If ABC determines that employees are not expected to complete the 2-year service period, ABC would cease recognizing the compensation cost for the incremental fair value of the award and reverse any portion of compensation cost already recorded, similar to a forfeiture.

**Example 11.15: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Requisite Service as of the Acquisition Date**

AC exchanges replacement awards that require one year of post-combination vesting for share-based payment awards of TC for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, TC's awards had a requisite service period of 4 years. As of the acquisition date, the TC employees holding unexercised awards had rendered a total of 7 years of service since the grant date. Even though TC employees had already rendered all of the requisite service, AC attributes a portion of the replacement award to post-combination vesting in accordance with ASC paragraphs 805-30-30-12 and 30-13 because the replacement awards require one year of post-combination vesting. The total service period is 5 years—the requisite service period for the original acquiree award completed before the acquisition date (4 years) plus the requisite service period for the replacement award (one year). Note that the total service provided prior to the acquisition (7 years) is not relevant to this computation. The portion
attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (4 years) to the total service period (5 years). Thus, $80 ($100 × 4 ÷ 5 years) is attributed to pre-combination vesting and therefore included in the consideration transferred in the business combination. The remaining $20 is attributed to post-combination vesting and therefore is recognized as compensation cost in AC’s post-combination financial statements in accordance with ASC Topic 718. ASC paragraph 805-30-55-20

Example 11.16: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

AC exchanges replacement awards that require one year of post-combination vesting for share-based payment awards of TC for which employees had not yet rendered all of the required services as of the acquisition date. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, the awards of TC had a requisite service period of 4 years. As of the acquisition date, the TC employees had rendered 2 years' service, and they would have been required to render 2 additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of the TC awards is attributable to pre-combination vesting.

The replacement awards require only one year of post-combination vesting. Because employees have already rendered 2 years of service, the total requisite service period is 3 years. The portion attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (2 years) to the greater of the total service period (3 years) or the original service period of TC's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to pre-combination vesting and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to post-combination vesting and is therefore recognized as compensation cost over the remaining one year vesting period in AC’s post-combination financial statements. ASC paragraphs 805-30-55-21 and 55-22

Example 11.17: Acquirer Replacement Awards for Which No Post-combination Vesting Is Required Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

Assume the same facts as in Example 11.16, except that AC exchanges replacement awards that require no post-combination vesting for share-based payment awards of TC for which employees had not yet rendered all of the requisite service as of the acquisition date. The terms of the replaced TC awards did not eliminate any remaining requisite service period upon a change in control. (If the TC awards had included a provision that eliminated any remaining requisite service period upon a change in control, the guidance
in Example 11.13 would apply.) The fair-value-based measure of both awards is $100. Because employees have already rendered 2 years of service and the replacement awards do not require any post-combination vesting, the total service period is 2 years. The portion of the fair-value-based measure of the replacement awards attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (2 years) to the greater of the total service period (2 years) or the original service period of TC's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to pre-combination vesting and therefore included in the consideration transferred in the business combination, and the excess of the fair value-based measure of the replacement award ($100) over the $50 attributed to the consideration transferred, or $50, is attributed to post-combination vesting. Because no post-combination vesting is required following the acquisition, the $50 attributed to post-combination vesting is recognized immediately as compensation cost in the post-combination financial statements. ASC paragraphs 805-30-55-23 and 55-24

(PRE-ASU 2018-07) ATTRIBUTION - NONEMPLOYEES

11.033a The fair value of share-based awards granted by the acquiring entity to nonemployees generally should be treated as part of the consideration transferred using the same approach used for replacement awards issued to the acquired entity’s employees. This will apply whether the acquired entity issued awards to nonemployee service providers or to employees of another entity as a result of a spin-off. For additional information on ASU 2018-07, see Paragraph 11.023a.

Example 11.17a: Share Options Granted to Nonemployees in a Business Combination

Background

On January 1, 20X4, ABC Corp. issues share options to Company A, a third-party service provider, in connection with a marketing agreement where Company A provides marketing services to ABC. The share options vest on January 1, 20X8. On January 1, 20X5, ABC is acquired by XYZ Corp.

Q. If XYZ issues share options in exchange for the unvested share options held by employees and nonemployees of ABC, how should XYZ account for the replacement share options that it issues to nonemployees (i.e., Company A) of ABC?

A. XYZ should account for the fair value of the share options that it issues to nonemployees as part of the consideration transferred using the same approach for attributing the replacement award to pre- and post-combination vesting, to the extent that the fair value of the new share options does not exceed the fair value of the share options in ABC surrendered in the exchange. Therefore, XYZ would include 25% (i.e., one of four years vested) of the fair value of ABC’s share options (measured at the acquisition date) in determining the consideration transferred. If the share options
issued by XYZ to nonemployees (i.e., Company A) are subsequently forfeited, no adjustment should be made to the consideration transferred.

(POST-ASU 2018-07) ATTRIBUTION - NONEMPLOYEES

ASC Paragraph 805-30-55-9A

The portion of a nonemployee replacement award attributable to precombination vesting is based on the fair-value based measure of the acquiree award multiplied by the percentage that would have been recognized had the grantor paid cash for the goods or services instead of paying with a nonemployee award. For this calculation, the percentage that would have been recognized is the lower of:

a. The percentage that would have been recognized calculated on the basis of the original vesting requirements of the nonemployee award

b. The percentage that would have been recognized calculated on the basis of the effective vesting requirements. Effective vesting requirements are equal to the services or goods provided before the acquisition date plus any additional postcombination services or goods required by the replacement award.

11.033b ASU 2018-07 modifies the accounting treatment for unvested share-based awards granted to nonemployees in a business combination, which were treated similar to share-based payments granted to employees prior to the adoption. The new ASU added a notion of effective vesting requirements, which are the goods or services provided before the acquisition date plus the additional goods or services required by the replacement award. If the effective vesting period is longer than the vesting period of the original award, the amount attributed to pre-combination vesting could be lower than it would be before adoption of ASU 2018-07. The portion of the compensation expense attributed to postcombination vesting should be recognized in the same manner as if the grantor had paid cash for the goods or services, consistent with the attribution of other nonemployee share-based payment awards.

Example 11.17b: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Nonemployees Have Not Delivered all of the Goods or Services as of the Acquisition Date

In a business combination, AC (the acquirer) exchanges replacement awards that require the delivery of 10 widgets postcombination for share-based payment awards of TC (the acquiree) for which the grantee had not met the necessary vesting condition to deliver 40 widgets before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. As of the acquisition date, TC grantee has delivered 20 widgets, and would have been required to deliver an additional 20 widgets after the acquisition date for its awards to vest. However, AC concluded that it needed only 10 additional widgets after the acquisition date, rather than the 20 remaining under the original contract. Only a portion of TC’s awards is attributable to precombination vesting.
The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the percentage that would have been recognized on the award. The percentage that would have been recognized is the lower of the percentage that would have been recognized on the basis of the original vesting requirements and the percentage that would have been recognized on the basis of the effective vesting requirements. The percentage that would have been recognized on the basis of the original vesting requirements equals 50%, which is calculated as 20 widgets delivered divided by 40 widgets required to be delivered. The percentage that would have been recognized on the basis of the effective vesting requirements equals 66.67%, which is calculated as 20 widgets delivered divided by 30 widgets (the sum of 20 widgets delivered plus 10 widgets required postcombination). Thus, $50 ($100 × 50%) is attributed to precombination vesting and is included in the consideration transferred in the business combination. The remaining $50 is attributed to the postcombination vesting and is recognized as compensation cost in AC’s postcombination financial statements. ASC paragraphs 805-30-55-32 and 55-33

ACCOUNTING FOR FORFEITURES OF REPLACEMENT AWARDS IN A BUSINESS COMBINATION

11.033e Regardless of its accounting policy election for forfeitures in its ongoing accounting for employee or nonemployee share-based payment awards under ASC paragraphs 718-10-35-3 and 718-10-35-1D, respectively, the acquirer will reduce the value of the nonvested replacement awards to reflect the estimate of the awards expected to vest. As a result, the value of the nonvested replacement awards attributable to precombination vesting and included in consideration transferred reflects the acquirer’s estimate at the acquisition date of the number of replacement awards not expected to vest. That is, the portion of a nonvested replacement award included in consideration transferred reflects the acquirer’s estimate of the number of replacement awards for which the service is expected to be rendered (or goods are expected to be delivered).

11.033d However, the acquirer’s accounting policy election for forfeitures will affect the accounting for postcombination compensation cost as follows:

- An acquirer that has a policy to estimate forfeitures of awards also will reduce the number of replacement awards attributable to postcombination vesting for its estimate at the acquisition date of the number of replacement awards not expected to vest. Changes in the acquirer’s forfeiture estimate for replacement awards attributable to both the pre- and postcombination vesting periods are reflected in compensation cost for the periods in which the changes in estimates occur rather than as adjustments to the consideration transferred.

- An acquirer that has a policy to recognize forfeitures of awards as they occur will attribute the amount to consideration transferred in the same way (i.e., using an estimate of forfeitures). It will then gross up the portion allocated to postcombination vesting assuming that no forfeitures will occur and recognize
this amount as compensation cost over the postcombination vesting period. Any forfeitures of replacement awards are reflected as a reduction in compensation cost in the periods in which the forfeitures occur. As is the case when forfeitures are estimated, the effect of actual forfeitures does not change the value of the replacement awards included in the consideration transferred.

Example 11.17c: Effect of Acquirer’s Forfeiture Accounting Policy on Post-Acquisition Accounting for Replacement Share-Based Payment Awards

AC acquires TC. AC is obligated to replace share-based payment awards of TC. The replacement awards require one year of postcombination vesting by TC employees for the awards to vest. TC employees completed 4 of the 5 years of the requisite service period before the date of the business combination. The fair value of TC’s awards and the replacement awards is $100 on the acquisition date. At the acquisition date, AC estimates that the requisite service period will be rendered for 90% of the awards, and 10% of the awards will be forfeited before the end of the requisite service period.

If AC elects to estimate forfeitures

The amount attributable to precombination vesting and included in consideration transferred is $72 [$100 acquisition date fair value of TC’s replaced award × (1 - 10% forfeiture rate) × (4 years’ precombination vesting ÷ 5-year service period)].

The amount attributable to postcombination vesting and recorded as postcombination compensation cost is $18 [$100 acquisition date fair value of AC’s replacement award × (1 - 10% forfeiture rate) - $72 included in consideration transferred]. The postcombination compensation cost is recognized over the remaining one-year service period. Any changes in the 10% forfeiture estimate are reflected as an adjustment to compensation cost as those changes in estimate occur and ultimately trued-up to the actual number of awards that vest. If, for example, the actual forfeiture rate is 5%, AC will recognize compensation cost of $23 ($100 acquisition date fair value of AC’s replacement award × (1 - 5% actual forfeiture rate) - $72 (allocated to consideration transferred).

If AC elects to recognize forfeitures as they occur

The amount attributable to precombination vesting and included in consideration transferred is $72 (same as if AC’s accounting policy is to estimate forfeitures).

The initial amount attributable to postcombination vesting and recorded as postcombination compensation cost is $28 ($100 acquisition date fair value of its replacement award - $72 included in consideration transferred). The postcombination compensation cost is recognized over the remaining one-year requisite service period. The effects of any forfeitures are reflected as a reduction to compensation cost as they occur. If the 10% forfeiture estimate ultimately is accurate and all the forfeitures occur in the last quarter before vesting, the compensation cost recognized each quarter after the business combination will be: 1st Q: $7, 2nd Q: $7, 3rd Q: $7 (in each case the amount
11.034 If the acquirer issues a replacement award that has a graded vesting schedule, we believe that ASC paragraphs 805-30-55-11 and 55-12 require the acquirer to follow its own policy with respect to straight-line or accelerated attribution for awards with graded vesting features, regardless of the policies of the target entity. The acquirer does not carry over the acquiree's attribution election for these types of awards. The result may be that some compensation cost is never recognized by either party or that some compensation cost is recognized by both parties.

Example 11.18: Graded Vesting Replacement Awards

ABC Corp. acquires DEF Corp. on January 1, 20X9. ABC issues a replacement award of 100 share options with a fair value of $1,000 to replace share options with a fair value on the acquisition date of $1,000 held by DEF employees.

The vesting for the original DEF awards is graded, with 25% vesting each year over 4 years. At the acquisition date, DEF's employees have provided two years of service. DEF's share option plan does not contain a change of control provision. However, the terms of the business combination require ABC to issue to DEF employees a replacement award with identical vesting provisions. Both ABC and DEF's attribution policy is to recognize compensation cost on a graded vesting schedule. DEF’s accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero. The amount of the award attributed to pre-combination and post-combination vesting is determined as follows:

The total service period is determined on a tranche-by-tranche basis based on ABC's policy of using accelerated attribution.

<table>
<thead>
<tr>
<th>ABC's Awards Vesting Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1</td>
</tr>
<tr>
<td>25.00%</td>
</tr>
<tr>
<td>Tranche 2</td>
</tr>
<tr>
<td>12.50% 12.50%</td>
</tr>
<tr>
<td>Tranche 3</td>
</tr>
<tr>
<td>8.33%  8.34%  8.33%</td>
</tr>
<tr>
<td>Tranche 4</td>
</tr>
<tr>
<td>6.25%  6.25%  6.25%  6.25%</td>
</tr>
<tr>
<td>52.08% 27.09% 14.58% 6.25%</td>
</tr>
</tbody>
</table>

**Amount attributed to pre-combination vesting**

$1,000\(^1\) \times 79.17\(^2\) (52.08% + 27.09%) = $792

\(^1\) Fair-value-based measure of DEF's award immediately before the acquisition.

\(^2\) Service rendered as of 1/1/20X9 based on ABC's attribution election.
Amount attributed to post-combination vesting

$1,000^3 - $792^4 = $208

3 Fair-value-based measure of ABC's award immediately before the acquisition.
4 Amount attributable to pre-combination vesting

Amount of compensation expense recognized in the post-combination period

First post-combination year: $1,000 × 14.58% = $146

Second post-combination year: $1,000 × 6.25% = $62

The measurement of pre-combination vesting is based on ABC's policy of using the accelerated attribution methodology. In this case, both parties used that method. However, the answer would be the same even if DEF had elected to use the straight-line methodology (i.e., as discussed above, we believe ASC paragraphs 805-30-55-11 and 55-12 require the acquirer to follow its own policy with respect to attribution of awards with graded vesting features). Additionally, the calculation uses the entire award as the unit of measure. As a result, the attribution of the $208 allocated to the remaining tranches is based on the total service period associated with those tranches and is allocated and measured as if the acquirer had been accounting for them from inception. In many cases (and in this example), entities would get the same answer regardless of whether the unit of account is the entire award or each tranche, because the fair value and the requisite service period are the same before and after the transaction. However, differences would arise if one or both of them were different.

Example 11.18a: Graded Vesting Replacement Awards – Part II

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues a replacement award of 100 share options with a fair value of $1,000 to replace share options with a fair value on the acquisition date of $1,000 held by DEF employees.

The vesting for the original DEF awards is graded, with 33.3% vesting each year over three years. At the acquisition date, DEF’s employees have provided two years of service. DEF’s share option plan does not contain a change of control provision. However, the terms of the business combination require ABC to issue to DEF employees a replacement award with a four-year graded vesting schedule. ABC’s attribution policy is to recognize compensation cost on a straight-line basis, subject to a floor. DEF’s accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero.

ABC’s legal counsel has interpreted the contract terms to mean that any previously vested tranches (67 shares or 66.7%) remain vested, the 20X8 tranche will vest at its full 25% amount (i.e., 25 share options for a cumulative amount vested of 91.7%) and then the 20X9 tranche will be the remaining 8 share options (i.e., 8.3%). The graded vesting schedule for the ABC replacement awards and the DEF original awards is:
### ABC’s Replacement Awards Graded Vesting Schedule

<table>
<thead>
<tr>
<th></th>
<th>20X6</th>
<th>20X7</th>
<th>20X8</th>
<th>20X9</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight-line without floor</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Straight-line with floor</td>
<td>33.3%</td>
<td>33.3%</td>
<td>25%</td>
<td>8.3%</td>
</tr>
</tbody>
</table>

### DEF’s Original Awards Graded Vesting Schedule

<table>
<thead>
<tr>
<th></th>
<th>20X6</th>
<th>20X7</th>
<th>20X8</th>
</tr>
</thead>
<tbody>
<tr>
<td>33.3%</td>
<td>33.3%</td>
<td>33.3%</td>
<td></td>
</tr>
</tbody>
</table>

Although ABC’s policy is to recognize compensation cost on a straight-line basis for the entire award, the replacement award has a front-loaded vesting schedule that is subject to the floor. ASC paragraph 718-10-35-8 states that the amount of compensation cost recognized at any date must at least equal the portion of the grant-date fair value of the award that has vested at that date.

#### Amount attributed to precombination vesting

\[ \$1,000^1 \times 66.7\%^2 = \$667 \]

1 Fair-value-based measure of DEF’s award immediately before the acquisition.
2 Amount attributed to pre-combination vesting in accordance with acquirer’s policy for the greater of straight-line attribution (2 of 4 years' service provided) or the floor (66.7% vested).

#### Amount attributed to postcombination vesting

\[ \$1,000^3 - \$667^4 = \$333 \]

3 Fair-value-based measure of ABC’s award immediately before the acquisition.
4 Amount attributable to precombination service.

#### Amount of compensation cost recognized in the postcombination period

Postcombination compensation cost year 20X8 (based on the floor): \( \$1,000 \times 25.00\% = \$250 \)

Postcombination compensation cost year 20X9: \( \$1,000 \times 8.3\% = \$83 \)

The compensation cost to be recognized in the postcombination period will be recognized on a straight-line basis but subject to the floor. Given the front-loaded vesting schedule of the replacement awards, this will result in 25% in 20X8 and 8.3% in 20X9.
SETTLEMENT OF SHARE-BASED AWARDS

11.034a In some transactions, share-based payment awards of the acquired entity are settled as part of the business combination. In the acquirer’s financial statements, the accounting for the settlement of awards in the business combination will be the same whether the acquirer settles the awards as part of the business combination or the acquired entity settles the awards on the instructions of the acquiring entity and the acquiring entity reimburses the acquired entity for the cost of the settlement. An acquiring entity reimbursement sometimes is a direct addition to the consideration transferred and sometimes is indirect – such as through the mechanics of a working capital calculation specified in the acquisition agreement. In any of these instances, the acquiring entity should follow the accounting guidance in Paragraphs 11.025 and 11.030 to determine the portion of the amount paid that will be accounted for as additional consideration and the portion of the amount paid that will be accounted for as postcombination compensation cost.

11.035 If an acquirer is permitted to settle acquiree awards that are not fully vested by either issuing a replacement award with identical vesting provisions or by settling the awards in cash, and the acquirer elects to settle the awards in cash, the acquirer has effectively waived the remaining vesting period and, as a result, any compensation cost attributed to post-combination vesting would be immediately recognized by the acquirer in its post-combination financial statements. In this scenario, the acquirer has effectively released the award holders from their post-combination vesting requirements.

Example 11.19: Acquirer Cash Settles an Acquiree’s Award

ABC Corp. acquires DEF Corp. on January 1, 20X9. ABC pays DEF's employees $1,100 in cash to replace share options held by DEF employees with a fair value on the acquisition date of $1,000.

The original service period for DEF awards is 4 years, of which 2 years have been completed at the acquisition date. The original vesting for DEF's awards is graded with 25% vesting each year. DEF's share option plan does not contain any change-of-control provisions. However, the terms of the business combination require ABC to either issue to DEF employees replacement awards with identical vesting provisions or, at ABC's election, a cash payment equal to 110% of the fair value of the award ($1,000 × 110%, or $1,100) at the acquisition date. ABC elected to settle the awards in cash.

ABC's attribution policy based on ASC Topic 718 is to recognize the compensation cost ratably (straight-line method) over the service period of the longest vesting tranche. DEF’s attribution policy is to recognize compensation cost on a graded vesting schedule and, therefore, as of the acquisition date DEF has attributed 79.17% (Example 11.18 illustrates the calculation of this percentage) of the compensation cost associated with the DEF awards to pre-combination vesting. DEF’s accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero. The amount of the award attributed to pre-combination and post-combination vesting is determined as follows:
**Amount attributed to pre-combination vesting**

$1,000^{1} \times 50\% \ (2 \text{ years} / 4 \text{ years})^{2} = $500

1 Fair-value-based measure of DEF’s award immediately before the acquisition.
2 Service rendered as of 1/1/20X9 based on ABC’s attribution election.

**Amount attributed to post-combination vesting**

$1,100^{3} - $500^{4} = $600

3 Entity ABC's cash settlement
4 Amount attributable to pre-combination vesting

The cash settlement of an award that is not vested at the acquisition date is similar to the acquirer cash settling the acquiree's employee share options, because the settlement eliminates any remaining requisite service periods. Because there is no post-combination vesting required, ABC recognizes $600 of compensation cost immediately in its post-combination financial statements. The measurement of pre-combination vesting is based on ABC’s policy of recognizing compensation cost ratably, rather than DEF’s accelerated attribution methodology (which is discussed in ASC paragraphs 718-20-55-29 and 55-30) and illustrated in Example 11.18).

**CHANGE-IN-CONTROL PROVISIONS**

11.036 Share option or other share-based compensation award plans often include a provision that provides for the acceleration of awards in the event of a change in control of the issuer (a *change-in-control provision*). Consistent with the guidance in ASC paragraphs 805-20-55-50 and 55-51, entities should not anticipate the consummation of a business combination. Instead, the remaining unrecognized compensation cost should be recognized in the acquiree's financial statements when the business combination is consummated.

11.037 In other instances, existing awards are sometimes modified to add a change-in-control provision in contemplation of a change in control of an acquiree. The effect of the change-in-control provision on the attribution of an acquirer's replacement award between pre-combination and post-combination vesting depends on how the change-in-control provision arose (i.e., the provision was included in the original acquiree award; the provision was added through a modification of the acquiree award initiated by the acquiree in contemplation of a change in control; or the provision was added through a modification of the acquiree award at the request of the acquirer. See discussion beginning at Paragraph 11.045).
Recognition by an Acquiree of the Effect of Acceleration of Awards When a Change in Control Provision Is Triggered

11.038 If a change-in-control provision was included in the original terms of an acquiree award and that provision is triggered by an acquisition of the acquiree such that unvested awards become immediately vested at the acquisition date, the total vesting period and the original vesting period would be the same for purposes of attributing the replacement award to pre-combination and post-combination vesting (i.e., the shortened vesting period resulting from the triggering of the change-in-control provision was provided for by the terms of the original award). No post-combination vesting is required and if the fair value of both awards is the same the total fair value-based measure of the replacement award would be attributed to the consideration transferred in the business combination, and no amount would be attributed to post-combination compensation cost. This is illustrated in Example 11.20.

11.039 If separate financial statements of an acquiree are issued when push-down accounting is not being elected, the remaining unrecognized compensation cost measured from the acquiree's perspective (i.e., based on grant-date fair value when the award is equity-classified) will be recognized in the acquiree's financial statements in the period that includes the date that the acceleration of vesting is triggered (i.e., the acquisition date).

11.040 If separate financial statements of an acquiree are issued and push-down accounting is elected, there is diversity in practice as to when the remaining unrecognized compensation cost is recognized by the acquiree. See discussion in Paragraph 27.032.

11.041 Paragraph not used.

Modification of Acquiree Share-Based Compensation Awards Initiated by the Acquiree in Contemplation of a Change in Control

11.042 If the original provisions of an acquiree's awards do not contain a change-in-control provision and the acquiree modifies the terms of the awards to provide for acceleration of vesting in the event of a change in control, the accounting will depend on the facts and circumstances. Judgment should be used to determine whether the modification was initiated by the acquiree in contemplation of the business combination or initiated by the acquirer. Factors to consider include whether the entity is actively pursuing potential targets and suitors, actively exploring strategic alternatives, or is in the initial process of strategic planning that may evolve into more specific strategic initiatives. If the acquiree effects the modification at its own initiative in contemplation of a possible change in control but prior to specific discussions with the acquirer, that may indicate that the modified terms will be incorporated into the acquirer's accounting for the business combination. In those circumstances, the total vesting period and the original vesting period would be the same for purposes of attributing the award to pre-combination and post-combination vesting because of the modification of the award. Accordingly, no post-combination vesting is required and if the fair value of both awards is the same, the total fair-value-based measure of the replacement awards would be
attributed to the consideration transferred in the business combination and no amount would be attributed to post-combination compensation cost. However, there may be accounting required in the acquired entity’s financial statements. This is illustrated in Example 11.21.

11.043 From the perspective of the acquiree, the modification of the award to include the change-in-control provision may be a Type III modification (i.e., an improbable-to-probable modification) and, as such, the acquiree would recognize cumulative compensation cost associated with the modification in accordance with ASC paragraphs 718-20-55-109A, 55-109B, 55-116, 55-117, and 55-121, as applicable depending on whether the award is to employees or nonemployees. However, if the modification was determined to be a Type I modification (i.e., a probable-to-probable modification), the acquiree would recognize cumulative compensation cost in accordance with ASC paragraphs 718-20-55-110 through 55-112. See Example 11.21.

11.044 In contrast, if the acquiree initiates the modification once discussions with the acquirer have moved beyond a preliminary stage, that action may indicate that the modified terms should not be incorporated into the acquirer's accounting for the business combination. In those circumstances, the accounting would be the same as when the acquirer requests a modification of the terms of share-based payment awards as discussed below and illustrated in Example 11.22.

Modifications of Acquiree Share-Based Compensation Awards at the Request of the Acquirer in Contemplation of a Change in Control

11.045 If a change-in-control provision is added to an acquiree's share-based payment award at the request of an acquirer, the accounting would be the same as if the acquirer issued a fully vested replacement award in exchange for the original unvested award. See discussion in this Section of Other Payments to an Acquiree (or Its Former Owners) That Are not Part of the Consideration Transferred. For example, an acquirer may request an acquiree to offer an acceleration of an existing award to a member of the acquiree's senior management in exchange for termination of an employment contract because the acquirer intends to integrate the roles and responsibilities of the senior management member into those of the acquirer's existing senior management group. This is illustrated in Example 11.22.

11.046 The impact of the modification of the vesting provisions of share-based compensation awards under each of the situations described above is illustrated in the following examples.

Example 11.19a Settlement of Share Awards on Consummation of a Business Combination

On July 1, 20X7, XYZ Corp pays cash to acquire all of the outstanding equity securities of ABC Corp., including outstanding share options. The share option awards contain a change of control provision such that they immediately vest on a change in control of ABC.
The grant-date fair value of the share options was $8 million. The fair value of the share options on July 1, 20X7 is $10 million. All share awards vested at the date of the business combination and the cash paid to redeem the share options was $10 million. ABC had previously recognized $3 million of compensation cost related to the share options.

**Acquirer’s Accounting**

From XYZ’s perspective, it paid $10 million to settle fully vested awards. Accordingly, the entire $10 million is included in the consideration paid by XYZ because there is no future service required for either the original awards (which vested on change of control included in the original terms) or the replacement award (cash settlement) and XYZ paid an amount equal to the acquisition-date fair value of the awards.

**Acquired Entity’s Accounting**

**Scenario 1.** ABC elects not to apply pushdown accounting in its stand-alone financial statements. In which quarter and how should ABC record the compensation costs?

Consistent with the guidance in ASC paragraphs 805-20-55-50 and 55-51, the remaining compensation cost (based on the grant-date fair value) is recognized in the quarter that includes July 1, 20X7.

Financial statements for the period ended June 30, 20X7 will disclose the cost to be recognized in the subsequent period. On July 1, 20X7, ABC will record the settlement of the share options as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>5,000,000&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>Paid-in capital-share options</td>
<td>3,000,000&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>APIC</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Contributed capital from XYZ</strong></td>
<td><strong>10,000,000&lt;sup&gt;3&lt;/sup&gt;</strong></td>
</tr>
</tbody>
</table>

<sup>1</sup> Grant-date fair value ($8,000,000) less compensation cost previously recognized ($3,000,000)

<sup>2</sup> Eliminate paid-in capital from compensation cost previously recognized

<sup>3</sup> Cash payment by XYZ to settle the share options

**Scenario 2.** ABC elects to apply pushdown accounting in its stand-alone financial statements. How should the $5 million of unrecognized compensation cost be reflected in the predecessor (period prior to the acquisition) and successor (period following the acquisition) financial statements of ABC?

Because the recognition of compensation cost occurs on consummation of the business combination, we believe that ABC can choose either to present the amount as compensation cost in the predecessor financial statements (i.e., it is recognized immediately before the consummation of the business combination as in Scenario 1) or to reflect the amount in equity of the successor financial statements as part of acquisition
accounting adjustments, in which case no compensation cost would be presented in either the predecessor or successor financial statements (i.e., the compensation cost is recognized concurrent with the consummation of the business combination and, therefore, falls on the \textit{black line} that separates the predecessor / successor periods). (See discussion in paragraph 27.032.) ABC should apply the same accounting for all liabilities triggered by the consummation of the business combination. In either case, ABC should disclose the accounting for these items.

\begin{example}
\textbf{Example 11.20: Original Share-Based Payment Award Provides for Accelerated Vesting on Change in Control}

On January 1, 20X7, DEF Corp. grants its employees 100,000 share options, with an exercise price of $30 per share (equal to the grant date fair value of DEF's common stock). The fair-value-based measure of the awards at the grant date is $1,000,000 ($10 per share option). The terms of the awards provide for cliff vesting at the end of four years, and also provide for accelerated (immediate) vesting in the event of a change in control of DEF. DEF's accounting policy is to estimate forfeitures expected to occur. Assume forfeitures are estimated at zero.

ABC Corp. acquires DEF on January 1, 20X9. Because of the change-in-control provision, DEF's share awards immediately vest at the acquisition date. At that date, the fair-value-based measure of the fully vested DEF awards is $2,000,000 ($20 per share), and ABC issues a fully vested replacement award to DEF employees with an equivalent fair value of $2,000,000.

Before the acquisition date, 2 years of the original 4-year vesting period for the DEF awards were complete. However, because the terms of the original award provide for accelerated vesting of the DEF share option awards in the event of a change in control, the change in control results in a change in the requisite service period (original service period) from 4 years to 2 years and, as a result, the original service period and the pre-combination vesting period are the same (2 years) for purposes of attributing the replacement award to pre-combination and post-combination vesting.\footnote{Accounting by DEF (acquiree): As a result of the acceleration of vesting, the acquiree awards are fully vested at the acquisition date. Because the terms of the original awards provided for the acceleration of vesting in the event of a change in control, DEF (the acquiree) recognizes cumulative compensation cost in this period.}

Because no post-combination vesting by the DEF employees is required, and since the fair-value-based measure of the replacement awards issued by ABC (the acquirer) is equal to the fair-value-based measure of the DEF awards, the entire fair-value-based measure of the ABC replacement awards ($2,000,000) is attributed to pre-combination vesting and included in the consideration transferred in the business combination. This result is consistent with that shown in the illustration in Example 11.13, \textit{Acquirer Replacement Awards That Require No Post-combination Vesting Exchanged for Acquiree Awards for which Employees Have Rendered the Required Services as of the Acquisition Date}.

\end{example}
its separate financial statements equal to the fair value of the DEF awards as of the original grant date ($1,000,000). Because DEF would have recognized $500,000 in cumulative compensation cost prior to the acquisition date (2 years/4 years × $1,000,000), DEF would recognize an additional $500,000 of compensation cost in its separate financial statements at the acquisition date.

Example 11.21: Acquiree Initiates Modification of Share-Based Compensation Awards in Contemplation of a Change in Control

Assume the same facts as in Example 11.20, except:

- The terms of the original DEF Corp. awards provide that in the event of a change in control, the acquirer is obligated to replace the DEF awards with identical replacement awards; however, there was no provision for acceleration of vesting in the event of a change in control;

- DEF’s accounting policy is to estimate forfeitures and it previously had estimated a forfeiture rate of 5%;

- DEF, in contemplation of a change in control, elects to modify the DEF awards immediately preceding the acquisition to provide for accelerated vesting of the awards in the event of a change in control (the fair-value-based measure of the DEF awards before the modification is $2,300,000 and after the modification is $2,000,000, because the awards have a shorter expected term after the modification).

Acquirer's Accounting

The attribution by ABC Corp. (the acquirer) of the replacement awards issued to the DEF employees between pre-combination and post-combination vesting is the same as that indicated in the preceding example. Because no post-combination vesting is required, and since the fair-value-based measure of the replacement awards issued by ABC (the acquirer) is equal to the fair-value-based measure of the DEF awards, the entire fair-value-based measure of the ABC replacement awards ($2,000,000) is attributed to pre-combination vesting and included in the consideration transferred in the business combination.

Acquiree's Accounting

When an entity modifies an award at a point in time that could be considered to be in contemplation of a business combination, there could be required accounting for the modified award in the acquired entity's financial statements starting at the modification date. Changes to the terms of awards in conjunction with a business combination are modifications, and modification accounting is applied when there are changes to the fair value, vesting conditions or classification of awards.

At the date of modification, DEF assessed the likelihood that the original awards would have vested under their original terms and under the modified terms. In making this determination, DEF assumes that the replacement awards ABC issued will continue to
vest under the original terms of the awards. Based on the estimated forfeiture rate of 5%, DEF determined that 95% of the original awards would have continued to vest following the change in control; however, because of the modification to accelerate vesting, the 5% forfeiture rate is expected to be reduced to 0%. Therefore, for this example, DEF determines that this modification, which changes the estimated forfeiture rate from 5% to 0%, is a Type III modification (i.e., improbable-to-probable) for those awards no longer expected to be forfeited as a consequence of the modification (i.e., for 5% of the awards). The awards expected to vest before and after the modification (95% of the awards) are a Type I modification (i.e., probable-to-probable). This distinction between the portion of the awards treated as a Type III modification (5%) versus the portion treated as a Type I modification (95%) is based on the forfeiture assumption in place before the acquisition date. Accordingly, DEF (the acquiree) would recognize cumulative compensation cost in its separate financial statements equal to the grant date fair value of the awards expected to vest before and after the modification plus the modification date fair value of the awards expected to vest as of the modification date, which were not expected to vest before the modification. Thus, cumulative compensation that would be reported in DEF's financial statements would be $1,050,000 ([$1,000,000 × 95%] + [$2,000,000 × 5%]). Of this amount, DEF would have recognized $475,000 ($1,000,000 × 95% × 2 years / 4 year service period) prior to the modification. As a consequence, DEF would recognize cumulative compensation cost of $575,000 subsequent to the modification.

Example 11.22: Modifications of Acquiree Share-Based Compensation Award at the Request of the Acquirer in Contemplation of a Change in Control

On January 1, 20X8, DEF Corp. granted 10,000 share options with an exercise price of $30 per share (equal to the grant date fair value of DEF's common stock). The fair-value-based measure of the awards at the grant date was $1,000,000 ($10 per share option). The terms of the award provide for cliff vesting at the end of four years. Also, in the event of a change in control of DEF prior to the vesting date, an acquirer would be obligated to issue identical replacement awards (i.e., all terms of the replacement award are required to be the same as those of the DEF award). The awards do not provide for acceleration of vesting upon involuntary termination (following a change in control or otherwise).

ABC Corp. enters into an agreement to acquire DEF. Immediately following the acquisition, ABC intends to integrate the roles and responsibilities of DEF’s management group into those of ABC’s existing senior management group, which will result in all of DEF’s employees with share-based payment awards being terminated. ABC requests that DEF offer an acceleration of the vesting of the awards on closing of the acquisition, in anticipation of the change in control.

ABC acquires DEF on January 1, 20X9. At that date, the fair-value-based measure of the DEF awards is $2,000,000 ($20 per share option). As a result, at the acquisition date (January 1, 20X9) the awards become fully vested, ABC issues fully vested replacement awards in exchange for the DEF awards, and DEF’s employees are terminated.
In this example, because the modification of the awards and the decision to terminate DEF employees are effected at the request of ABC (the acquirer), the attribution of the fair-value-based measure of the replacement award issued by ABC between pre-combination and post-combination vesting is the same as if:

- The DEF award had remained outstanding under its original terms at the acquisition date;
- The DEF award had been exchanged for an identical replacement award issued by ABC; and
- ABC had granted recipients of the replacement award immediate vesting in exchange for termination of employment.

In other words, the termination of employment of DEF employees is not a part of the business combination, but is a separate transaction required to be accounted for apart from the business combination. See the discussion of Preexisting Relationships in this Section.

The attribution of the fair-value-based measure of the replacement award issued by ABC to DEF employees follows the guidance illustrated in Example 11.17, Acquirer Replacement Awards for which No Post-combination Vesting Is Required Exchanged for Acquiree Awards for which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date. The fair-value-based measure at the acquisition date of both the DEF award and the replacement award is the same ($2,000,000). The portion of the fair-value-based measure of the replacement award attributable to pre-combination vesting equals the fair-value-based measure of the DEF award (the acquiree award), or $2,000,000, multiplied by the ratio of the pre-combination vesting period (1 year) to the greater of the total service period (1 year) or the original service period of the DEF award (4 years).

Thus, $500,000 ($2,000,000 × 1/4) is attributable to pre-combination vesting and is included in the consideration transferred in the business combination, and the excess of the fair-value-based measure of the replacement award ($2,000,000) over the $500,000 attributed to the consideration transferred, or $1,500,000, is attributed to post-combination vesting. Because no service by DEF's management group is required following the acquisition, the $1,500,000 attributed to post-combination vesting is immediately recognized as compensation cost in the post-combination financial statements.

AWARDS WITH PERFORMANCE CONDITIONS

11.047 Under ASC Topic 718, awards with performance conditions require that compensation cost be recognized when the achievement of the performance condition is considered probable of achievement. If an award has multiple performance conditions (and thus, for example, the number of options or shares to be awarded varies depending
on the performance condition(s) satisfied), compensation cost is accrued if it is probable
that a performance condition will be satisfied, based on the most likely outcome. When
an acquirer issues replacement awards, and both the original and replacement awards
include performance conditions, the determination of the pre-combination and total
vesting periods will be affected by the probability of achieving the performance
conditions. Specifically, the original vesting period of the acquiree's award should be the
vesting period used by the acquiree to accrue compensation cost as of the acquisition date
in accordance with ASC Topic 718. Similarly, the total vesting period should be based on
the original vesting period for the acquiree's award (determined as above), plus the
vesting period of the replacement award, determined in accordance with ASC Topic 718.

11.048 If, at the acquisition date, it is not probable that all performance conditions (if
any) included in either the acquiree's awards or the acquirer's replacement awards will be
met, then no amount is recognized as either pre- or post-combination vesting. If, in a
period subsequent to the acquisition date, it becomes probable that the performance
condition for the replacement award will be achieved, the acquirer recognizes the related
cumulative compensation cost in the post-combination financial statements in which such
period falls. In other words, the acquirer does not make adjustments to the consideration
transferred in the business combination or the compensation cost recognized in the
previously issued post-combination financial statements.

11.049 Depending on the entity's operations subsequent to the business combination, it
may be challenging for an acquirer to structure a replacement award that has equivalent
performance conditions. For example, for employee awards, an entity may integrate the
operations of the target into the existing operations of one of its subsidiaries. That
subsidiary's operations may be such that the performance conditions of the target's
original award are not a relevant measure on which to set performance conditions for the
replacement award. In these circumstances, an acquirer may be required to issue
replacement awards that have only service conditions. Some share-based plans with
performance conditions have as part of their original terms that if the entity is acquired
and the acquirer is unable to issue replacement awards replicating the performance
conditions, the vesting of the replacement awards will automatically accelerate. The
accounting described beginning at Paragraph 11.029 is relevant in determining how the
award is allocated between pre-combination and post-combination vesting.

AWARDS WITH MARKET CONDITIONS

11.049a Under ASC Topic 718, market conditions affect the valuation of share-based
payment awards, and compensation cost is recognized if the service condition is met
regardless of whether the market condition is met. Similarly, in a business combination,
market conditions affect the measurement of both the acquiree's replaced award and the
acquirer's replacement award, based on circumstances at the acquisition date. Otherwise,
exchanges of awards with market conditions follow the same accounting treatment as
awards with service conditions. Unlike awards with performance conditions, for which
compensation is reversed if the condition is not achieved, compensation cost is not
reversed if a market condition is not achieved, provided the requisite service has been
rendered. For awards with market conditions, the allocation of pre-combination and post-
combination services is consistent with the analysis for awards with service conditions, except that the market condition also is considered when determining the post-combination service period.

**POST-ACQUISITION CHANGES IN ESTIMATES**

**11.050** If an entity’s policy is to estimate forfeitures expected to occur, changes in the number of replacement awards for which requisite service is expected to be rendered is reflected as an adjustment to compensation cost in the period in which the changes in estimated forfeitures occur. The acquirer therefore does not adjust consideration transferred in periods subsequent to the acquisition date if actual forfeitures differ from the forfeitures estimated at the acquisition date. An acquirer that elects to recognize forfeitures as they occur also attributes the postacquisition forfeiture experience to postacquisition compensation cost and will only reflect forfeitures as they occur. Stated differently, any difference between the estimated and actual forfeitures of replacement awards is reflected in compensation cost regardless of the acquirer’s policy for forfeitures; however, the pattern of recognition will differ under the two policies as illustrated in Example 11.17c.

**11.051** Likewise, an acquirer would not adjust the amount of consideration transferred for other changes resulting from changes in estimates related to performance conditions or other events or modifications occurring after the acquisition date, except for measurement period adjustments. Judgment will sometimes be necessary to distinguish measurement period adjustments from changes attributed to subsequent events. In general, the more time that elapses following the acquisition date, the more likely it is that the adjustments do not relate to facts and circumstances that existed at the acquisition date and should therefore be reflected in post-combination earnings. See the discussion of Adjustments to Provisional Amounts during the Measurement Period in Section 10.

**11.052** The acquirer applies the same guidance as described above for determining consideration transferred, regardless of the classification of the award. If the award is liability classified, any subsequent changes in value (other than measurement period adjustments), including the related tax effects, are recognized in the acquirer's post-combination financial statements and not as an adjustment to the consideration transferred.

**11.052a** Consistent with the accounting for awards issued to continuing employees, if employee awards that were vested at the acquisition date subsequently expire unexercised, no adjustment is made to either the consideration transferred or compensation cost. In addition, for nonemployee awards, the same applies in that no adjustment is made to either the consideration transferred or compensation cost when there are expired unexercised awards.
LAST-MAN-STANDING PLANS

11.053 Occasionally, as part of a business combination, the acquirer will establish a share-based payment award plan that provides for a specified number of awards with the following conditions:

- Awards issued to employees under the terms of the business combination are forfeited if employment is terminated within a certain time period; and
- Awards that are forfeited through termination of employment are reallocated to the remaining employees.

11.054 These plans are sometimes referred to as last-man-standing plans. The forfeiture and reallocation to other employees holding share-based payment awards issued as part of a business combination constitutes the forfeiture of one award by a participant and a grant of a new award to other participants. The acquiring entity should account for the reallocated shares as a new grant (i.e., using a fair-value-based measure on the date of the reallocation), and recognize the resulting compensation cost over the requisite service period from the reallocation date. This accounting applies even though the awards issued can never revert to the acquirer (as is the case in a last-man-standing plan).

Example 11.23: Last-Man-Standing Plans

ABC Corp. acquires DEF Corp. on January 1, 20X9. As required by the acquisition agreement, ABC issues a replacement award of 500 share options with a fair value of $7,500 ($15 /option) to replace share options for DEF’s Last-Man-Standing Plan with a fair value of $7,500.

Other relevant information about DEF's Last-Man-Standing Plan is as follows:

- On January 1, 20X7, DEF issued 500 share options with a fair value of $5,000 to 5 of its executives (100 options each).
- The original share options provided for cliff vesting at the end of the 3-year period ending January 1, 20Y0.
- If any of the executives terminate employment prior to January 1, 20Y0, the forfeited awards are reallocated in equal amounts to the executives that remain employed. On December 31, 20X8, one of the executives terminated employment and 100 share options were reallocated to the four remaining executives.

Amount of Replacement Awards Attributed to Pre-combination Vesting

The portion of the replacement awards attributed to pre-combination vesting is $4,000. The determination of this amount requires two computations, because the originally issued DEF awards that remain outstanding at the acquisition date and the options reissued at December 31, 20X8 are accounted for as two separate awards. The portion of
the replacement award for the originally issued DEF awards and the reissued awards attributed to pre-combination vesting is $4,000 and $0, as shown below.

**Originally Issued and Outstanding Options**

400 share options × $15 × 2/3 = $4,000

Computed as the acquisition-date fair-value-based measure of DEF’s originally issued and outstanding options at the acquisition date (400 × $15 = $6,000) multiplied by the ratio of the pre-combination vesting period (2 years) to the greater of the total service period or the original service period (both of which are 3 years).

**Reissued Options**

100 share options × $15 × 0 = $0

Computed as the acquisition-date fair-value-based measure of DEF’s reissued options at the acquisition date (100 × $15 = $1,500) multiplied by the ratio of the pre-combination vesting period (none) over the greater of the total service period or the original service period (both of which are 1 year). Because there was no pre-combination vesting period (i.e., the reissued awards were issued on December 31, 20X8), none of the fair-value-based measure of the replacement awards is attributed to pre-combination vesting.

**Amount of Replacement Awards Attributed to Post-combination Vesting**

The portion of the replacement awards attributed to post-combination vesting is $3,500, which is equal to the sum of the fair-value-based measure of each of the replacement awards less the amount attributed to pre-combination vesting, as shown below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair-value-based measure of replacement awards for originally issued and outstanding DEF awards ($6,000) less amount attributed to pre-combination vesting ($4,000)</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Fair-value-based measure of replacement awards for reissued awards ($1,500) less amount attributed to pre-combination vesting ($0)</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>$ 3,500</td>
</tr>
</tbody>
</table>

These computations assume that no additional forfeitures are expected. If, after the acquisition, replacement options held by the former DEF executives are forfeited and new options are reallocated and reissued by ABC to the remaining former DEF executives, the reissued options would be accounted for as a forfeiture of the awards issued at the acquisition date by ABC, and as a grant of new awards in its post-combination financial statements.
Ordinarily, settling an outstanding share option in a subsidiary, either in cash or by issuing stock or share-based awards in the parent, is treated as a modification of an award. However, the exchange of share-based awards or awards for consideration from the parent is treated as the acquisition of a noncontrolling interest if:

- Those share-based awards were outstanding at the date the parent first gained control of the subsidiary, and
- Those share-based awards have not been modified subsequent to the parent gaining control.

If there is a future requisite vesting period associated with the new awards issued by the parent, the proportionate amount of the consideration issued in the acquisition of the noncontrolling interest related to the future vesting should be recognized as post-acquisition compensation cost.

Example 11.23a summarizes whether an exchange of awards as part of a transaction that is the acquisition of noncontrolling interest for five different circumstances should be accounted for as either (1) acquisition of noncontrolling interest or (2) a modification of awards.

### Example 11.23a: Treatment of the Exchange of Awards in the Acquisition of Noncontrolling Interest

<table>
<thead>
<tr>
<th>Acquistion of Noncontrolling Interest</th>
<th>Modification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Awards fully vested at the date of the acquisition of the subsidiary</td>
<td>X</td>
</tr>
<tr>
<td>Awards partially vested at the date of the acquisition of the subsidiary and vest before the exchange</td>
<td>X</td>
</tr>
<tr>
<td>Awards partially vested on the date of the acquisition of the subsidiary and not fully vested at the date of the exchange&lt;sup&gt;1&lt;/sup&gt;</td>
<td>X</td>
</tr>
<tr>
<td>Awards fully vested but issued after the date of the acquisition of the subsidiary&lt;sup&gt;2&lt;/sup&gt;</td>
<td>X</td>
</tr>
<tr>
<td>Awards partially vested but issued after the date of the acquisition of the subsidiary&lt;sup&gt;3&lt;/sup&gt;</td>
<td>X</td>
</tr>
</tbody>
</table>

<sup>1</sup> In this scenario, the exchange of awards would be treated as the acquisition of a noncontrolling interest. However, the proportionate amount of the consideration relating to the future requisite service period should be recognized as post-combination compensation cost and unrecognized compensation would be recognized immediately.

<sup>2</sup> In this scenario, the exchange of awards would be treated as a modification. Changes to the terms of awards in conjunction with a business combination are modifications, with modification accounting applied.
when there are changes to the fair value, vesting conditions or classification of awards. Accordingly, a
calculation to determine whether there is incremental compensation cost of the modification is required.
The amount paid for the fully vested awards that is equal to or less than the fair value of the award before
the exchange would be treated as the acquisition of a noncontrolling interest.
3 In this scenario, the exchange of awards would be treated as a modification. Changes to the terms of
awards in conjunction with a business combination are modifications, with modification accounting applied
when there are changes to the fair value, vesting conditions or classification of awards. Accordingly, a
calculation to determine whether there is incremental compensation cost of the modification is required and
incremental compensation cost relating to the modification of an unvested award is recognized for the
remaining vesting term.

Example 11.23b: Accounting for the Exchange of Partially Vested Awards
at the Acquisition Date of the Subsidiary

DEF Corp. issued 1,000 share options to employees on January 1, 20X5. The share
options vest over a three-year period with a grant-date fair value of $5 and an exercise
price of $10. DEF’s accounting policy is to account for forfeitures as they occur.
However, no share options were forfeited. On January 1, 20X7, ABC Corp. acquired
60% of DEF. The share options had an acquisition date fair value of $6.

On January 1, 20X8, ABC exchanged fully vested replacement share options for the DEF
fully vested share options outstanding. Both the replacement share options and the
outstanding share options had a fair value of $8 on the date of replacement.

ABC would account for the exchange as an acquisition of noncontrolling interest as the
original share options were outstanding as of the acquisition date. ABC would record the
following entries from January 1, 20X7 through January 1, 20X8:

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X7 (acquisition date)</td>
<td>APIC 4,000</td>
<td>Noncontrolling interest 4,000</td>
</tr>
<tr>
<td>December 31, 20X7</td>
<td>Expense 2,000</td>
<td>Noncontrolling interest 2,000</td>
</tr>
<tr>
<td>January 1, 20X8 (replacement date)</td>
<td>Noncontrolling interest 6,000</td>
<td>APIC 6,000</td>
</tr>
</tbody>
</table>

1 Pre-combination portion of the award based on acquisition date fair value (1,000 awards × $6 × 2/3)
2 Post-combination compensation cost based on the proportion of service rendered in the post-combination period (1,000 awards × $6 × 1/3)
Example 11.23c: Accounting for the Exchange of Fully Vested Awards Issued after the Acquisition Date of the Subsidiary

ABC Corp. acquired 60% of DEF Corp. on January 1, 20X4. Subsequent to the acquisition date, on January 1, 2005, DEF issued 1,000 share options to employees that vest over a three-year period. The share options had a grant-date fair value of $5 and an exercise price of $10. DEF’s accounting policy election is to account for forfeitures as they occur. However, no share options were forfeited. On January 1, 20X9, ABC exchanged fully vested replacement share options for each DEF fully vested share option outstanding. The replacement share options had a fair value of $8 on the date of exchange. The fair value of the share options of DEF immediately before the modification is $6. Assume no share options in DEF have been exercised.

ABC would account for the exchange as a modification as the share options were issued subsequent to the acquisition date. ABC would immediately recognize additional compensation cost for the incremental fair value of $2,000 representing the post-acquisition compensation cost, because the replacement share options do not have a future requisite service period. In addition, ABC would record the amount paid for the fair value of the fully vested share options prior to the exchange as an acquisition of noncontrolling interest. Noncontrolling interest would be capped at the grant-date fair value of $5,000 (i.e., the amount of noncontrolling interest recognized related to the share options ($5 × 1,000 share options)). ABC would record the following:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>2,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>5,000</td>
</tr>
<tr>
<td>APIC</td>
<td>7,000</td>
</tr>
</tbody>
</table>

ACQUIRER'S ACCOUNTING FOR UNREPLACED AWARDS

11.055 In some business combinations, the acquirer may not replace outstanding acquiree employee or nonemployee share-based payment awards. This may occur in situations where the acquirer acquires less than 100% of the shares of the acquiree and the terms of the acquiree’s awards permit them to remain outstanding and continue to vest under their original terms. In that situation, the acquirer determines the fair value of the acquiree’s awards at the acquisition date. This amount constitutes the grant-date fair value of the awards for the acquirer’s post-combination accounting. That is, the acquisition date fair value of the acquiree share-based awards that remain outstanding is used as the basis for determining the compensation cost in the acquirer’s post-combination financial statements based on the proportion of service required (or goods expected to be delivered for nonemployee awards) in the post-combination period. The pre-combination portion of the award is reflected as noncontrolling interest in the acquirer’s consolidated financial statements. For example, if the acquiree’s employee awards had a fair value of $50,000 at the acquisition date and the employees had provided three years of service out of a
requisite service period of five years, the acquirer would reflect $30,000 as noncontrolling interest in its acquisition accounting. It would then recognize compensation cost of $20,000 over the remaining two-year service period.

**ACQUIRER'S SUBSEQUENT GRANT OF AWARDS WHEN ACQUIRER DID NOT EXCHANGE ACQUIREE'S AWARDS IN THE BUSINESS COMBINATION TRANSACTION**

11.055a In some business combinations, the acquirer may not replace outstanding acquiree share-based awards. Subsequently, the acquirer may grant new share-based awards to those former target company employees and nonemployees. These awards should not be considered part of the consideration transferred in the acquisition of the acquiree unless the facts and circumstances indicate that the acquirer was obligated under the terms of the acquisition agreement or applicable law to assume the awards, or agreed to compensate the target company employees and nonemployees for their outstanding acquiree share-based awards. A grant made shortly after the acquisition date to former target employees and nonemployees that is significantly different from the acquirer’s normal grants may be evidence of an implied agreement to compensate the target employees and nonemployees for their outstanding share-based awards, which may result in a portion of the grants being considered as part of the consideration transferred. An acquirer should consider the facts and circumstances of an arrangement when evaluating the substance of the arrangement.

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**Example 11.23a: Employee Share Options of Acquiree That Are Not Assumed by the Acquirer**

**Background**

ABC Corp (an acquirer in a business combination) was not legally obligated to, and did not, assume, acquire, or exchange the outstanding share options of DEF Corp. (the Acquiree). In accordance with the terms of DEF’s outstanding share options, the employees had 90 days after a change in control to exercise vested share options. Because these share options were out-of-the-money, the share options expired unexercised. Subsequently, ABC granted share options to employees, including employees that were formerly employed by DEF, in an amount and with terms that were consistent with ABC’s past practice for annual grants. Employees in similar positions received the same number of share options regardless of whether they were previously employed by DEF.

**Q.** Should ABC record the fair value of the share options granted to DEF’s former employees as additional consideration transferred in the acquisition of DEF?

**A.** No. ABC should not record the fair value of the share options as additional consideration transferred. ABC was not obligated to assume DEF’s outstanding share options. Additionally, ABC did not agree to compensate DEF employees for their lapsed share options. ABC granted new share options in an amount that was consistent
with its past practices for annual grants and did not grant a disproportionate amount of share options to DEF’s former employees. Accordingly, ABC should not record any portion of the fair value of the new share options as additional consideration or otherwise attribute the new awards to the acquisition of DEF.

11.055b Not used.

PAYROLL TAXES ON SHARE-BASED AWARDS

11.055c The liability for employer payroll taxes should be recognized on the date that measurement and payment of the payroll tax is required (triggering event), which generally is the exercise date of share options. A liability should not be recognized as part of the consideration transferred if the triggering event has not occurred at the acquisition date. Additionally, no adjustment to the consideration transferred should be made when the triggering event occurs after the acquisition date. This view is consistent with ASC paragraph 718-10-25-22, which addresses recognition of employer payroll taxes on employer share-based compensation.

ACCOUNTING FOR THE INCOME TAX EFFECTS OF REPLACEMENT AWARDS CLASSIFIED AS EQUITY ISSUED IN A BUSINESS COMBINATION

See KPMG's Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations.

11.056 - 11.060 Not used.

ACQUISITION-RELATED COSTS

ACQUISITION-RELATED COSTS INCURRED BY THE ACQUIRER

ASC Paragraph 805-10-25-23

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

11.061 Acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred, but rather are accounted for as expense in the
period incurred, unless such costs are incurred to issue debt or equity securities, in which case they are recognized in accordance with other applicable GAAP. Success fees payable by the acquirer to external advisors (such as an investment banker) that are contingent on the closing of an acquisition are not recorded as a liability or expense until the completion of the acquisition, as the expense is not incurred until the closing of the business combination. Therefore, the success fee expense is recorded in the financial statement period that includes the acquisition date. See Paragraph 27.032 for a discussion of contingent expenses of the acquiree when pushdown accounting is applied to the acquiree's financial statements.

11.062 If acquisition-related costs incurred by an acquirer are paid by the acquired entity or selling shareholders, those costs are accounted for as a separate transaction and are not part of the accounting for the business combination. See Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred below.

Example 11.26: Acquisition-Related Costs

ABC Corp. acquires 100% of the stock of DEF Corp., a foreign company, for cash. The foreign government requires a 1% stamp duty to be paid by ABC within 30 days of the transfer of stock to legally document the transfer of ownership. The stamp duty is the legal obligation of ABC.

The stamp duty paid by ABC is not part of the consideration transferred for the acquisition of DEF and therefore is expensed in the period in which the cost is incurred.

Q&A 11.1: Costs Related to Directors and Officers Liability Insurance

Background

Following an acquisition, several of an acquiree's former executives and officers were terminated. The acquirer obtained directors and officers insurance to insure against issues that might arise from the period that the former executives and officers served in their capacity for the acquiree.

Q. How should an entity account for the cost of a directors and officers liability insurance policy acquired to cover former officers of an acquiree?

A. The entity should expense the costs when incurred. It would not be appropriate to amortize the costs over the statute of limitations period or other periods because the periods over which the acquirer would receive a benefit from this cost is indeterminable. Furthermore, the cost relates to issues that may arise from actions taken before the acquisition. The cost of the insurance policy is not considered to be an acquisition cost.
Costs Related to the Issuance of Equity Securities

11.063 An acquirer may incur costs related to the issuance of equity securities issued to effect a business combination. Such costs may include direct, incremental costs of the issuance, such as fees charged by underwriters, attorneys, accountants, and printers. These costs effectively reduce the proceeds from the stock issuance and, therefore, should reduce the amount recognized in equity. An entity should record internal costs, such as salaries, as current period expenses, because such costs would have occurred even without the issuance of the equity securities.

Costs Related to the Issuance of Debt

11.064 An acquirer may incur costs in connection with the issuance of debt associated with a business combination. For example, such costs may include fees paid to creditors, attorneys, and rating agencies. Debt issue costs reduce the proceeds from the debt issued, and are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the proceeds change the nature of such costs. Direct costs paid to third parties in connection with a debt issuance, whether in a transaction related to a business combination or otherwise, should be capitalized and amortized over the term of the debt as a component of interest cost. Entities should not capitalize internal costs related to the issuance of debt.

11.065 An entity may incur fees in connection with the issuance of debt and also pay fees to the same service provider/creditor in a related business combination. The fees allocated to the debt issuance and the cost of the acquisition should be representative of the actual services provided. For example, if an entity pays fees to an investment banker in connection with a business combination and financing, those fees should be allocated between the costs of the acquisition and debt issuance costs considering factors such as the fees charged by investment bankers in connection with other similar recent transactions (e.g., fees charged by an investment banker solely for advisory services for an acquisition or fees charged by an investment banker solely for arranging financing). Whether these or other factors are considered, the allocation should normally result in an effective debt service cost (interest and amortization of debt issuance costs) that is comparable to the effective cost of other recent debt issues of similar investment risk and maturity. SAB Topic 2A

OTHER PAYMENTS TO AN ACQUIREE (OR ITS FORMER OWNERS) THAT ARE NOT PART OF THE CONSIDERATION TRANSFERRED

Statement 141(R)

B370. The Boards also considered concerns about the potential for abuse. Some constituents, including some respondents to the 2005 Exposure Draft, said that if acquirers could no longer capitalize acquisition-related costs as part of the cost of the business acquired, they might modify transactions to avoid recognizing those costs as expenses. For example, some said that a buyer might ask a seller to make payments to the buyer's vendors on its behalf. To facilitate the negotiations and sale of the business, the seller might agree to make those payments if the total
amount to be paid to it upon closing of the business combination is sufficient to reimburse the seller for payments it made on the buyer's behalf. If the disguised reimbursements were treated as part of the consideration transferred for the business, the acquirer might not recognize those expenses. Rather, the measure of the fair value of the business and the amount of goodwill recognized for that business might be overstated. To mitigate such concerns, [ASC Topic 805] requires any payments to an acquiree (or its former owners) in connection with a business combination that are payments for goods or services that are not part of the acquired business to be assigned to those goods or services and accounted for as a separate transaction. [ASC Topic 805] specifically requires an acquirer to determine whether any portion of the amounts transferred by the acquirer are separate from the consideration exchanged for the acquiree and the assets acquired and liabilities assumed in the business combination. [ASC paragraphs 805-10-25-20 through 25-23 and 55-18] provide guidance for making that determination.

11.066 The guidance in the above paragraph, and the guidance in ASC paragraphs 805-10-25-20 through 25-23 and 55-18 previously discussed, was included in ASC Topic 805 in part to mitigate concerns over whether an acquirer might arrange for an acquiree to make payments for goods or services on behalf of the acquirer that are unrelated to the acquisition. That guidance requires an acquirer to determine whether any portion of the consideration transferred relates to such transactions and, if so, to exclude such transactions from the acquisition accounting and, instead, assign a portion of the consideration transferred to such transactions and account for them as separate transactions in accordance with other relevant. Since the costs are a separate transaction, the acquirer should recognize an expense and liability for reimbursement to the acquiree as these costs are incurred. GAAP.

Example 11.27: Acquisition-Related Payments Made by an Acquiree

ABC Corp. acquires DEF Corp. for $10,000. The acquisition agreement states that the price is comprised of $9,500 as consideration for DEF and $500 as reimbursement of DEF’s acquisition-related transaction costs. The cost of $500 is entirely DEF’s cost and no costs were incurred by DEF on behalf of ABC.

The following amounts are the value of DEF’s assets and liabilities measured in accordance with ASC Topic 805 on the acquisition date:

<table>
<thead>
<tr>
<th>Category</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$3,000</td>
</tr>
<tr>
<td>Current liabilities (excluding accruals for transaction costs)</td>
<td>$2,000</td>
</tr>
<tr>
<td>Long-lived assets</td>
<td>$8,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

ABC treats the entire $10,000 as consideration transferred for the purpose of determining goodwill. This is based on the guidance in ASC paragraph 805-10-55-18. As the
reimbursement by ABC of DEF’s costs is for the primary benefit of DEF, the costs are more likely part of the exchange for the acquiree. Accordingly, ABC would record the following:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>3,000</td>
</tr>
<tr>
<td>Long-lived assets</td>
<td>8,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>6,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>2,000</td>
</tr>
<tr>
<td>Debt</td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Conversely, if the transaction costs were included in the acquiree's accounts payable to be paid by the combined company, it would be expected that the offer price would be reduced to $9,500 and ABC would record the following:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>3,000</td>
</tr>
<tr>
<td>Long-lived assets</td>
<td>8,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>6,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>2,500</td>
</tr>
<tr>
<td>Debt</td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>9,500</td>
</tr>
</tbody>
</table>

This example only applies to costs incurred by and related to the acquiree.

OTHER TRANSACTIONS

CHANGES IN INTEREST RATE ON ACQUIRER'S DEBT RESULTING FROM A CHANGE IN CONTROL

11.067 The acquirer in a business combination may have outstanding debt with provisions that could result in an increase in the interest rate in the event of a merger or acquisition. If the interest rate on debt of the acquirer is increased as a result of a business combination, the additional interest costs are not part of the business combination transaction and therefore are not included in the consideration transferred. The additional interest costs are recognized by the acquirer as incurred or accreted.

COSTS CONTINGENT ON A BUSINESS COMBINATION

11.068 In connection with a business combination, an acquirer may choose to exit an activity of the acquiree, involuntarily terminate employees of the acquired entity, or relocate employees of the acquired entity. Costs resulting from such activities are costs of the combined entity and are not part of the consideration transferred. The accounting for
such costs is discussed in ASC Subtopic 420-10, *Exit or Disposal Cost Obligations - Overall*. Costs incurred to integrate the acquired entity into the operations of the accounting entity would also not be part of the consideration transferred. See discussion of *Liabilities Associated with Restructuring or Exit Activities of the Acquiree* in Section 7.

**HEDGING A FORECASTED TRANSACTION CONTINGENT ON CONSUMMATION OF A BUSINESS COMBINATION**

11.069 ASC paragraph 815-20-25-43 prohibits fair value hedge accounting of a firm commitment to enter into a business combination or to acquire a subsidiary, minority interest, or equity method investee. ASC paragraphs 815-20-25-15(g) and 25-15(h) are explicit in their guidance in prohibiting cash flow hedge accounting for a forecasted transaction involving a business combination or acquisition of a subsidiary, noncontrolling interest, or equity method investee. The FASB's Derivatives Implementation Group (DIG) has discussed whether it is appropriate to designate the occurrence of a forecasted transaction that is contingent on consummating a business combination as the hedged item in a cash flow hedge.

**Example 11.28: Derivative Transaction That Will Lock In the Interest Rate Today on the Forecasted Issuance of Debt Expected to Occur in Six Months**

The following example is derived directly from DIG Agenda Item 14-13:

Company A enters into a definitive agreement to acquire the outstanding common stock of Company B for cash. The transaction is expected to close in six months. Given the significance of the purchase price relative to its cash balance, Company A needs to borrow money immediately before the closing of the transaction to fund the acquisition. However, in the unlikely event that the transaction with Company B is not consummated, Company A will not incur the debt as it has sufficient working capital to meet its operational needs. Company A is concerned that interest rates will increase during the next six months and, therefore, desires to enter into a derivative transaction that will lock in the interest rate today on the forecasted issuance of the debt expected to occur in six months.

11.070 While the FASB staff has not reached a definitive conclusion on the appropriate accounting treatment for the above example, we believe that it is acceptable to hedge a forecasted transaction that is contingent on the consummation of a business combination if the forecasted transaction does not directly affect the accounting for the acquisition and meets the criteria for being the hedged item as defined by ASC paragraph 815-20-25-15. In the above example, the forecasted issuance of debt does not directly affect the accounting for the acquisition.
If Company A determines that it is probable that the business combination will be consummated, that the forecasted transaction is likely to occur, and that all the other relevant hedging criteria in ASC paragraphs 815-20-25-3, 25-15, 25-75, 25-94, and 25-95 have been met, then cash flow hedge accounting would be appropriate for the forecasted transaction. It is important to note that the facts and circumstances related to the forecasted business combination need to be evaluated to determine whether the transaction is probable.

Certain constituents have argued that the consensus reached in EITF Issue No. 95-14, "Recognition of Liabilities in Anticipation of a Business Combination" (which was nullified by ASC Subtopic 420-10), does not support the assertion that a forecasted business combination can be probable of occurring before the consummation of the business combination. We believe that reference to EITF 95-14 is not appropriate, as the Issue was narrow in scope and addressed only the recognition of liabilities in anticipation of a business combination. EITF 95-14 did not specifically address whether a forecasted business combination could ever be considered likely to occur.

Furthermore, to the extent an entity concludes that a business combination is probable of occurring for purposes of hedging a forecasted transaction contingent on the consummation of a business combination, an entity also would conclude that the business combination is probable of occurring for purposes of SEC Rule 3-05 of Regulation S-X. This rule provides, in part, that audited financial statements prepared under Regulation S-X are required if the consummation of a significant business combination is considered probable.

1 ASU 2016-09 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016 (i.e., January 1, 2017 for public companies with a calendar year end). For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2017, and interim periods in fiscal years beginning after December 15, 2018. An entity can early adopt the ASU in any interim or annual period. The adoption date for an entity that early adopts after its first interim period is the beginning of the fiscal year and adjustment to previously reported interim periods in that fiscal year should be included in the year-to-date results.

2 Based on Case C in ASU 2018-07.

3 On May 10, 2017, the FASB clarified the modification guidance in ASC Topic 718 by issuing ASU 2017-09, Compensation-Stock Compensation (Topic 718) Scope of Modification Accounting (ASU 2017-09). Under ASU 2017-09, an entity applies modification accounting unless all of the following are the same immediately before and after the modification: fair value; vesting conditions of the award; and the classification as either a liability or equity instrument. ASU 2017-09 is effective for all entities for annual and interim periods in fiscal years beginning after December 15, 2017 (i.e., January 1, 2018 for entities with a calendar year end). An entity can early adopt ASU 2017-09 as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The amendments in ASU 2017-09 are applied prospectively to an award modified on or after the adoption date.
Section 12 - Subsequent Measurement and Accounting

Detailed Contents

Reacquired Rights
   Example 12.1: Reacquired Right Subsequently Sold to a Third Party

Assets and Liabilities Arising from Contingencies

Indemnification Assets
   Example 12.2: Subsequent Accounting for Indemnification Asset When Estimated Collectibility Changes
   Example 12.3: Subsequent Accounting for an Indemnification Asset When the Amount of the Related Indemnified Liability Decreases and the Fair Value of the Assets Securing the Indemnification also Decreases

Derecognition of Indemnification Assets
   Example 12.4: Subsequent Settlement of an Indemnified Tax Uncertainty at Less Than the Liability and Related Indemnification Asset Recognized at the Acquisition Date

Defensive Intangible Assets
   Defensive Assets Used in IPR&D Activities
   Other Defensive Intangible Assets
      Example 12.5: Acquired Trade Name the Acquirer Intends to Hold for Defensive Purposes

Contingent Consideration
   Subsequent Measurement of Contingent Consideration
      Subsequent Measurement of Equity-Classified Contingent Consideration
      Subsequent Measurement of Liability-Classified Contingent Consideration

Contingently Issuable Debt

Other Applicable GAAP
   Example 12.5a: Subsequent Accounting for a Liability for an Unfavorable Executory (Revenue) Contract

Consistency of Accounting Policies

Error Discovered after a Business Combination
   Example 12.6: Subsequent Discovery of Errors in Acquiree’s Financial Statements
   Example 12.7: Litigation with Dissenting Shareholders
ASC Paragraph 805-10-35-1

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable generally accepted accounting principles (GAAP) for those items, depending on their nature. However, [ASC] Topic [805] provides guidance on subsequently measuring and accounting for any of the following assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination:

a. Reacquired rights (see [ASC] paragraph 805-20-35-2)
b. Assets and liabilities arising from contingencies recognized as of the acquisition date (see [ASC] paragraph 805-20-35-3)
c. Indemnification assets (see [ASC] paragraph 805-20-35-4)
d. Contingent consideration (see [ASC] paragraph 805-30-35-1)
e. Contingent consideration arrangements of an acquiree assumed by the acquirer (see [ASC] paragraph 805-30-35-1A).

12.000 Recognition and measurement of the assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination is discussed in Section 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree. Subsequent to an acquisition, an acquirer accounts for most of the assets acquired, liabilities assumed or incurred, and equity instruments issued in an acquisition in accordance with other applicable GAAP. However, for the items specified in ASC paragraph 805-10-35-1, guidance is provided in ASC paragraphs 805-20-35-2 through 35-4C and 40-2 and 40-3. Additionally, as discussed beginning at Paragraph 12.015, guidance on accounting for defensive intangible assets is provided in ASC paragraphs 350-30-25-5, 35-5A and 35-5B, 55-1 and 55-1B, 55-28H, 55-28I, 55-28K, 55-28L.

REACQUIRED RIGHTS

ASC Paragraph 805-20-35-2

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

12.001 Consistent with the exception to the fair value measurement principle with respect to the initial measurement of a reacquired right, ASC Topic 805 requires the acquirer to amortize a reacquired right over the remaining contractual period of the related contract in which the right was granted, even if market participants would consider potential contract renewals in determining fair value. Thus, ASC paragraphs 350-30-50-4 through 50-5, 55-1C, and 275-10-50-15A are not applicable to the determination of the useful life
of a reacquired right. Section 7 discusses the initial recognition and measurement of reacquired rights at the acquisition date.

12.002 If an acquirer subsequently sells a reacquired right to a third party, the carrying amount of the intangible asset is included in the determination of the gain or loss on the sale.

Example 12.1: Reacquired Right Subsequently Sold to a Third Party

ABC Corp., a franchisor, acquires DEF Corp. on April 30, 20X8 in a business combination. ABC had a preexisting relationship with DEF and recognizes an intangible asset related to a reacquired franchise right previously granted to DEF. ABC applied the measurement principle in ASC paragraph 805-20-30-20 and determined the value of the reacquired franchise right to be $100,000, based on the remaining contractual period of five years as of the acquisition date. ABC did not consider potential contract renewals in determining fair value, even though a market participant would consider such renewals. Consistent with the term used for measuring the reacquired franchise right, ABC will amortize the reacquired right over the remaining contract period (five years). ABC did not recognize any settlement gain or loss on the business combination because the royalty rate that DEF was paying under the franchise agreement was consistent with the current market rate at the acquisition date. Two years later on April 30, 20X0, ABC sells the reacquired franchise right to XYZ Corp. for cash of $210,000, with an initial contract period of 10 years. Assume that all material services related to the sale of the franchise right to XYZ have been substantially performed by ABC, and that all of the requirements for recognition of revenues from franchise sales have been met.

ABC should derecognize the intangible asset of $60,000 ($100,000 less two-year amortization of $40,000) and reflect the net effect of $150,000 ($210,000 received from XYZ—carrying amount of $60,000 for the intangible asset) in earnings, presented in its income statement in a manner consistent with its reporting of other revenues from franchise sales (see ASC Subtopic 952-605, Franchisors - Revenue Recognition).

ASSETS AND LIABILITIES ARISING FROM CONTINGENCIES

ASC Paragraph 805-20-35-3

An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.

12.003 ASC Topic 805 requires that assets and liabilities arising from contingencies of an acquiree be recognized and measured at fair value at the acquisition date if fair value can be determined during the measurement period. If not, these items are recognized in accordance with the recognition and measurement provisions of ASC Topic 450, Contingencies. Any gains or losses attributable to pre-acquisition contingencies that are not recognized at acquisition date or within the measurement period are recorded outside
of purchase accounting. See Section 7 for a discussion of initial recognition and measurement of assets and liabilities arising from contingencies.


12.005 We expect that in most circumstances entities will continue their current practices when contingencies are recognized and measured in the acquisition accounting using an ASC Topic 450 approach—which likely is a continuation of the ASC Topic 450 approach until the contingency is resolved (see related discussion in Paragraphs 7.156 - 7.157). However, in the case of warranty obligations or other contingencies that are initially recognized at fair value, ASC paragraphs 805-20-25-17 and 25-28 suggest that ASC Subtopic 460-10, Guarantees - Overall, might be a potential source of guidance on the subsequent accounting. In accordance with ASC Subtopic 460-10, entities might amortize the initially measured amount to income over the contingency period (i.e., the warranty period) or they might continue to measure the contingency at its acquisition-date fair value until its resolution.

12.005a After adopting ASC Topic 606, the accounting for warranties is differentiated between assurance-type and service-type warranties. In both cases, the assumed liability is measured at fair value. The subsequent accounting for assurance-type warranties is consistent with the methods described in Paragraph 12.005. However, service-type warranties are accounted for as unfulfilled performance obligations under ASC Topic 606. See Section 4.5.20 in KPMG's Handbook, Revenue recognition.

INDEMNIFICATION ASSETS

ASC Paragraph 805-20-35-4

At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management’s assessment of the collectibility of the indemnification asset.

ASC Paragraph 805-20-35-4B (Before adoption of ASU 2016-13)

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

**ASC Paragraph 805-20-35-4B (After adoption of ASU 2016-13)**

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

**ASC Paragraph 805-20-40-3**

The acquirer shall derecognize the indemnification asset recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

**12.006** Indemnification assets are an exception to the recognition and measurement principles of ASC Topic 805. An acquirer recognizes indemnification assets at the same time and measures them on the same basis as the indemnified item, subject to any contractual limitations on the amount of the indemnification and, for indemnification assets not measured at fair value, the need for a valuation allowance for uncollectible amounts. The acquirer would not recognize a valuation allowance for an indemnification asset measured at fair value, because the collectibility considerations are reflected in the measurement of fair value. An acquirer should not present indemnification assets as a reduction of the associated liability, but rather should include them in assets in the balance sheet. See the discussion of Indemnification Assets in Section 7.

**12.007** Subsequent to initial recognition, the acquirer continues to measure an indemnification asset recognized at the acquisition date on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount and, for an indemnification asset not subsequently measured at fair value, the need for a valuation allowance for uncollectible amounts.

**12.008** The initial and subsequent accounting for indemnification assets recognized at the acquisition date also applies to assets and liabilities that are exceptions to the recognition
or measurement principles of ASC Topic 805. For example, an acquirer would initially and continue to subsequently recognize and measure an indemnification asset related to a liability from an uncertain tax position using assumptions consistent with those used to measure the indemnified item (i.e., ASC Subtopic 740-10, Income Taxes - Overall).

12.009 ASC paragraphs 805-20-35-4 and 40-3 address the subsequent accounting for an indemnification asset recognized at the acquisition date. However, as discussed in ASC paragraphs 805-20-25-28, 30-18 through 30-19, indemnification may relate to an item not recognized at the acquisition date. For example, an indemnification may relate to an environmental contingency whose fair value is not determined at the acquisition date and for which it is less than probable that a liability exists at the acquisition date in which case an acquirer would not recognize the contingent liability at the acquisition date. Because the related indemnified item was not initially recognized at the acquisition date, the indemnified item is subsequently accounted for under other applicable GAAP, including ASC Topic 450, as appropriate. Likewise, the indemnification asset is not recognized at the acquisition date, and is subsequently accounted for under other applicable GAAP, including ASC Topic 450, as appropriate. In these circumstances, we also believe the indemnification asset should be recognized and measured at the same time and on the same basis as the indemnified item, subject to any contractual limitations on the amount of the indemnification and the need for a valuation allowance for uncollectible amounts.

12.009a An acquisition agreement may require a portion of the consideration transferred to be placed in an escrow account to allow the acquirer to make indemnification claims against the former shareholders of the acquiree and retrieve the funds if the acquiree fails to meet the terms of the agreement. If so, the funds placed into escrow are treated as part of the consideration transferred, and the acquirer recognizes assumed contingencies and related indemnification assets as described in Section 7. Funds released from the escrow account to the acquirer would be recorded as a reduction in a related indemnification asset, if any, or otherwise as a reduction to purchase consideration if they are released because of facts and circumstances that existed as of the acquisition date. A release of escrow to the acquirer related to anything other than a specific indemnification provided in the purchase agreement (e.g., a dispute or litigation over false or misleading representations) may need to be accounted for outside of the business combination. See Paragraphs 12.033 and 12.034 for additional details.

12.010 Examples 12.2 through 12.3 illustrate the subsequent accounting for indemnification assets that were initially recognized at the acquisition date (other than those covered by ASC paragraph 805-20-35-4B). Example 12.4 illustrates the subsequent accounting for indemnification assets covered by ASC paragraph 805-20-35-4B.

Example 12.2: Subsequent Accounting for Indemnification Asset When Estimated Collectibility Changes

ABC Corp. has been fully indemnified for a liability arising from a contingency assumed in the acquisition of DEF Corp. The liability recognized at the acquisition date was $10
million. Because of management’s collectibility assessment, ABC measured the indemnification asset at the acquisition date at $9 million.

Subsequent to the acquisition, the carrying amount of the liability remains at $10 million. However, the concerns about the collectibility of the indemnification asset no longer exist (due to events following the acquisition).

Because there are no longer concerns about the collectibility of the indemnification asset, ABC would reverse the valuation allowance. Because the change in estimated collectibility resulted from events that occurred after the acquisition date, the change in the valuation allowance would be recognized in earnings.

Example 12.3: Subsequent Accounting for an Indemnification Asset When the Amount of the Related Indemnified Liability Decreases and the Fair Value of the Assets Securing the Indemnification also Decreases

ABC Corp. was fully indemnified for a liability arising from a contingency that was assumed in the acquisition of DEF Corp. The liability recognized at the acquisition date was $10 million. ABC also recognized an indemnification asset of $10 million at the acquisition date. The indemnification is secured by, and limited to, collateral held in escrow, and the initial fair value of the collateral was $10 million.

Following the acquisition, ABC obtains new information and measures the liability at $6 million. The fair value of the escrowed assets (e.g., ABC shares included in the consideration transferred for the acquisition of DEF) has subsequently declined to $4.5 million.

In this case, the liability would be measured at $6 million and ABC would reduce the indemnification asset to $6 million. However, the carrying amount of the indemnification asset would be reduced by a valuation allowance of $1.5 million, with a corresponding charge against current earnings, due to the decline in fair value of the assets that collateralize the indemnification.

DERECOGNITION OF INDEMNIFICATION ASSETS

12.011 Consistent with the derecognition of the related asset or liability recognized at the acquisition date, ASC paragraphs 805-20-35-4 and 40-3 specify that the acquirer derecognizes an indemnification asset only when it collects the asset, sells it, or otherwise loses the right to it.

12.012 If the amounts recognized by an acquirer for an indemnified liability and a related indemnification asset recognized at the acquisition date do not change subsequent to the acquisition and are ultimately settled at the amounts recognized in the acquisition accounting, there would be no effect on the statement of income. However, if either or both of the recognized amounts change subsequent to the acquisition, either because of
new information or ultimate settlement, and the indemnified liability relates to an expense, we believe there would be an effect on the income statement, even if both the indemnified liability and the related indemnification asset change by equal and offsetting amounts. In such situations, we believe the acquirer should present the effect on the income statement on a *gross*, rather than a *net* basis.

12.013 For example, if an acquirer has been indemnified for losses from a specific litigation matter, and a liability and an indemnification asset were recognized at the acquisition date in the amount of $5 million, and both the liability and the indemnification asset are subsequently increased to $9 million because new information was obtained following the acquisition date, we believe the income statement generally should be presented gross and reflect a $4 million charge related to the recognized increase in the liability, and a $4 million credit related to the recognized increase in the indemnification asset. Both the charge and the credit should be classified in accordance with other applicable GAAP (e.g., ASC Section 220-20-45 and EITF Issue No. 01-10, “Accounting for the Impact of the Terrorist Attacks of September 11, 2001”), which could, in certain circumstances, be classified in the same income statement line item.

12.013a If either or both of the amounts recognized by an acquirer for an indemnified liability and a related indemnification asset at the acquisition date change subsequent to the acquisition, either because of new information or ultimate settlement, and the indemnification relates to the cost of a capital asset, we believe the change would not be recorded through the income statement given the indemnified item is a capital asset, and there would be no expense in the absence of an indemnification arrangement.

12.013b For example, in 20X3, ABC Corp. acquired a business from XYZ Corp. The property on which the business operates was subject to environmental review by the state. In the purchase agreement, XYZ agreed to indemnify ABC for environmental remediation costs exceeding $7 million. In 20X5, ABC received a final ruling from the state that the environmental issue could be addressed by ABC constructing a new waste water treatment plant on the site. ABC constructed the plant in 20X5 at a cost of $10 million, and submitted a claim to XYZ for reimbursement of $3 million. Upon meeting the probable and reasonably estimable criteria for recognition in 20X5, ABC recorded the cost of the waste water treatment plant asset of $7 million, an indemnification asset of $3 million and recognized the construction cost of $10 million. During 20X6, XYZ challenged ABC’s management of the construction costs and ABC agreed to settle for a $2 million reimbursement. As a result, ABC increased its cost basis in the water treatment plant by $1 million and decreased the indemnification asset by $1 million. We believe no effect on the income statement (assuming there is no impairment of the related asset) is recognized when the indemnified item is a capital asset, and there would be no expense in the absence of an indemnification arrangement, only a higher cost basis in the asset. Therefore, it is appropriate for any change to the measurement of the indemnification asset, even when recorded subsequent to the measurement period, to be offset against the cost basis in the capital asset with no income statement effect, as the construction of a capital asset does not represent an expense. We believe this conclusion is further supported by the principles described in paragraphs B301 to B303 of Statement 141R. In the guidance for indemnification assets, the Board made certain exceptions to
the acquisition date recognition and fair value measurement provisions of the accounting for business combinations to permit entities to prevent recognition or measurement anomalies.

### Example 12.4: Subsequent Settlement of an Indemnified Tax Uncertainty at Less Than the Liability and Related Indemnification Asset Recognized at the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination on April 30, 20X8. In accounting for the acquisition, ABC recognized a $10 million liability at the acquisition date related to an uncertain tax position of DEF, measured in accordance with FIN 48 (ASC Subtopic 740-10). ABC was fully indemnified for any liability resulting from the ultimate resolution of the tax uncertainty, and there were no concerns about the collectibility of the indemnification. Thus, ABC also recognized an indemnification asset of $10 million at the acquisition date.

There were no changes in the amounts recognized by ABC with respect to either the liability for the uncertain tax position or the indemnification asset until September 30, 20X9, when the liability for the uncertain tax position was effectively settled (ASC paragraphs 740-10-25-10 through 25-11), with no payment being required by ABC (note that for illustrative purposes, the accrual of interest and penalties, if any, related to the tax uncertainty are ignored in this example). As a result, ABC derecognized the $10 million liability it recognized at the acquisition date on September 30, 20X9, with an offsetting credit to income tax expense in accordance with ASC Subtopic 740-10.

ABC also derecognized the indemnification asset of $10 million at September 30, 20X9. However, the offsetting charge to the income statement would not be to income tax expense, but rather would be classified as an expense based on other applicable GAAP.

### DEFENSIVE INTANGIBLE ASSETS

**ASC Paragraph 805-20-30-6**

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

12.015 A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as defensive intangible assets or locked-up assets. In accordance with ASC Topic 805, an acquirer would recognize and measure all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Subtopic 820-10. This has led to questions as to how defensive intangible assets should be accounted for subsequent to their acquisition. The EITF considered and reached a consensus on this issue, which is contained in ASC paragraphs 350-30-15-15, 25-5, 35-5A through 35-5B, 55-1, 55-1B, and 55-28H through 55-28L.

DEFENSIVE ASSETS USED IN IPR&D ACTIVITIES

12.016 The EITF’s conclusions require that intangible assets acquired in a business combination that are used in research and development activities (regardless of whether they have an alternative future use) are accounted for in accordance with ASC paragraph 350-30-35-17A, which provides that:

ASC Paragraph 350-30-35-17A

Intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered indefinite lived until the completion or abandonment of the associated research and development efforts. During the period those assets are considered indefinite lived they shall not be amortized but shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in [ASC] Section [350-30-35]. Consistent with the guidance in [ASC] paragraph 360-10-35-49, intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that have been temporarily idled shall not be accounted for as if abandoned.

12.017 Thus, when intangible IPR&D assets are acquired in a business combination, they are considered to be indefinite lived until completion or abandonment of the associated research and development efforts, and are not amortized during the period of development. Additional research and development costs incurred subsequent to the acquisition of the IPR&D asset are expensed as incurred, in accordance with ASC Subtopic 730-10, Research and Development - Overall. Once the development effort is completed, the useful life of the asset is determined based on the guidance in ASC paragraph 350-30-35-3, and the IPR&D asset recognized in the acquisition accounting is amortized over its estimated useful life. Additionally, the acquirer performs a final impairment test under the indefinite-lived intangible asset model in accordance with ASC paragraph 350-30-35-18 immediately prior to reclassifying the asset to definite-lived. If the development effort is abandoned, and the IPR&D has no future alternative use, the
IPR&D asset is written off. During the development period, the IPR&D asset is tested for impairment.

12.018 When an IPR&D asset is intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. For instance, if the IPR&D asset is acquired in a business combination to protect an existing, ongoing R&D project of the acquirer, the acquired IPR&D asset should be measured at its acquisition-date fair value and considered an indefinite-lived intangible asset until the completion or abandonment of the existing R&D project of the acquirer. Upon completion or abandonment of the acquirer’s existing R&D project, the IPR&D asset’s useful life would be determined in accordance with the guidance in ASC paragraph 350-30-35-3. Alternatively, if the IPR&D asset is acquired in a business combination to defend an existing, completed product of the acquirer, and further development of the acquired IPR&D asset is not planned, its useful life is determined, and the asset would be amortized over that period, consistent with the guidance in ASC paragraphs 350-30-35-6 through 35-13. The determination of the useful life of an IPR&D asset to be used for defensive purposes will require the exercise of judgment. The assumptions used in determining the useful life and the amortization methodology of an IPR&D asset should be consistent with the assumptions used in determining its fair value. See the discussion of the determination of fair value of IPR&D assets in Section 17.

OTHER DEFENSIVE INTANGIBLE ASSETS

12.019 ASC Subtopic 350-30 provides the following guidance for defensive intangible assets:

- The determination of whether an acquired intangible is a defensive intangible asset is based on the intentions of the acquirer. That determination may change as the acquirer’s intentions change. For example, an intangible asset that was accounted for as a defensive intangible asset on the acquisition date will cease to be a defensive asset if the acquirer subsequently decides to actively use the asset.

- A defensive intangible asset should be accounted for as a separate unit of accounting. It should not be included as part of the acquirer’s cost of an existing intangible asset, because the defensive intangible asset is separately identifiable.

- A defensive intangible asset should be assigned a useful life in accordance with ASC paragraphs 350-30-35-3. The useful life should reflect the acquirer’s consumption of the expected benefits related to that asset (i.e., the benefit a reporting entity receives from holding a defensive intangible asset in the form of direct and indirect cash flows resulting from the prevention of others from realizing any value from the intangible asset (defensively or otherwise).

- It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish
over time as a result of a lack of market exposure or as a result of competitive or other factors.

- If an intangible asset meets the definition of a defensive intangible asset, it cannot be considered immediately abandoned.

12.020 The following example, taken from ASC paragraph 350-30-55-28H, illustrates the determination of whether an intangible asset is within its scope.

Example 12.5: Acquired Trade Name the Acquirer Intends to Hold for Defensive Purposes

ABC Corp., a consumer products manufacturer, acquires an entity that sells a product that competes with one of ABC’s existing products. ABC 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, ABC’s existing product is expected to experience an increase in market share. ABC does not have any current plans to reintroduce the acquired trade name in the future.

Analysis. Because ABC 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.

CONTINGENT CONSIDERATION

ASC Paragraph 805-30-35-1

Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with [ASC] paragraphs 805-10-25-13 through 25-18 and [ASC] Section 805-10-30. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which [ASC] Topic 815 requires the changes to be initially recognized in other comprehensive income.
ASC Paragraph 805-30-35-1A

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in [ASC paragraph 805-30-35-1].

12.021 Contingent consideration is initially recognized by an acquirer at the acquisition date as part of the consideration transferred, measured at its acquisition-date fair value. See the discussion of Contingent Consideration in Section 6, and the discussion of determining the fair value of contingent consideration issued in a business combination in Section 18.

12.022 Changes in the fair value of contingent consideration initially recognized that result from additional information about facts and circumstances that existed at the acquisition date that the acquirer obtains during the measurement period are measurement period adjustments. Those changes are recognized as adjustments to the amount provisionally recognized as of the acquisition date, and therefore are adjustments to the acquisition accounting. See the discussion of Adjustments to Provisional Amounts during the Measurement Period in Section 10.

12.022a Contingent consideration arrangements could be altered in certain instances, such as disputes over the terms of the arrangement or changes in the terms. We believe that any adjustment due to disputes over the terms of a contingent consideration arrangement should be recognized in current earnings, unless there is a clear and direct link to the consideration transferred based on facts and circumstances that existed as of the acquisition date. If a clear and direct link is established between the dispute and the amount of consideration transferred, the consideration transferred is adjusted. See discussion of clear and direct link at Paragraph 12.033. Any additional consideration transferred to the selling shareholders due to litigation over the value of the consideration transferred should be expensed unless the settlement occurs during the measurement period and meets the clear and direct link criteria. Any post-acquisition change to the contingent consideration terms is accounted for separately from the business combination.

SUBSEQUENT MEASUREMENT OF CONTINGENT CONSIDERATION

12.023 The accounting for changes in fair value of contingent consideration after the acquisition date, other than measurement period adjustments, depends on whether the contingent consideration is classified as equity (equity-classified) or a liability (liability-classified). The classification is reassessed at each reporting period. Contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity. Contingent consideration that is liability-classified (or in some instances asset-classified) is remeasured to fair value at each reporting date until the contingency is resolved, with changes in fair value being recognized in earnings (i.e., operating income), unless the arrangement is a hedging instrument in a cash flow hedge for which ASC Topic 815 requires the changes to be initially recognized in other
comprehensive income. For guidance on presenting contingent consideration in the statement of cash flows, see chapter 18 of KPMG's Handbook, *Statement of cash flows.*

**Subsequent Measurement of Equity-Classified Contingent Consideration**

**12.024** An acquirer does not remeasure contingent consideration classified as equity and its subsequent settlement is accounted for within equity. Each reporting period, the acquirer reassesses the classification of contingent consideration based on the classification of the underlying instrument. Along with the other criteria in ASC Section 815-40-25, an instrument continues to be equity classified if:

(a) Currently authorized, but unissued shares less the maximum number of shares that could be required to settle the existing commitments that may require the issuance of stock during the length of the contingent consideration are greater than the

(b) Maximum number of shares required to be delivered under the contingent consideration.

If these criteria are no longer met by the underlying instrument, the contingent consideration is remeasured at fair value with the change recognized as an adjustment to stockholders' equity and the underlying instrument is reclassified to a liability.

**Subsequent Measurement of Liability-Classified Contingent Consideration**

**12.025** The FASB concluded that an acquirer should account for all liabilities for contingent payments (including contingent consideration) similarly, and should remeasure such liabilities at fair value after the acquisition date until settled. An acquirer recognizes such changes in fair value in earnings as they occur (unless the changes result from measurement period adjustments, or the contingent consideration has been used as a hedging instrument in a cash flow hedge as discussed in Paragraph 12.023). An acquirer should classify changes in fair value resulting from (1) the passage of time (i.e., accretion expense) and (2) revisions to the amount or timing of the initial measurement of the contingent consideration as an operating item in the income statement. This classification guidance is also consistent with ASC paragraph 410-20-35-5, which addresses financial accounting and reporting of liabilities associated with asset retirement obligations.

**12.026** Many obligations for contingent consideration that qualify for classification as liabilities meet the definition of a derivative instrument in ASC Topic 815, *Derivatives and Hedging.* However, before issuance of ASC Topic 805, contingent consideration issued in a business combination was excluded from the scope of ASC Topic 815. In deliberating ASC Topic 805, the FASB concluded that all contracts that would otherwise be within the scope of ASC Topic 815 (if not issued in a business combination) should be subject to the requirements of ASC Topic 815. As a result, liabilities for contingent consideration arising from a business combination that are subject to the requirements of ASC Topic 815, are subsequently measured at fair value, with changes in fair value recognized in earnings, unless the arrangement is a hedging instrument in a cash flow hedge for which ASC Topic 815 requires the changes to be initially recognized in other
comprehensive income. We are not aware of situations where contingent consideration has been used as a hedging instrument, and expect that any situations where this might apply will be rare.

12.026a The classification of contingent consideration is reassessed each reporting period to assess potential changes to the classification of the underlying instrument. On the date the underlying instrument is reclassified to equity, the contingent consideration is remeasured at fair value with the gain or loss recognized in earnings immediately before the underlying instrument is reclassified to equity. Previously recorded fair value adjustments on liability classified contingent consideration are not reversed.

CONTINGENTLY ISSUABLE DEBT

12.027 An acquisition agreement in a business combination may provide for the issuance of additional consideration in the form of notes, with interest payable during the contingency period to an escrow agent who holds the notes. ASC Topic 805 requires that an acquirer initially measure and recognize all contingent consideration, including contingently issuable debt, at its acquisition-date fair value and include the amount so determined in the consideration transferred to effect the acquisition. The initial fair value measurement would include consideration of all appropriate information, including any difference between the stated rate and market rate of interest on the contingently issuable debt. Because the note instruments would be liability-classified contingent consideration, an acquirer would remeasure the notes to fair value at each reporting date until the contingency is resolved, and recognize the changes in fair value in earnings. Such increases or decreases would include the effect of the accrual of interest and all other changes affecting the fair value measurement, including (but not limited to) any changes in fair value arising from changes in the appropriate market interest rate and changes in the estimate of the amount of the contingently issuable consideration that will ultimately be issued.

12.028 An acquirer may also be obligated to make payments of interest on the contingently issuable debt into an escrow account. In those situations, an intangible asset (or liability) would be recognized at the acquisition date, in an amount equal to the fair value derived from the difference, if any, between the interest rate that will be earned on the amounts paid into escrow and the interest rate a market participant would expect to earn on the amounts paid into escrow during the period of the contingency. The intangible asset (or liability) would be accreted to interest income such that, along with the interest earned on the escrowed funds, the acquirer would recognize interest income on the escrowed funds at the market rate determined as of the acquisition date. Amounts paid into escrow, and any interest earned thereon, would be recognized by the acquirer as a deposit throughout the period of the contingency and would ultimately be eliminated when the amount in escrow is either transferred to the seller as a part of payment of the recognized liability for the contingently issuable debt or returned to the acquirer in cash.
OTHER APPLICABLE GAAP

12.029 As previously noted, an acquirer would subsequently account for most of the assets acquired, liabilities assumed or incurred, and equity instruments issued in an acquisition, in accordance with other applicable GAAP. ASC paragraphs 805-20-35-5, 35-7, 35-8 and 805-30-35-2 and 35-3 provide the following examples of other relevant GAAP that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination:

(a) ASC paragraph 350-30-15-4 prescribes the accounting for goodwill and identifiable intangible assets acquired in a business combination, including:

1. Recognition of intangible assets used in research and development activities, regardless of whether those assets have an alternative future use

2. Classification of research and development intangible assets as indefinite-lived until the completion or abandonment of the associated research and development efforts.

(b) ASC Topic 944, Financial Services—Insurance, provides guidance on the subsequent accounting for an insurance or reinsurance contract acquired in a business combination.

(c) ASC Topic 740 prescribes the subsequent accounting for deferred tax assets (including valuation allowances) and liabilities acquired in a business combination.

(d) ASC Topic 718 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that is attributable to grantees' future services.

(e) ASC Topic 810 provides guidance on accounting for changes in a parent’s ownership interest in a subsidiary after control is obtained.

Example 12.5a: Subsequent Accounting for a Liability for an Unfavorable Executory (Revenue) Contract

The following facts apply to all 4 scenarios presented below.

ABC Company (ABC) acquires XYZ Corporation in a business combination. Before the acquisition, XYZ entered into a non-cancellable executory contract with a customer to supply parts at fixed prices. At the time of the acquisition by ABC, the rates were below market (i.e., ABC assumed an unfavorable contract). ABC recognized a liability on the balance sheet for the below market component of the contract.

Note: The conclusions below apply regardless of whether ABC has adopted ASC Topic 606, Revenue from Contracts with Customers. See discussion of the effect of ASC Topic 606 adoption on an acquirer's accounting for a business combination beginning at Paragraph 17.084a.
Scenario 1

The contract requires delivery of a fixed number of parts. Subsequent to the acquisition of XYZ, ABC and the customer modify the contract to reduce the number of parts ABC will deliver under the contract.

ABC should account for the change prospectively as a change in estimate. ABC should revise its per-part allocation of the liability at the date of the modification by dividing the remaining balance over the revised number of parts to be delivered at the date of the modification. It would not be appropriate for ABC to make a one-time adjustment to reduce the liability as a result of the change in the number of units to be delivered.

Scenario 2

The contract does not specify the number of parts to be delivered. At the date of the XYZ acquisition, ABC expected XYZ to deliver 80,000 parts over the remainder of the contract. Subsequent to the acquisition, the customer notifies ABC that it will order only 10,000 more parts because it plans to discontinue the product of which XYZ's parts are a component.

Similar to Scenario 1, ABC should account for the change in the estimate of the number of parts to be delivered prospectively by reallocating the remaining liability balance to the remaining parts. ABC should not derecognize a portion of the liability to retain its original estimated per-part allocation of the liability.

Scenario 3

As a result of cost reductions from synergies with its own operations, the contract becomes more profitable to ABC.

The cost savings realized after the acquisition are an economic event that occurred after the acquisition, and therefore ABC should not adjust the liability as a result of this event. ABC continues to allocate the liability for the unfavorable contract to the parts based on its original allocation.

Scenario 4

Subsequent to ABC's acquisition of XYZ, the selling prices of similar parts in the marketplace have decreased, such that the contract is now priced at market and no longer unfavorable to ABC.

Similar to Scenario 3, the increase in market price is an economic event that occurred after the acquisition, and therefore ABC should not adjust the liability as a result of this event. ABC continues to allocate the liability for the unfavorable contract to the remaining parts based on its original allocation.
CONSISTENCY OF ACCOUNTING POLICIES

12.030 Accounting policies of the acquiree should be conformed to those of the acquirer after a business combination. Dissimilar operations, assets, or transactions may be a basis for different accounting policies. Alternatively, the acquirer may change its accounting policies to conform to those of the acquiree, which would be considered a change in accounting principle, permitted only if the acquirer can justify use of an allowable alternative accounting principle that is preferable under ASC Subtopic 250-10, Accounting Changes and Error Corrections - Overall.

ERROR DISCOVERED AFTER A BUSINESS COMBINATION

12.031 Material errors in the acquiree’s financial statements may be discovered subsequent to a business combination. In some situations, if the acquirer had known about the errors at the time of the acquisition, it would have affected the consideration transferred (e.g., where the consideration was determined based on the acquiree’s precombination financial statements). However, if the consideration would have changed but there is no actual adjustment of the consideration paid by the buyer to the seller as a result of the subsequent identification of the error, there can be no adjustment to the acquisition accounting. Therefore, any change in assets or liabilities resulting from the correction of the error would be recognized in earnings in the acquirer’s postcombination financial statements. Alternatively, if it is determined that the nature of the errors discovered would not have affected the consideration transferred, the adjustment would generally be recorded to goodwill.

12.032 These scenarios described in the preceding paragraph are presented in the following decision tree.
Example 12.6: Subsequent Discovery of Errors in Acquiree’s Financial Statements

**Scenario 1.** Company A acquires Target for $100 million on October 31, 20X0. The acquisition agreement provides for a working capital adjustment with a provision for arbitration in the event of a dispute. Four months after the acquisition, Company A determines that Target has failed to accrue a $10 million liability owed to a regulatory authority. This liability was not discovered during Company A’s due diligence process. Company A believes that the definition of a liability was met at the acquisition date. The former owner of Target (Seller) refuses to reimburse Company A for the liability and the amount is in dispute. The dispute will be resolved through arbitration per the acquisition agreement.

Company A would record the liability with the corresponding debit to expense rather than to goodwill. The amount in dispute does not represent an asset to Company A. Because Company A would have adjusted the consideration paid had it known about the liability, it cannot record the debit as goodwill. Even though the amount was discovered during the measurement period. Stated differently, had Company A known about the liability, it would have paid less for Target resulting in the same amount of goodwill as is currently recorded (in essence, the reduction of the consideration paid would have been offset by the liability). The fact that the agreement provided for a working capital adjustment does not automatically mean that an adjustment to goodwill is appropriate. If both parties had agreed to an adjustment to working capital, Company A would have recorded a receivable from Seller rather than an adjustment to goodwill. In this example, if Company A were to record the debit as a receivable, it likely would need to record a full valuation allowance through earnings because the amount is in dispute. If Company A subsequently receives a settlement from Seller when the dispute is resolved, the amount would be recorded as a gain in the income statement through the same line item as the expense was recorded in the earlier period.

**Scenario 2.** DEF Corp. acquires Target in a business combination. The terms of the acquisition agreement require DEF to pay $200 million and do not address potential adjustments to the consideration related to Target’s working capital. After finalizing Target’s acquisition-date balances, DEF identified an inventory cut-off error that existed at the acquisition date and resulted in a $3 million overstatement of inventory. DEF can demonstrate that the acquisition of Target was important to its future strategic plans and the consideration would have been $200 million regardless of the amount of working capital of Target on the acquisition date. DEF has not filed a claim against Seller for the difference in balances.

DEF should record the adjustment to reduce inventory as an increase to goodwill.

12.033 With respect to litigation over the purchase price, an SEC staff speech noted that contingencies that arise from the dispute and related litigation are not preacquisition contingencies that would be recognized in the acquisition accounting. The staff has only
accepted settlement of the litigation over the purchase price as being an adjustment to the consideration transferred in situations where there is a clear and direct link to the consideration transferred such as when the litigation is seeking enforcement of an escrow arrangement that specifies a minimum amount of working capital in the acquired business, which may establish a clear and direct link to the consideration transferred.

12.034 Often the litigation is complicated by claims involving misrepresentation and other assertions by the claimants. In such cases, the acquirer would need to be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the consideration transferred otherwise, subsequent adjustments would be recognized in current earnings. The SEC staff speech notes that in situations where the initial determination of the fair value of the acquired assets and liabilities is incorrect (such as the situation in Scenario 1 above) any adjustment generally would not be reflected as an adjustment to the acquisition accounting. Similarly, claims that one party mislead the other or disputes about the meaning of certain language in the acquisition agreement are not unique to business combinations and therefore such settlements normally would be recognized in current earnings.

Example 12.7: Litigation with Dissenting Shareholders

Company A, a private-equity firm, acquired Target on September 30, 20X0 for $2 billion in cash, or $167 a share, and simultaneously took Target private. A minority number of Target’s shareholders dissented to the acquisition and brought litigation against Company A to obtain additional consideration for their shares in Target. Under the applicable state law, court judgments of fair value are subject to interest at 5% above the Federal Reserve discount rate of 1.75%, which accrues from the date of the merger through the date of payment of the judgment.

On November 30, 20X0, the court ruled in favor of the dissenting shareholders and awarded them $170 per share. Company A paid this amount on December 15, 20X0, plus interest of $2 per share in accordance with state law. Although one may view the incremental consideration as an additional cost in acquiring Target, the SEC staff has taken the position that the additional consideration of $3 per share ($170 - $167) paid to the dissenting former shareholders of Target is an expense in Company A’s postcombination financial statements. Additionally, the related interest of $2 per share paid on December 15, 20X0 is also charged as an expense in Company A’s postcombination financial statements. Associated legal costs are charged to expense by Company A as incurred.

1 ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, is effective for public business entities that are SEC filers for annual and interim periods in fiscal years beginning after December 15, 2019. For all other public business entities, it is effective for annual and interim periods in fiscal years beginning after December 15, 2020. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2020, and interim periods in fiscal years beginning after December 15, 2021. Early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018.
Section 13 - Disclosures

Detailed Contents

Business Combinations Completed during the Reporting Period, or after the Reporting Period but before Issuance of the Acquirer's Financial Statements
  General Information about the Acquisition Transaction
  Consideration Transferred
  Contingent Consideration Arrangements and Indemnification Assets
  Certain Acquired Receivables
  Assets Acquired and Liabilities Assumed
  Goodwill
  Bargain Purchases
  Equity Interest Not Acquired (Noncontrolling Interest)
  Business Combination Achieved in Stages (Step Acquisitions)
  Separately Accounted for Transactions, Including Preexisting Relationships
  Additional Disclosures for Public Entities
Pro Forma Disclosure Requirement of ASC Topic 805 Compared to Pro Forma Information Required to Be Presented in Filings with the SEC
  Q&A 13.0: Update of Pro Forma Financial Information Required by Article 11 Objectives of Pro Forma Financial Information Disclosures
  Pro Forma Financial Information Required, and Guidance on the Form, Content, and Basis of Preparation
  When Pro Forma Financial Information Is Required
  Periods for Which Pro Forma Financial Information Is Required
    Q&A 13.1: Pro Forma Disclosures in Interim Periods
  Immaterial Business Combinations That Are Material in the Aggregate
  Business Combinations Completed after Reporting Date but before Issuance of the Financial Statements
  Disclosure of Adjustments Recognized during the Current Period
  Measurement Period Adjustments
  Contingent Consideration Adjustments
  Reconciliation of Changes in Goodwill during the Reporting Period
Additional Disclosures to Meet Disclosure Objectives
Example Disclosures
  Example 13.1: Disclosure of a Material Business Combination in the Year of Acquisition, Completed During the Reporting Period
**13.000** ASC Topic 805, *Business Combinations*, outlines the acquirer’s disclosure requirements in the context of two overall objectives, which are set out in ASC paragraphs 805-10-50-1 and 50-5. Disclosures should enable financial statement users to evaluate:

1. 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 or are available to be issued (determined in accordance with ASC Section 855-10-25); and
2. The financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

**13.001** ASC paragraphs 805-10-50-2, 805-20-50-1, 50-4, 50-4A, and 50-5, 805-30-50-1 and 50-4 include a number of specific disclosure requirements, consistent with these objectives. However, if the disclosures required by ASC paragraphs 805-10-50-2 and 50-6 do not satisfy the overall disclosure objectives of ASC paragraphs 805-10-50-1 and 50-4, ASC paragraph 805-10-50-7 requires the acquirer to disclose whatever additional information is necessary to meet those objectives.

**13.002** The disclosures are required for each material business combination during the periods presented. We believe this includes prior periods presented for comparative purposes. For individually immaterial business combinations that are material collectively, the disclosures required by ASC paragraphs 805-10-50-2(e) through 50-2(h), 805-20-50-1(a) through 50-1(e) and 805-30-50-1(a) through 50-1(f) are required in the aggregate. For business combinations occurring after the reporting date but before the financial statements of the acquirer are issued, the disclosures in ASC paragraph 805-10-50-2 are required unless the initial accounting for the business combination is incomplete at the date of issuance of the acquirer’s financial statements. In such event, the acquirer is required to disclose the disclosures that could not be made, including the reason they could not be made.

**13.003** Additionally, ASC paragraphs 270-10-50-5 and 50-7a note that the disclosure requirements of ASC Topic 805 are applicable to interim financial information.

**13.004** Many of the disclosure requirements are illustrated in an example presented in ASC paragraphs 805-10-55-37 through 55-49. The disclosures presented are referenced to the specific disclosure requirements of ASC paragraph 805-10-50-4 that they illustrate. The entire example from ASC paragraphs 805-10-55-37 through 55-49 is presented in Paragraph 13.035.
BUSINESS COMBINATIONS COMPLETED DURING THE REPORTING PERIOD, OR AFTER THE REPORTING PERIOD BUT BEFORE ISSUANCE OF THE ACQUIRER’S FINANCIAL STATEMENTS

ASC Paragraph 805-10-50-1
The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a. During the current reporting period
b. After the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25).

ASC Paragraph 805-10-50-2
To meet the objective in [ASC paragraph 805-10-50-1], the acquirer shall disclose the following information for each business combination that occurs during the reporting period: …[Information discussed below]

GENERAL INFORMATION ABOUT THE ACQUISITION TRANSACTION

ASC Paragraph 805-10-50-2(a) through 50-2(d)

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

CONSIDERATION TRANSFERRED

ASC Paragraph 805-30-50-1(b)

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.
CONTINGENT CONSIDERATION ARRANGEMENTS AND INDEMNIFICATION

ASSETS

ASC Paragraph 805-30-50-1(c)

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 Paragraph 805-20-50-1(a)

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.

CERTAIN ACQUIRED RECEIVABLES

ASC Paragraph 805-20-50-1(b)

b. For acquired receivables not subject to the requirements of [ASC] Subtopic 310-30 [Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality], all of the following:

1. The fair value of the receivables
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

(Before the adoption of ASU 2016-02, Leases1) The disclosures shall be provided by major class of receivable, such as loans, direct finance leases in accordance with [ASC] Subtopic 840-30, and any other class of receivables.

(After the adoption of ASU 2016-02, Leases2) 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 [ASC] Subtopic 842-30 on leases—lessor, and any other class of receivables.
13.005 The above disclosure requirements about receivables acquired was developed to help in assessing considerations of credit quality included in the fair value measures to address concerns that without additional disclosures, it would be impossible to determine the contractual cash flows and the amount of the contractual cash flows not expected to be collected if receivables were recognized at fair value. Statement 141(R), par. B258

**ASSETS ACQUIRED AND LIABILITIES ASSUMED**

**ASC Paragraph 805-20-50-1(c) and 50-1(d)**

c. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed (see Example 5 [ASC paragraph 805-10-55-37]).

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 [ASC] Topic 450 and [ASC] Section 450-20-25)
   ii. The nature of the contingencies.

   An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

2. For contingencies that are not recognized at the acquisition date, the disclosures required by [ASC] 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.

**GOODWILL**

**ASC Paragraph 805-30-50-1(a), 50-1(d), and 50-1(e)**

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 [ASC] Subtopic 280-10 [Segment Reporting - Overall], the amount of goodwill by reportable segment. If the assignment of goodwill to reporting units required by [ASC] 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 issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose that fact.
BARGAIN PURCHASES

ASC Paragraph 805-30-50-1(f)

f. In a bargain purchase (see [ASC] paragraphs 805-30-25-2 through 25-4), both of the following:

1. The amount of any gain recognized in accordance with [ASC] 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.

EQUITY INTEREST NOT ACQUIRED (NONCONTROLLING INTEREST)

ASC Paragraph 805-20-50-1(e)

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.

BUSINESS COMBINATION ACHIEVED IN STAGES (STEP ACQUISITIONS)

ASC Paragraph 805-10-50-2(g)

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 [ASC] 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.
SEPARATELY ACCOUNTED FOR TRANSACTIONS, INCLUDING PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-50-2(e) and 50-2(f)

e. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination (see [ASC] 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.

f. The disclosure of separately recognized transactions required in [ASC paragraph 805-10-50-2](e) shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

ADDITIONAL DISCLOSURES FOR PUBLIC ENTITIES

13.006 ASC paragraph 805-10-50-2(h) requires additional disclosures for entities that meet the definition of a public entity as described in ASC Section 805-10-20, i.e., “a business entity or 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 additional disclosure requirements apply only to a public entity's financial statements, not to the financial statements of a subsidiary of a public entity. For example, if a subsidiary of a public entity acquires another entity in a business combination, the disclosure requirements in ASC paragraph 805-10-50-2(h) do not apply to the acquiring subsidiary's stand-alone financial statements if that subsidiary is not itself a public entity.

13.007 ASC paragraph 805-10-50-2(h) specifies that a public entity should disclose 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 when comparative information is provided.

ASC Paragraph 805-10-50-2(h)

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 [ASC paragraph 805-10-50-2](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 [ASC] paragraph 250-10-45-9.

13.008 Under ASC paragraphs 250-10-45-9 and 45-10, disclosure of the information required by ASC paragraph 805-10-50-2(h) would be deemed impracticable only if any of the following conditions exist:

(a) After making every reasonable effort to do so, the entity is unable to apply the requirement;

(b) Retrospective application requires assumptions about management’s intent in a prior period that cannot be independently sustained; or

(c) Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that:

(1) Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and

(2) Would have been available when the financial statements for that prior period were issued.

13.009 The period for disclosure of the amounts of revenue and earnings of the acquiree included in the acquirer’s consolidated income statement since the acquisition date is limited to the end of the annual reporting period that includes the acquisition date. (ASC
paragraph 805-10-50-2(h)) For example, ABC Corp. acquires DEF Corp. in 20X8, and the acquisition is material to ABC. ABC is required to disclose revenue and earnings of DEF included in ABC’s consolidated income statement for the period from the acquisition date to the end of ABC’s 20X8 fiscal year. The limitation of this requirement to the acquirer’s current reporting period was adopted by the FASB due to its recognition that this information will be available for a short period following the acquisition date, but that distinguishing the postcombination earnings of an acquiree from those of the combined entity may prove impractical as the operations of the acquiree are integrated with the combined entity.

13.010 The pro forma information required by ASC paragraph 805-10-50-2(h) is not required to be audited. The auditor would, however, be required to perform the procedures prescribed by AU 558, Required Supplementary Information.

13.011 ASC Topic 805 does not provide detailed guidance on the determination of the pro forma revenue and earnings required to be disclosed. However, Article 11 of Regulation S-X sets forth the requirements for presentation of pro forma information by SEC registrants that are required when significant business combinations have occurred. The Article 11 pro forma information is not presented in the financial statements, and, when required to be presented, is supplemental to, and more extensive than, the information required by ASC Topic 805 to be disclosed in the notes to the financial statements. The following section provides information and guidance with respect to the SEC’s requirements for presentation of pro forma information. We believe this guidance is useful, and believe that the basis of determining the pro forma disclosures required under ASC Topic 805 should be consistent with the basis used to determine the pro forma information that is required, in certain instances, to be included in filings with the SEC.

PRO FORMA DISCLOSURE REQUIREMENT OF ASC TOPIC 805 COMPARED TO PRO FORMA INFORMATION REQUIRED TO BE PRESENTED IN FILINGS WITH THE SEC

13.012 ASC paragraph 805-10-50-2(h) requires public entities to disclose pro forma financial information unless it is impracticable to do so. If it is impracticable to make any of the required disclosures, disclosure of such fact, along with an explanation of why the disclosure is impracticable, is required.

13.013 Article 11 of SEC Regulation S-X also requires SEC registrants to present pro forma financial information in certain circumstances. Such information is not required to be included in a registrant’s financial statements, but is required to be separately filed. Article 11 does not provide any guidance if it is impracticable to make any of the required disclosures. Thus, if an entity that is required to file pro forma financial information is not able to do so, consultation with the SEC staff may be advisable.

13.014 The pro forma financial information required to be disclosed under ASC paragraph 805-10-50-2(h) and presented under Article 11 differs in significant respects. Thus, the inclusion of pro forma financial information required to be disclosed in a public
Q&A 13.0: Update of Pro Forma Financial Information Required by Article 11

ABC Corp. files Form 8-K in December 20X5 to report an acquisition of a business with a calendar year-end. The Form 8-K includes financial statements of the acquiree and pro forma financial information as required by Article 11 through September 30, 20X5. ABC consummated the acquisition on January 5, 20X6. ABC provided the pro forma financial information required by ASC paragraph 805-10-50-2(h) in its annual financial statements for the year ended December 31, 20X5. ABC files a new registration statement in May 20X6 after filing Form 10-Q for the quarter ended March 31, 20X6, which also includes pro forma financial information required by ASC paragraph 805-10-50-2(h).

Q. Can pro forma financial information required by ASC paragraph 805-10-50-2(h) satisfy the Article 11 requirement for updated pro forma financial information?

A. No. ASC paragraph 805-10-50-2(h) pro forma presentations may differ in style and content from the requirements of Article 11. Although ABC provided the pro forma financial information as required by ASC paragraph 805-10-50-2(h) in its Form 10-K and Form 10-Q, all information included in a registration statement must comply with Regulation S-X, including the age of financial statement requirements in S-X Rule 3-12, at the date of effectiveness of the registration statement. Therefore, ABC will need to update the pro forma financial information as required by Article 11 through December 31, 20X5 for filing in the registration statement.

13.015 The remainder of this section discusses and compares the pro forma financial information disclosure requirements of ASC paragraph 805-10-50-2(h) and the pro forma financial information requirements of Article 11. The discussion is not all inclusive, particularly with respect to the Article 11 requirements. When preparing pro forma financial information required by Article 11, reference should be made to Article 11 in its entirety, as well to SEC Financial Reporting Manual – Topic 3. KPMG’s SEC Financial Statement Requirements for Business Combinations, also provides more comprehensive discussions of the pro forma financial information requirements of Article 11.

13.016 The discussion and comparisons in this section are presented in the following order:

- Objectives of Pro Forma Financial Information Disclosures
• Pro Forma Financial Information Required, and Guidance on the Form, Content, and Basis of Preparation
• When Pro Forma Financial Information Is Required
• Periods for which Pro Forma Financial Information Is Required

OBJECTIVES OF PRO FORMA FINANCIAL INFORMATION DISCLOSURES

13.017 ASC Topic 805. ASC paragraph 805-10-50-1 provides the following overall objective on disclosures: The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination.

13.018 Article 11. The objective of Article 11 pro forma information is to provide investors with information about the continuing impact of a particular transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time. Such statements (i.e., pro forma financial information) should assist investors in analyzing the future prospects of the registrant because they illustrate the possible scope of the change in the registrant’s historical financial position and results of operations caused by the transaction. S-X Article 11-02(a)

PRO FORMA FINANCIAL INFORMATION REQUIRED, AND GUIDANCE ON THE FORM, CONTENT, AND BASIS OF PREPARATION

13.019 ASC Topic 805. The specific pro forma disclosures required by ASC paragraph 805-10-50-2(h) are set out above under Additional Disclosures for Public Entities. ASC Topic 805 provides no further guidance as to the form, content, or basis of presentation of the pro forma disclosures. Compared to the more detailed instructions included in Article 11, however, ASC paragraph 805-10-50-2(h) requires acquirers to disclose the nature and amount of any material, nonrecurring items included in the reported pro forma results of operations.

13.020 Article 11. Article 11 provides significant guidance as to the form, content, and basis of preparation of the pro forma financial information required to be presented. Under Article 11, the required pro forma information consists of a pro forma condensed balance sheet as of the end of the most recent period, a pro forma condensed statement of income for the most recent fiscal year and for the period from the most recent fiscal year-end to the most recent interim date for which a balance sheet is required, and accompanying explanatory notes.

13.021 Additional guidance related to the preparation of the pro forma information required to be presented under Article 11 includes:

• The pro forma balance sheet should be adjusted for events that are directly attributable to the transaction and factually supportable, regardless of whether they have continuing effect or are nonrecurring. Pro forma adjustments to the
balance sheet should be made assuming the transaction occurred at the date of
the most recent balance sheet presented.

- The pro forma condensed income statement is intended to present the ongoing
operations of the registrant as they might appear after the transaction is
consummated, and should disclose income (loss) from continuing operations
before nonrecurring charges or credits directly attributable to the transaction.
Information should also include primary and fully diluted pro forma per share
data based on continuing operations. Material nonrecurring charges or credits
and related tax effects which result directly from the transaction, and which
will be included in the income of the registrant within the 12 months
succeeding the transaction should be disclosed separately. Pro forma
adjustments for the income statement should be computed assuming the
transaction was consummated at the beginning of the fiscal year presented and
carried forward through any interim period presented, and should give effect
to events that are directly attributable to the transaction, expected to have a
continuing impact on the registrant, and factually supportable.

- The pro forma information should ordinarily be in columnar form, showing
condensed historical information, pro forma adjustments, and the pro forma
results.

- Infrequent or nonrecurring items included in the underlying historical
financial statements that are not directly affected by the transaction should not
be eliminated in pro forma results.

- The acquiree’s assets and liabilities are adjusted to reflect their acquisition-
date fair value (subject to the exceptions to the recognition and measurement
principles of ASC Topic 805), giving consideration to the related pro forma
expense adjustments, such as depreciation and amortization, resulting from
the new basis of such assets and liabilities.

- The impact of a planned disposition of operations in conjunction with a
business combination should be reflected in the pro forma financial statements
if it is identifiable with reasonable certainty when the pro forma information is
prepared. Even though ASC Topic 805 nullified EITF Issue No. 95-3,
“Recognition of Liabilities in Connection with a Purchase Business
Combination,” the SEC staff indicated that it would still be appropriate to
depict the recurring effects of exiting revenue producing activities. Pro forma
data may be necessary, if the disposition is material, even if disposed
operations do not satisfy ASC Section 205-20-45 criteria of a discontinued
operation. Division of Corporation Finance – Financial Reporting Manual,
par. 3120.1.

- When the acquiree’s accounting principles will be changed to conform to
those of the acquirer’s, pro forma information should consistently apply the
new accounting principles to all periods.

- The tax effects of pro forma adjustments normally should be calculated at the
statutory rate in effect during the respective periods.
• New contractual arrangements such as major new compensation contracts with management would require pro forma adjustments if the new contracts are entered into as part of the acquisition agreement. The effects of new major distribution, cost sharing, or management agreements, and compensation or benefits plans may be reflected if amounts can be factually supported, are directly attributable to the transaction, and are expected to have a continuing impact on the statements of operations of the combined entity.

• The pro forma financial statements may include an adjustment for the proceeds to be received from a security offering to the extent that the amount of the adjustment is subject to a firm commitment underwriting agreement.

• Adjustment should not be made to the amount of research and development expenses historically incurred by the acquiree related to in-process research and development (IPR&D) recognized in a business combination, even if research and development costs incurred by the acquiree during the pro forma period include IPR&D costs that will be recognized as assets by an acquirer as part of its accounting for the acquisition. This position is consistent with the treatment of costs incurred by an acquiree during the pro forma period related to other internally developed assets that may be recognized as assets by the acquirer in an acquisition, even though the costs of developing such assets were expensed as incurred by the acquiree in accordance with relevant GAAP.

• The treatment of transaction costs depends on how those costs are reflected in the historical financial statements. The possible treatment of transaction costs in pro forma financial information is as follows:
  • No adjustment should be included in the pro forma condensed income statement for direct and incremental transaction costs that are related to the transaction and not yet reflected in the historical financial statements of either the target or acquirer. However, an adjustment should be included in the pro forma condensed balance sheet because adjustments to the pro forma condensed balance sheet include nonrecurring items that are directly attributable to the transaction.
  • Adjustments should remove direct and incremental transaction costs for a specific acquisition from the pro forma condensed income statement if those costs are already reflected in the historical financial statements of either the target or acquirer.
  • If other acquisitions are reflected in the historical financial statements, adjustments should remove direct and incremental transaction costs related to those acquisitions from the pro forma condensed income statement only if full pro forma effect is also given to the other acquisitions.
  • All pro forma adjustments should refer to notes that clearly explain the assumptions involved.

13.022 A summary of the pro forma information requirements of ASC Topic 805 and Article 11 and the key differences is presented below.
<table>
<thead>
<tr>
<th>Income statement line items</th>
<th>ASC Topic 805</th>
<th>Article 11</th>
<th>Key Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue and earnings</td>
<td>Major captions through income from continuing operations before extraordinary items and cumulative effect of a change in accounting principle.</td>
<td>ASC Topic 805 does not require (or prohibit) presentation of income from continuing operations. Article 11 does not permit presentation of items below income from continuing operations before extraordinary items and cumulative effect of a change in accounting principle.</td>
<td></td>
</tr>
<tr>
<td>Per share information</td>
<td>Not required</td>
<td>Required</td>
<td>Pro forma basic and diluted per share information based on continuing operations is required under Article 11.</td>
</tr>
<tr>
<td>Balance sheet</td>
<td>Not required</td>
<td>Required</td>
<td>Article 11 requires presentation of pro forma condensed balance sheet unless the acquiree’s balance sheet has been reflected in the acquirer’s historical balance sheet.</td>
</tr>
<tr>
<td>Explanatory notes</td>
<td>Required, including: The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business</td>
<td>Required, including: An introductory paragraph that describes the transaction, the entities involved, and the periods for which the information is</td>
<td>Substantially converged</td>
</tr>
<tr>
<td>Assumption of transaction date</td>
<td>A) For non-comparative presentation (one year), beginning of the current annual period for the current period pro forma information</td>
<td>Beginning of the annual period presented for both the annual and subsequent interim periods pro forma condensed income statements.</td>
<td>Substantially converged</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td></td>
<td>B) For comparative presentation (two years), beginning of the comparative prior annual period for the comparative prior period and current period pro forma information.</td>
<td>As of the latest balance sheet date for which historical balance sheet is presented for pro forma condensed balance sheets.</td>
<td></td>
</tr>
</tbody>
</table>

**WHEN PRO FORMA FINANCIAL INFORMATION IS REQUIRED**

13.023 ASC Topic 805. ASC paragraph 805-10-50-2(h) requires the disclosures of pro forma financial information when the issuer has consummated a business combination that occurs during the current reporting period or after the reporting date but before the
financial statements are issued or are available to be issued (appropriate date determined in accordance with ASC Topic 855). For individually immaterial business combinations that occur during a reporting period that are material collectively, ASC paragraph 805-10-50-3 requires disclosure of the information in the aggregate.

13.024 Article 11. Article 11 requires pro forma information to be presented if a business combination has occurred in the latest fiscal year or subsequent interim period, or is probable. Significance for making the determination is determined in accordance with S-X Rule 1-02(w). The determination of significant can be complex, and reference should be made to S-X Rule 1-02(w) in its entirety when making such determinations. There are other circumstances under which pro forma financial information is required under Article 11, such as the disposition of a significant portion of a business. However, discussion of circumstances requiring presentation of pro forma financial information other than significant business combinations is outside the scope of this publication.

13.025 A summary of when pro forma information is required under ASC paragraph 805-10-50-2(h) and Article 11 and the key differences is presented below:

<table>
<thead>
<tr>
<th>When Pro Forma Financial Information Is Required</th>
<th>ASC Topic 805</th>
<th>Article 11</th>
<th>Key Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>When pro forma information is required</td>
<td>Required whenever annual or interim period financial statements covering a period including a business combination that is material (or business combinations that are material in the aggregate) are presented.</td>
<td>Required whenever a significant combination has occurred or is probable, as described in Article 11 and determined in accordance with S-X Rule 1-02(w). Presentation of pro forma information is not permitted if the acquiree’s income statement has been included in the acquirer’s historical income statement for all of the latest fiscal year. Generally required to be filed on Form 8-K or included in registration</td>
<td>Under ASC Topic 805, the requirement to disclose pro forma financial information is based on whether a business combination is material. The requirement for presentation of pro forma information for a business combination is determined under Article 11 based on whether a business combination is significant under S-X Rule 1-02(w). Periods of presentation in subsequent years can be different under ASC Topic 805 and Article 11. For example, under ASC Topic 805 pro forma information for an</td>
</tr>
<tr>
<td>Materiality</td>
<td>ASC Topic 805 need not be applied to immaterial items.</td>
<td>Significance is defined in S-X Rule 1-02(w) substituting 20% for 10%.</td>
<td>Because the definition of significance under Regulation S-X is different from the definition of materiality under GAAP, pro forma information for an acquisition may be required by GAAP but not by Article 11 (or vice versa).</td>
</tr>
<tr>
<td>---</td>
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</tbody>
</table>

The 2009 acquisition that occurred in 2009 continues to be required in the 2009 financial statements when they are reissued in subsequent years (e.g., when they are presented with the 2011 and 2010 financial statements). Under Article 11, the 2009 pro forma information is not permitted to be presented once the acquiree’s income has been included in the acquirer’s historical income statement for all of the latest fiscal year.

ASC paragraph 805-10-50-1 does not specifically require pro forma information unless a business combination has occurred before the issuance of financial statements. Article 11 requires disclosure of pro forma information when it is probable that a significant business combination will occur.

Materiality ASC Topic 805 need not be applied to immaterial items. Significance is defined in S-X Rule 1-02(w) substituting 20% for 10%. Because the definition of significance under Regulation S-X is different from the definition of materiality under GAAP, pro forma information for an acquisition may be required by GAAP but not by Article 11 (or vice versa).
PERIODS FOR WHICH PRO FORMA FINANCIAL INFORMATION IS REQUIRED

13.026 ASC Topic 805. ASC paragraph 805-10-50-2(h) requires that pro forma financial information be provided for the current period and, if comparative financial statements are presented, for the comparable prior reporting period. This requirement is applicable for both annual and interim periods.

13.027 Article 11. Pro forma information consists of a pro forma condensed balance sheet as of the end of the most recent period, pro forma condensed statements of income for the most recent fiscal year and for the period from the most recent fiscal year-end to the most recent interim date for which a balance sheet is required, and accompanying explanatory notes. A pro forma condensed income statement may be filed for the corresponding interim period for the comparative prior year. If the acquirer’s historical balance sheet reflects the acquisition, the pro forma balance sheet is not permitted. Similarly, if the transaction is reflected in the acquirer’s historical income statement for 12 months, pro forma income statement information is not permitted.

13.028 A summary of the periods for which pro forma information is required under ASC Topic 805 and Article 11 and the key differences is presented below:

<table>
<thead>
<tr>
<th>Periods for which Pro Forma Financial Information Is Required</th>
<th>ASC Topic 805</th>
<th>Article 11</th>
<th>Key Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interim period</td>
<td>Pro forma information for the current quarter, the year-to-date periods, and the comparative prior periods (if presented). ¹</td>
<td>Pro forma condensed income statement for the most recent annual period and interim period from the most recent fiscal year-end to the most recent interim date for which a balance sheet is required. Pro forma condensed balance sheet as of most recent balance sheet date, unless the acquirer’s historical balance sheet reflects the acquisition.</td>
<td>Article 11 does not require presentation of pro forma information for the comparable prior interim period, but it is optional, while comparative information for prior periods is required (if comparative financial statements are presented) under ASC Topic 805. Article 11 requires presentation of the most recent annual period together with interim information.</td>
</tr>
<tr>
<td>Annual period</td>
<td>Pro forma information for the current annual period and comparative prior period.</td>
<td>Pro forma condensed income statement for the most recent annual period.</td>
<td>Article 11 does not permit presentation of comparative annual periods.</td>
</tr>
</tbody>
</table>
Pro forma condensed balance sheet as of the most recent balance sheet date, unless the acquirer’s historical balance sheet reflects the acquisition.

ASC paragraphs 270-10-S99-1(b)(4) and 805-10-S50-1 require SEC registrants to include certain pro forma disclosures in interim financial statements when a material business combination has occurred during the current fiscal year. The pro forma requirements in ASC paragraphs 805-10-50-2(h), 270-10-S99-1, and 805-10-S50-1 are generally consistent except that in addition to pro forma revenue and net income required by ASC paragraphs 805-10-50-2(h), 270-10-S99-1, and 805-10-S50-1 also require disclosure of pro forma income before extraordinary items and the cumulative effect of accounting changes, including such income on a per share basis, and net income and net income per share.

Q&A 13.1: Pro Forma Disclosures in Interim Periods

ABC Corp. acquired a significant business in November 20X8 and filed the appropriate Form 8-K, including the financial statements of the acquired business and the pro forma financial statements as required by SEC rules and regulations. ABC provided the pro forma disclosures required by ASC paragraph 805-10-50-2(h) in its annual financial statements for the year ended December 31, 20X8.

Q. Is ABC required to include pro forma financial information for the acquired business in its Form 10-Q filing for the quarter ended March 31, 20X9?

A. ASC paragraph 805-10-50-2 does not specifically discuss the application of the pro forma disclosures to interim periods. However, the discussion in ASC paragraph 805-10-50-2 refers to the reporting period and is similar to the discussion previously found in paragraph 58 of FASB Statement No. 141, which stated that pro forma disclosure in an interim period is required “if a material business combination is completed during the current year.” Paragraph (b)4 of Article 10 of SEC Regulation S-X provides similar guidance. While the business combination did not occur in the current period, it is material to the first quarter results because the comparative interim period (first quarter of 20X8) did not include the acquired business and therefore, we believe disclosure of pro forma information in the current interim financial information is appropriate for material acquisitions as long as the comparative interim period does not include the acquisition.

13.029 Refer to KPMG’s SEC Financial Statement Requirements for Business Combinations, for additional discussion of pro forma financial information requirements for SEC registrants.
IMMATERIAL BUSINESS COMBINATIONS THAT ARE MATERIAL IN THE AGGREGATE

13.030 Disclosure for business combinations that are individually immaterial but material in the aggregate also are required. In particular, disclosure of the information specified in ASC paragraphs 805-10-50-2(e) through 50-2(h), 805-20-50-1(a) through 50-1(e), and 805-30-50-1(a) through 50-1(f) are required in the aggregate.

BUSINESS COMBINATIONS COMPLETED AFTER REPORTING DATE BUT BEFORE ISSUANCE OF THE FINANCIAL STATEMENTS

ASC Paragraph 805-10-50-4
If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-10-50-2 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

ASC Paragraph 805-20-50-3
If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-20-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

ASC Paragraph 805-30-50-3
If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-30-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

DISCLOSURE OF ADJUSTMENTS RECOGNIZED DURING THE CURRENT PERIOD

ASC Paragraph 805-10-50-5
The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the
current reporting period that relate to business combinations that occurred in the
current or previous reporting periods.

MEASUREMENT PERIOD ADJUSTMENTS

ASC Paragraph 805-20-50-4A

If the initial accounting for a business combination is incomplete (see [ASC]
paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities,
oncontrolling 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
[ASC] 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 [ASC] 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.

13.031 Measurement period adjustments are no longer applied retrospectively in the
acquirer's financial statements. However, we believe that measurement period
adjustments should continue to be reflected in the acquirer's pro forma disclosures on a
retrospective basis.

CONTINGENT CONSIDERATION ADJUSTMENTS

ASC Paragraph 805-30-50-4

[ASC] paragraph 805-10-50-5 identifies the second objective of disclosures about
the effects of business combinations that occurred in the current or previous
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 [ASC] Section 820-10-50.

RECONCILIATION OF CHANGES IN GOODWILL DURING THE REPORTING PERIOD

ASC paragraph 805-30-50-4(b)

b. A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by [ASC] paragraph 350-20-50-1.

13.032 ASC paragraph 350-20-50-1 was amended by ASC Topic 805 to significantly expand the required disclosure of changes in goodwill during the reporting period. Under the amended guidance, an entity is required to provide a rollforward of goodwill reflecting:

- The gross amount of goodwill and the accumulated impairment losses at the beginning of the period
- 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
- Goodwill included in a disposal group classified as held for sale and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale
- Adjustments resulting from the recognition of deferred tax assets during the period
- Impairment losses recognized during the period
- Net exchange differences arising during the period
- Any other changes in the carrying amounts during the period
- The gross amount of goodwill and accumulated impairment losses at the end of the period.

ASC paragraph 350-20-55-24 provides an example disclosure of the rollforward of goodwill.

13.033 The above disclosures are required for business combinations accounted for under ASC Topic 805. Disclosures about adjustments related to business combinations in which the acquisition date preceded the effective date of ASC Topic 805 are subject to the disclosure requirements under Statement 141.
ADDITIONAL DISCLOSURES TO MEET DISCLOSURE OBJECTIVES

ASC Paragraph 805-10-50-7

If the specific disclosures required by [ASC] Subtopic [805-10] and other generally accepted accounting principles (GAAP) do not meet the objectives set out in [ASC] paragraphs 805-10-50-1 and 805-10-50-5, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

13.034 The FASB concluded that it is not necessary or possible to identify all of the specific information that may be necessary to meet the disclosure objectives for all business combinations. Instead, the FASB decided to include the overall disclosure objectives stated in ASC paragraphs 805-10-50-1 and 50-5, and to specify particular disclosures that are generally required to meet the overall objectives. However, if the specific disclosures required by ASC Topic 805 and the disclosures required by other GAAP do not satisfy the overall disclosure objectives, the acquirer is required to disclose the additional information necessary to do so.

EXAMPLE DISCLOSURES

13.035 The following illustrative disclosures are taken from ASC paragraphs 805-10-55-37 through 55-49.

Example 13.1: Disclosure of a Material Business Combination in the Year of Acquisition, Completed During the Reporting Period

Note X: Acquisitions

Paragraph Reference

ASC paragraphs 805-10-50-2(a) through 50-2(d) On June 30, 20X0, AC acquired 15 percent of the outstanding common shares of TC. On June 30, 20X2, AC acquired 60 percent of the outstanding common shares of TC. TC is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, AC 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 paragraphs 805-30-50-1(a) and 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 AC and TC. All of the goodwill was assigned to AC’s network segment.
None of the goodwill recognized is expected to be deductible for income tax purposes.

The following table summarizes the consideration paid for TC 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 TC.

### At June 30, 20X2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consideration</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$5,000</td>
</tr>
<tr>
<td>Equity instruments (100,000 common shares of AC)</td>
<td>$4,000</td>
</tr>
<tr>
<td>Contingent consideration arrangement</td>
<td>$1,000</td>
</tr>
<tr>
<td><strong>Fair value of total consideration transferred</strong></td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Fair value of AC’s equity interest in TC held before the business combination</strong></td>
<td>$2,000</td>
</tr>
<tr>
<td><strong>Acquisition-related costs</strong> (included in selling, general, and administrative expenses in AC’s income statement for the year ending December 31, 20X2)</td>
<td>$1,250</td>
</tr>
<tr>
<td><strong>Recognized amounts of identifiable assets acquired and liabilities assumed</strong></td>
<td></td>
</tr>
<tr>
<td>Financial assets</td>
<td>$3,500</td>
</tr>
<tr>
<td>Inventory</td>
<td>$1,000</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Identifiable intangible assets</td>
<td>$3,300</td>
</tr>
<tr>
<td>Financial liabilities</td>
<td>($4,000)</td>
</tr>
<tr>
<td>Liability arising from a contingency</td>
<td>($1,000)</td>
</tr>
<tr>
<td><strong>Total identifiable net assets</strong></td>
<td>$12,800</td>
</tr>
<tr>
<td><strong>Noncontrolling interest in TC</strong></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>$2,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$12,000</td>
</tr>
<tr>
<td>ASC paragraphs 805-30-50-1(b)(4)</td>
<td>The fair value of the 100,000 common shares issued as part of the consideration paid for TC ($4,000) was determined on the basis of the closing market price of AC’s common shares on the acquisition date.</td>
</tr>
<tr>
<td>ASC paragraphs 805-30-50-1(b)(3), 50-1(c), and ASC paragraph 805-10-50-4(a)</td>
<td>The contingent consideration arrangement requires AC to pay the former owners of TC 5 percent of the revenues of XC, an unconsolidated equity investment owned by TC, 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 AC 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 ASC Section 820-10-35 refers to as Level 3 inputs. Key assumptions include (a) a discount rate range of 20 percent to 25 percent and (b) a probability adjusted level of revenues in XC 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.</td>
</tr>
<tr>
<td>ASC paragraph 805-20-50-1(b)</td>
<td>The fair value of the financial assets acquired includes receivables under capital leases of data networking equipment with a fair value of $2,000. The gross amount due under the contracts is $3,100, of which $450 is expected to be uncollectible.</td>
</tr>
<tr>
<td>ASC paragraph 805-20-50-4A</td>
<td>The fair value of the acquired identifiable intangible assets of $3,300 is provisional pending receipt of the final valuations for those assets.</td>
</tr>
<tr>
<td>ASC paragraphs 805-20-50-1(d) and 50-5</td>
<td>A liability of $1,000 has been recognized for expected warranty claims on products sold by TC during the last 3 years. AC expects that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between $500 and $1,500. As of December 31, 20X2, there has been no change since June 30, 20X2, in the amount recognized for the liability or any change in the range of outcomes or assumptions used to develop the estimates.</td>
</tr>
</tbody>
</table>
The fair value of the noncontrolling interest in TC, a private company, 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 Level 3 measurement as defined in ASC Section 820-10-35. Key assumptions include (a) a discount rate range of 20 percent to 25 percent, (b) a terminal value based on a range of terminal EBITDA multiples between 3 and 5 (or, if appropriate, based on long-term sustainable growth rates ranging between 3 percent and 6 percent), (c) financial multiples of companies deemed to be similar to TC, and (d) adjustments because of the lack of control or lack of marketability that market participants would consider when estimating the fair value of the noncontrolling interest in TC.

AC recognized a gain of $500 as a result of remeasuring to fair value its 15 percent equity interest in TC held before the business combination. The gain is included in other income in AC’s income statement for the year ending December 31, 20X2.

The amounts of TC’s revenue and earnings included in AC’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), or January 1, 20X1 (if comparative financial statements are presented), are:

<table>
<thead>
<tr>
<th></th>
<th>Revenue</th>
<th>Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual from 6/30/20X2–12/31/20X2</td>
<td>$4,090</td>
<td>$1,710</td>
</tr>
<tr>
<td>Supplemental pro forma from 1/1/20X2–12/31/20X2</td>
<td>$27,670</td>
<td>$12,870</td>
</tr>
<tr>
<td>Supplemental pro forma for 1/1/20X1–12/31/20X1</td>
<td>$26,985</td>
<td>$12,325</td>
</tr>
</tbody>
</table>

The disclosure example provided in ASC Topic 805 (shown above) does not include replacement awards or deferred taxes, both of which may be common elements of business combinations and would be included in the required disclosures. Therefore, this...
example should be seen as illustrative but does not address all possible items for which disclosure would be required.

1 ASU 2016-02, *Leases*, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted. See discussion in KPMG's Leases Handbook.

2 ASU 2016-02, *Leases*, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted. See discussion in KPMG's Leases Handbook.
Section 14 - Effective Date and Transition

Detailed Contents

Transition

Acquisitions Prior to the Effective Date of ASC Topic 805

Income Taxes

Acquisition-Related Costs Incurred in a Business Combination which Commenced Prior to, but Was Completed after, the Effective Date of ASC Topic 805

Transition for Contingent Consideration from Acquisitions Prior to the Effective Date of ASC Subtopic 958-805
14. Effective Date and Transition

EFFECTIVE DATE

Statement 141(R)

74. [ASC Topic 805] shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning after December 15, 2008. Early adoption is prohibited.

14.000 The effective date for ASC Topic 805, Business Combinations, means that, for calendar-year companies, the Topic was effective for 2009. The FASB concluded that this date would allow sufficient time for issuers to prepare for implementation of this Topic.

TRANSITION

ACQUISITIONS PRIOR TO THE EFFECTIVE DATE OF ASC TOPIC 805

Statement 141(R)

75. Assets and liabilities that arose from business combinations whose acquisition dates preceded the effective date of ASC Topic 805 shall not be adjusted upon application of this Topic.

14.001 The FASB concluded it would not be feasible to apply ASC Topic 805 retrospectively and, accordingly, specified its application only to acquisitions occurring on or after its effective date. The accounting for the assets and liabilities that arose from business combinations occurring prior to the effective date of ASC Topic 805 is not changed by issuance of ASC Topic 805, with the sole exception of changes after its effective date in the valuation allowance for acquired deferred tax assets and changes in acquired income tax uncertainties that arose from business combinations occurring prior to the Statement’s effective date.

14.002 When an entity has acquired other entities (acquirees) both before and after the effective date of ASC Topic 805, there will sometimes be significant differences in the accounting for similar transactions or events related to those acquisitions that occur in subsequent periods. For example, significant differences could result in the accounting for changes in the measurement and the subsequent settlement of contingent consideration arrangements (see Contingent Consideration in Sections 6 and 12) and liabilities related to exit activities of the acquiree (see Liabilities Associated with Restructuring or Exit Activities of the Acquiree in Section 7). Some of these differences may not be eliminated for a prolonged period following the effective date of ASC Topic 805; for example, a contingent consideration arrangement entered into in connection with a business combination prior to the effective date of ASC Topic 805 will continue to be accounted for under FASB Statement No. 141, Business Combinations, and it could be several years after the effective date of ASC Topic 805 before the amount of payments required to settle the contingent consideration arrangement are finally determined and recognized by the acquirer.
INCOME TAXES

Statement 141(R)

77. For business combinations in which the acquisition date was before the effective date of [ASC Topic], the acquirer shall apply the requirements of [ASC Topic 740], as amended by [ASC Topic 805], prospectively. That is, the acquirer shall not adjust the accounting for prior business combinations for previously recognized changes in acquired tax uncertainties or previously recognized changes in the valuation allowance for acquired deferred tax assets. However, after the effective date of [ASC Topic 805]:

a. The acquirer shall recognize, as an adjustment to income tax expense (or a direct adjustment to contributed capital in accordance with [ASC paragraph 740-10-45-20], changes in the valuation allowance for acquired deferred tax assets.

b. The acquirer shall recognize changes in the acquired income tax positions in accordance with [ASC Topic 740], as amended by [ASC Topic 805].

14.003 Thus, for acquired tax uncertainties and valuation allowances for acquired deferred tax assets arising from business combinations preceding the effective date of ASC Topic 805, the acquirer:

- Does not adjust the accounting for previously recognized changes in acquired tax uncertainties or the valuation allowance for deferred tax assets that were recognized prior to the effective date of ASC Topic 805;

- Recognizes changes in the valuation allowance for acquired deferred tax assets after the effective date of ASC Topic 805 as adjustments to income tax expense (or as a direct adjustment to contributed capital) in the same manner as those changes are recognized for business combinations that occur after the effective date of ASC Topic 805; and

- Recognizes changes in acquired tax uncertainties after the effective date of ASC Topic 805 as adjustments to income tax expense in the same manner as those changes are recognized for business combinations that occur after the effective date of ASC Topic 805.

See KPMG's Handbook, Accounting for Income Taxes Section 10 for a discussion of income tax considerations in a business combination.

ACQUISITION-RELATED COSTS INCURRED IN A BUSINESS COMBINATION WHICH COMMENCED PRIOR TO, BUT WAS COMPLETED AFTER, THE EFFECTIVE DATE OF ASC TOPIC 805

14.004 An entity may initiate a business combination before the effective date of ASC Topic 805 and incur acquisition-related costs. Because ASC Topic 805 prohibits early adoption, the entity would capitalize the acquisition-related costs for this type of business combination as required under Statement 141. However, ASC Topic 805 requires that an entity charge acquisition-related costs to expense as incurred. Thus, if an acquisition
commences before the effective date of ASC Topic 805, but completion is not expected until after ASC Topic 805’s effective date, a question arises as to how the acquisition costs incurred and capitalized before the effective date of ASC Topic 805 should be accounted for.

14.005 Based on discussions with the FASB and SEC staffs, we believe that any of the following three alternatives are acceptable methods to account for acquisition-related costs capitalized by an acquirer before the effective date of Statement 141(R) (ASC Topic 805):

1. Expense the costs when it becomes probable (or virtually certain) that the acquisition will not be completed until after the effective date of ASC Topic 805. Thus, once it has become probable that the acquirer will not complete the acquisition before the effective date of ASC Topic 805, any acquisition-related costs previously capitalized would be recognized as expense, and any costs incurred thereafter would be charged to expense as incurred.

2. Expense the costs on the effective date of ASC Topic 805.

3. Expense the costs retrospectively (in the period incurred), using the guidance for a change in accounting principles in ASC Topic 250, *Accounting Changes and Error Corrections*, on the effective date of ASC Topic 805. This method requires retrospective application of the accounting principle to prior period financial statements.

14.006 The method selected by an acquirer to account for such costs is an accounting policy election and, therefore, should be disclosed in accordance with ASC paragraphs 235-10-50-1 through 50-6, and applied consistently to those costs. See the discussion of the accounting for the income tax effects of acquisition-related costs in KPMG’s *Handbook, Accounting for Income Taxes* Section 10 under *Business Combinations – Specific Application Matters*.

**TRANSITION FOR CONTINGENT CONSIDERATION FROM ACQUISITIONS PRIOR TO THE EFFECTIVE DATE OF ASC SUBTOPIC 958-805**

14.007 For business combinations occurring in annual reporting periods beginning after December 15, 2009, the requirements of ASC Topic 805 generally applied to business combinations involving not-for-profit entities (see Paragraph 1.017). Similar to the guidance in Paragraph 14.003 for business combinations involving for-profit entities, not-for-profit entities that consummated business combinations prior to the effective date of ASC Subtopic 958-805 (originally Statement No. 164) should continue to account for contingent consideration in those transactions in accordance with APB Opinion No. 16. Any additional consideration that becomes payable under those contingent consideration provisions will result in an adjustment to goodwill from that transaction.
Section 15 - Noncontrolling Interests in Consolidated Financial Statements

Detailed Contents

Overview

ASC Subtopic 810-10, Consolidation - Overall
Guidance on Subsequent Accounting for Noncontrolling Interests

Scope

Definition of Terms

Controlling Financial Interest

Nature and Classification of Noncontrolling Interest

Attribution of Net Income (or Loss) and Comprehensive Income (or Loss) to the Parent and the Noncontrolling Interest

Q&A 15.0: Attributing Earnings of Partially Owned Subsidiaries Between Parent and Noncontrolling Interest Using the Hypothetical Liquidation at Book Value Method

Example 15.1: Partially Owned Subsidiary before and after the Effective Date of ASC Topic 805 and ASC Subtopic 810-10

Example 15.2: Parent and Partially Owned Subsidiary after the Effective Date of ASC Topic 805 and ASC Subtopic 810-10

Example 15.3: Attributing the Effect of the Elimination of Intercompany Transactions for Variable Interest Entities versus Voting Interest Entities

Example 15.4: Attributing the Effect of the Elimination of Intercompany Transactions on Downstream Transactions

Example 15.5: Sale of Inventory to Parent by a 75% Owned Subsidiary That Is not a Variable Interest Entity

Attribution of Losses in Excess of a Subsidiary’s Equity

Income Tax Expense

Q&A 15.1: Financial Statement Presentation – Net Income Attributed to Noncontrolling Interest in Pass-Through Entities

Q&A 15.2: Financial Statement Presentation – Net Income Attributed to Noncontrolling Interest – Interim Periods

Changes in a Parent’s Ownership Interest in a Subsidiary

Changes in a Parent’s Ownership that do not Result in a Loss of Control

Example 15.6: Sale by Parent of a Portion of Its Ownership Interest in a Subsidiary

Q&A 15.2a: Effect of Shareholder Loans on Noncontrolling Interest
Example 15.7: Issuance of Additional Shares by a Subsidiary

Example 15.8: Acquisition by Parent of a Noncontrolling Interest of a Subsidiary That Has Other Comprehensive Income

Example 15.8a: Effect of Shareholder Loans on Noncontrolling Interest

Downstream Mergers

Example 15.9: Downstream Merger

Allocation of Goodwill for Impairment Testing When Parent’s Ownership Interest Changes

Changes in a Parent’s Ownership that Result in a Loss of Control

Example 15.10: Gain or Loss Recognized on Deconsolidation of a Subsidiary

Additional Guidance on Accounting for Decreases in Ownership of a Subsidiary

Scope of Guidance on Accounting for Decreases in Ownership of a Subsidiary Prior to Adoption of ASU 2014-09 and ASU 2017-05

Decreases in Ownership of a Subsidiary or a Group of Assets That Constitute a Business or Nonprofit Activity

Decreases in Ownership of Subsidiaries That Are In-Substance Real Estate or Oil- and Gas-Producing Activities

Transfer of a Subsidiary or Group of Assets That Is a Business or Nonprofit Activity to an Equity Method Investee or Joint Venture

Transfer of a Subsidiary or Group of Assets That Is Not a Business or Nonprofit Activity to an Equity Method Investee or Joint Venture

Scope of Guidance on Accounting for Decreases in Ownership of a Subsidiary after Adoption of ASU 2014-09 and ASU 2017-05

Decreases in Ownership of a Subsidiary or a Group of Assets That Constitute a Business or Nonprofit Activity

Decreases in Ownership of Subsidiaries That Are Oil- and Gas-Producing Activities

Transfer of a Subsidiary or Group of Assets That Is Not a Business or Nonprofit Activity

Accounting by Venture for Joint Venture Formations (New Basis or Carryover Basis)

Contributions of Nonmonetary Assets that Are Not Businesses

Seller Accounting for Contingent Consideration

Example 15.11: Multiple Transactions

Other Aspects

Earnings Per Share Considerations

Statement of Cash Flows

Translation of Foreign Currency – Sale, Exchange, or Liquidation of an investment in a Foreign Entity
Complete Sale or Substantial Liquidation of an Investment in a Foreign Entity
Sale of Part of an Investment in a Consolidated Foreign Entity
Other Events That May Result in the Loss of a Controlling Financial Interest of an
Investment in a Foreign Entity

Q&A 15.3: Initial Public Offering of Shares in a Foreign Subsidiary

Example 15.12: Loss of Control on a Foreign Subsidiary’s Bankruptcy Filing

Sale of, or Part of, an Equity Method Investment in a Foreign Entity

Example 15.13: Sale of Part of an Equity Method Investment in a Foreign Entity
When Significant Influence Is Retained

Example 15.14: Sale of Part of an Equity Method Investment in a Foreign Entity
When Significant Influence Is Not Retained

Sale of a Foreign Entity’s Net Assets

Example 15.15: Exchange of Net Assets within a Foreign Entity for an Interest in
a Joint Venture or Equity Method Investment

Exchange of Investments in Foreign Entities

Example 15.16: Contribution of Foreign Operations to a Consolidated Variable
Interest Entity

Accounting for Redeemable Noncontrolling Interests, Including the Application of ASC
Section 480-10-S99 by SEC Registrants

Introduction

Determining Whether Redeemable Noncontrolling Interests Should Be Classified as
Liabilities or as Equity Instruments

Classification of Redeemable Instruments under ASC Section 480-10-S99 and the
Applicability of that Guidance to Redeemable Noncontrolling Interests

Applicability of ASC Section 480-10-S99 and Related Guidance to Non-SEC
Registrants

Q&A 15.4: Subsequent Measurement of Redeemable Noncontrolling Interests
When the Amounts Determined under ASC Subtopic 810-10 and ASC Section
480-10-S99 Have Declined after Issuance

Recording Changes in the Carrying Amount of Redeemable Noncontrolling Interests
from the Application of ASC Section 480-10-S99 and the Effects of Those
Adjustments on Basic and Diluted Earnings per Share

Attribution of Net Income (Loss) and Comprehensive Income (Loss) to the Parent and
the Holders of Redeemable Noncontrolling Interests

Changes in a Parent’s Ownership Interest When Control Is Retained

Deconsolidation of a Subsidiary

Reclassifications of Noncontrolling Interests into Permanent Equity

Examples Illustrating the Accounting for Redeemable Noncontrolling Interests
Examples Involving the Acquisition of a Controlling Interest in a Subsidiary

Example 15.17: Purchase of a Controlling Interest; Noncontrolling Interest Contains an Embedded Redemption Feature (Formula-Based Redemption Amount)

Example 15.18: Purchase of a Controlling Interest; Noncontrolling Interest Contains an Embedded Redemption Feature (Fair-Value Redemption Amount)

Example 15.19: Purchase of a Controlling Interest; Noncontrolling Interest in the Form of Redeemable Preferred Stock (Redeemable for Stated Value Plus Accumulated Unpaid Dividends)

Example Involving a Decrease in the Parent’s Ownership Interest While Maintaining Control

Example 15.20: Sale of Redeemable Noncontrolling Interests While Maintaining Control (Formula-Based Redemption Amount)

Example Involving an Increase in the Parent’s Ownership Interest While Maintaining Control

Example 15.21: Acquisition of Redeemable Noncontrolling Interests While Maintaining Control (Formula-Based Redemption Amount)

Example Involving the Deconsolidation of a Subsidiary

Example 15.22: Parent’s Sale of a Subsidiary’s Shares That Results in a Loss of Control and Deconsolidation of the Subsidiary; There Is a Redeemable Noncontrolling Interest in the Subsidiary Prior to the Sale (Formula-Based Redemption Amount)

Presentation of Redeemable Noncontrolling Interests in Consolidated Financial Statements of SEC Registrants

Example 15.24: Consolidated Statement of Changes in Equity by an Entity with Redeemable Noncontrolling Interests (Option 1)

Example 15.25: Consolidated Statement of Changes in Equity by an Entity with Redeemable Noncontrolling Interests (Option 2)

Application of ASC Section 480-10-S99 to Redeemable Noncontrolling Interests of Certain Real Estate Entities

Background on Redemption/Exchange Rights in Typical UPREIT Structures

Evaluation of Whether ASC Section 480-10-S99 Applies to Noncontrolling Interests of a REIT Due to Redemption/Exchange Rights in an UPREIT Structure

Subsequent Measurement of Redeemable Noncontrolling Interests Subject to ASC Section 480-10-S99 of a REIT Due to Redemption/Exchange Rights in an UPREIT Structure

Earnings per Share for Redeemable Noncontrolling Interests of a REIT Subject to ASC Section 480-10-S99 Due to Redemption/Exchange Rights in an UPREIT Structure

Changes in a REIT’s Ownership Interest in the Operating Partnership of a Typical UPREIT Structure When Control Is Retained
Presentation of Redeemable Units in the Separate Financial Statements of the Operating Partnership in an UPREIT Structure

Disclosures of Noncontrolling Interests

Implementation Guidance

Example 15.26: Implementation Guidance (based on ASC paragraphs 810-10-55-4H through 55-4M)

Example 15.27: Illustrations of the Presentation and Disclosure Requirements for a Not-for-Profit Parent with One or More Less-Than-Wholly-Owned Subsidiaries
OVERVIEW

ASC SUBTOPIC 810-10, CONSOLIDATION - OVERALL

15.000 ASC Subtopic 810-10 provides extensive guidance about the manner in which noncontrolling interests, and changes in noncontrolling interests, in subsidiaries are accounted for and presented in the parent company’s consolidated financial statements.

15.001 After the initial effective date of FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements (guidance now contained in ASC Subtopic 810-10), the FASB amended its scope related to decreases in ownership of a subsidiary because of concerns that certain provisions in ASC Subtopic 810-10 conflict with other existing U.S. GAAP. Originally, ASC Subtopic 810-10 applied to legal entities, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. The FASB amended the scope of ASC Subtopic 810-10 so that the decrease in ownership provisions now applies to groups of assets or subsidiaries that are businesses and nonprofit activities, unless those activities are in-substance real estate or oil- and gas-producing activities. Those changes provide a basis for more consistent accounting for economically similar transactions that are effected through different legal forms. The amendments also clarify that ASC Subtopic 810-10’s decrease in ownership requirements would apply to transfers of a subsidiary that is a business or nonprofit activity to an equity method investee or joint venture and to exchanges of assets that constitute a business or nonprofit activity for a noncontrolling interest in another entity, unless those activities are in-substance real estate or oil- and gas-producing activities. See additional discussion in Additional Guidance on Accounting for Decreases in Ownership of a Subsidiary beginning at Paragraph 15.027.

GUIDANCE ON SUBSEQUENT ACCOUNTING FOR NONCONTROLLING INTERESTS

Statement 160

3. This Statement amends ARB 51 [ASC Subtopic 810-10] to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51’s [ASC Subtopic 810-10’s] consolidation procedures for consistency with the requirements of [ASC Topic 805, Business Combinations].

15.002 This Section focuses on the accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary included in ASC Subtopic 810-10. Other amendments to ASC Subtopic 810-10 resulting from the issuance of FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), are not discussed in this Section.

15.003 ASC paragraphs 810-10-55-4H through 55-4M provide implementation guidance to illustrate the presentation and disclosure requirements for noncontrolling interests in
consolidated financial statements. ASC paragraphs 810-10-55-4H through 55-4M have been reproduced in entirety as Example 15.26.

**SCOPE**

15.004 Entities that prepare consolidated financial statements have a *controlling financial interest* in one or more other entities. An entity that holds a controlling financial interest is defined as the *parent*, and an entity in which the parent holds a controlling financial interest is defined as the *subsidiary*.

15.005 The portion of the equity of a subsidiary that is not owned by the parent is defined as the *noncontrolling interest*. Prior to the issuance of Statement 160, the authoritative accounting literature referred to such interests as *minority interests*. However, in recognition of the fact, as discussed below, that a holder of a minority of the equity of an entity might have a controlling financial interest in that entity and, conversely, that a holder of a majority of the equity might not have a controlling financial interest in that entity, the term minority interest was changed to noncontrolling interest.

15.006 In May 2009, the FASB issued FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions* (ASC Subtopics 958-805 and 958-810) to eliminate the scope exception for not-for-profit entities to consolidation requirements. ASC Subtopic 958-810 provides additional guidance on not-for-profit entities’ application of the provisions of ASC Subtopic 810-10. Not-for-profit entities are required to apply ASC Subtopic 810-10 prospectively in the annual financial statements for periods beginning on or after December 15, 2009. For guidance on whether a not-for-profit entity should retain its for-profit subsidiary’s accounting for a variable interest entity, see Question 8.1.1a in KPMG’s Consolidation of VIEs as amended by ASU 2015-02.

**DEFINITION OF TERMS**

15.007 Definitions and a discussion of certain terms appearing in the glossary and elsewhere and used in the discussion in this Section are presented below:

**ASC Master Glossary: Consolidated Financial Statements**

The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity.

**ASC Master Glossary: Noncontrolling Interest**

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

**ASC Master Glossary: Parent**

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)
ASC Master Glossary: Subsidiary

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

CONTROLLING FINANCIAL INTEREST

15.008 ASC paragraph 810-10-15-10(a) specifies that “All majority-owned subsidiaries – all entities in which a parent has a controlling financial interest – shall be consolidated.” Although the parent is identified as the party that holds a controlling financial interest in a subsidiary, that term is not defined in the glossary of ASC Section 810-10-20, nor is it defined elsewhere in the authoritative literature. However, the term is discussed in ASC Subtopic 810-10:

ASC Section 810-10-05

...Under the voting interest entity model, for legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity (see paragraph 810-10-15-8). For limited partnerships, the usual condition for a controlling financial interest is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership’s kick-out rights through voting interests (see paragraph 810-10-15-8A). If noncontrolling shareholders or limited partners have substantive participating rights, then the majority shareholder or limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest.

Under the VIE model, a controlling financial interest is assessed differently than under the voting interest entity model. This difference in assessment is required because a controlling financial interest may be achieved other than by ownership of shares or voting interests. A controlling financial interest in the VIE model requires both of the following:

a. The power to direct the activities that most significantly impact the VIE’s economic performance

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

A reporting entity with a controlling financial interest in a VIE is referred to as the primary beneficiary (see paragraph 810-10-25-38A). The reporting entity could be, but is not limited to being, an equity investor, some other capital provider such as a debt holder, or a party with another contractual arrangement such as a guarantor. This model applies to all types of legal entities within the scope of the Variable Interest Entities Subsections of this Subtopic that meet the definition of a VIE (see paragraph 810-10-15-14). …
ASC Paragraph 810-10-15-10(a)

A reporting entity shall apply consolidation guidance for entities that are not in the scope of the Variable Interest Entities Subsections (see the Variable Interest Entities Subsection of this Section) as follows: a. All majority-owned subsidiaries—all entities in which a parent has a controlling financial interest—shall be consolidated. However, there are exceptions to this general rule.

1. A majority-owned entity shall not be consolidated if control does not rest with the majority owner — for instance, if any of the following are present:
   i. The subsidiary is in legal reorganization
   ii. The subsidiary is in bankruptcy
   iii. The subsidiary operates under foreign exchange restrictions, controls, or other governmental restrictions so severe that they cast significant doubt on the parent’s ability to control the subsidiary.
   iv. In some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (hereafter referred to as noncontrolling rights). In paragraphs 810-10-25-2 through 25-14, the term noncontrolling shareholder refers to one or more noncontrolling shareholders and the terms limited partner and general partner refer to one or more limited or general partners. Those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.
   v. Control exists through means other than through ownership of a majority voting interest or a majority of kick-out rights through voting interests, for example as described in (c) through (e).

2. A majority-owned subsidiary in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of [ASC] Topic 940 and control is likely to be temporary.

15.009 ASC Topic 805 defines a business combination as a transaction or event in which an entity obtains control over one or more businesses, and states that control has the same meaning as a controlling financial interest in ASC paragraph 810-10-15-8. ASC Topic 805 expands on the “exceptions to the general rule” described in ASC paragraphs 810-10-15-8 and 15-10 where “control does not rest with the majority owner” by clarifying that control by one entity over another (i.e., a parent-subsidiary relationship) can be achieved by contract alone, and does not necessarily require the holding by the parent of an equity interest in the subsidiary.
**ASC Paragraph 805-10-25-12**

In a business combination achieved by contract alone, the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree’s net assets recognized in accordance with the requirements of [ASC] Topic [805]. In other words, the equity interests in the acquiree held by parties other than the acquirer are a noncontrolling interest in the acquirer’s postcombination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the noncontrolling interest.

**15.010** Thus, an entity that possesses a controlling financial interest in another entity is the parent, and consolidates that entity (which is the subsidiary). While the entity possessing the controlling financial interest (the parent) in an entity (the subsidiary) usually also owns a majority voting interest of the subsidiary, that is not necessarily the case and is not a precondition to having a controlling financial interest. If there is an interest in the equity of the subsidiary that is not held by the parent, such interest is a noncontrolling interest and is accounted for by the parent in accordance with ASC Subtopic 810-10.

**NATURE AND CLASSIFICATION OF NONCONTROLLING INTEREST**

**ASC Paragraph 810-10-45-15**

The ownership interests in the subsidiary that are held by owners other than the parent is a noncontrolling interest. The noncontrolling interest in a subsidiary is part of the equity of the consolidated group.

**ASC Paragraph 810-10-45-16**

The noncontrolling interest shall be reported in the consolidated statement of financial position within equity (net assets), separately from the parent’s equity (or net assets). That amount shall be clearly identified and labeled, for example, as noncontrolling interest in subsidiaries (see [ASC] paragraph 810-10-55-4I). An entity with noncontrolling interests in more than one subsidiary may present those interests in aggregate in the consolidated financial statements. A not-for-profit entity shall report the effects of any donor-imposed restrictions, if any, in accordance with [ASC] paragraph 958-810-45-1.

**ASC Paragraph 810-10-45-16A**

Only either of the following can be a noncontrolling interest in the consolidated financial statements:

- a. A financial instrument (or an embedded feature) issued by a subsidiary that is classified as equity in the subsidiary’s financial statements
- b. A financial instrument (or an embedded feature) issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary, that is considered indexed to
the entity’s own stock in the consolidated financial statements of the parent and that is classified as equity.

ASC Paragraph 810-10-45-17

A financial instrument issued by a subsidiary that is classified as a liability in the subsidiary’s financial statements based on the guidance in other Subtopics is not a noncontrolling interest because it is not an ownership interest. For example, [ASC] Topic 480 provides guidance for classifying certain financial instruments issued by a subsidiary.

ASC Paragraph 810-10-45-17A

An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) with the scope of the guidance in [ASC] paragraph 815-40-15-5C shall be presented as a component of noncontrolling interest in the consolidated financial statements whether the instrument was entered into by the parent or the subsidiary. However, if such an equity-classified instrument was entered into by the parent and expires unexercised, the carrying amount of the instrument shall be reclassified from noncontrolling interest to the controlling interest.

15.011 The FASB considered the nature of noncontrolling interests in a subsidiary and concluded that such interests include only financial instruments issued by a subsidiary that are classified as equity in the subsidiary’s financial statements. The FASB noted that equity is defined in FASB Concepts Statement No. 6, Elements of Financial Statements, as “the residual interest in the assets of an entity that remains after deducting its liabilities,” and that a noncontrolling interest represents the residual interest in the net assets of a subsidiary within the consolidated group held by owners other than the parent. Thus, the FASB concluded that any noncontrolling interest should be classified as equity in the consolidated financial statements, but should be presented separately from the parent’s equity to enable users to differentiate the equity attributable to the parent from the equity attributable to the noncontrolling interest.

ATTRIBUTION OF NET INCOME (OR LOSS) AND COMPREHENSIVE INCOME (OR LOSS) TO THE PARENT AND THE NONCONTROLLING INTEREST

ASC Paragraph 810-10-45-18

The amount of intra-entity income or loss to be eliminated in accordance with [ASC] paragraph 810-10-45-1 is not affected by the existence of a noncontrolling interest. The complete elimination of the intra-entity income or loss is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single economic entity. The elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.
ASC Paragraph 810-10-45-19

Revenues, expenses, gains, losses, net income or loss, and other comprehensive income shall be reported in the consolidated financial statements at the consolidated amounts, which include the amounts attributable to the owners of the parent and the noncontrolling interest.

ASC Paragraph 810-10-45-20

Net income or loss and comprehensive income or loss, as described in [ASC] Topic 220, shall be attributed to the parent and the noncontrolling interest.

15.012 ASC Subtopic 810-10 does not provide detailed guidance for the attribution of earnings and comprehensive income to the parent and the noncontrolling interest. Rather, the FASB observed that entities were making such attributions prior to the issuance of the guidance in ASC Subtopic 810-10, and noted that such attributions were generally reasonable and appropriate. Thus, the FASB concluded that detailed guidance in this area was not needed. It also noted that the methodology for attributing net income (or loss) and comprehensive income (or loss) to the noncontrolling interest is not expected to change from previous practice as a result of the guidance in ASC Subtopic 810-10 (other than with respect to the requirement that losses be attributed to the parent and the noncontrolling interest even if it results in a deficit noncontrolling interest – see Attribution of Losses in Excess of a Subsidiary’s Equity in this Section.

Q&A 15.0: Attributing Earnings of Partially Owned Subsidiaries Between Parent and Noncontrolling Interest Using the Hypothetical Liquidation at Book Value Method

ASC Subtopic 810-10 provides general guidance for attributing net income and comprehensive income to the parent and the noncontrolling interest. However, the guidance does not prescribe a specific attribution method for complex circumstances. In situations where a partially owned subsidiary's contractual arrangements do not attribute earnings solely based on ownership interests, questions may arise as to the appropriate attribution method to use.

The hypothetical liquidation at book value (HLBV) method was discussed in a Proposed Statement of Position, Accounting for Investors' Interests in Unconsolidated Real Estate Investments (Proposed SOP), in the context of the application of the equity method. Under the HLBV method, an equity method investor determines its share of an investee's earnings by comparing its claim on the investee's book value at the beginning and end of the period, assuming the investee were to liquidate all assets at their U.S. GAAP amounts and distribute the resulting cash to creditors and investors under their respective priorities. The Proposed SOP was never issued; however, the HLBV method is commonly used in practice by equity method investors when an investee's capital structure gives them different rights and priorities from their ownership interests, which is common in a number of structures where distributions are made pursuant to contractual waterfall provisions.
Q. Can a reporting entity attribute net income and comprehensive income of partially owned subsidiaries between the parent and noncontrolling interest using the hypothetical liquidation at book value method?

A. It depends. When a subsidiary's contractual arrangements provide for the allocation and distribution of earnings proportionally based on ownership interests, we believe the earnings' attribution is straightforward and should be based on the ownership interests. However, when there exists a substantive profit sharing arrangement or other contractual arrangement in which the investors' economic rights differ from their legal ownership interests in the entity, the reporting entity should attribute the partially owned subsidiary's earnings based on the contractual arrangement's terms. In this situation, the HLBV method may be an acceptable method if it reflects the economic terms of the arrangement.

Determining which contractual arrangements best reflect the economic terms of the arrangement depends on the specific facts and circumstances and requires the use of professional judgment. We believe contractual arrangements reflect the economic terms of the arrangement when their terms are consistent with the parties' economic interests over the subsidiary's life and on its liquidation. For example, when a subsidiary's contractual arrangements require certain expenses be attributed to one investor and all other revenues and expenses attributed equally between the investors, that attribution may not be substantive if, notwithstanding that contractual attribution, cash distributions and liquidating distributions are determined on another basis. In that case, application of the HLBV method, which determines the attribution assuming the partially owned subsidiary liquidates its net assets at their carrying amounts, may better reflect the economic terms of the arrangement. If uncertainty exists relative to the ultimate cash distributions example (e.g., if the attribution could change based on the outcome of a contingent event), a reporting entity should consider the facts and circumstances and use professional judgment when determining what attribution method best reflects the economic terms of the arrangement.

A reporting entity using the HLBV method generally should disclose the terms of the arrangements, and how it determined the attribution between the parent and noncontrolling interest in the notes to the financial statements.

15.013 While the methodology for attribution of a subsidiary’s net income (or loss) and comprehensive income (or loss) was not changed from previous practice as a result of the guidance in ASC Subtopic 810-10, the measurement of an acquired subsidiary’s assets and liabilities in an acquisition completed after the effective date of ASC Topic 805 does in some circumstances result in the attribution of a different amount of a subsidiary’s net income (or loss) and comprehensive income (or loss) to the noncontrolling interests than would have been the case for acquisitions completed prior to the effective date of ASC Topic 805. The following examples, which are based on the discussion in paragraph B38 of Statement 160, illustrate the method for attribution of a subsidiary’s net income (or loss):
Example 15.1: Partially Owned Subsidiary before and after the Effective Date of ASC Topic 805 and ASC Subtopic 810-10

Assume a parent acquired 80% of the ownership interests in a subsidiary in a single transaction. Assume further that the subsidiary recognized certain amortizable intangible assets as a result of the acquisition.

If the acquisition in this example was completed prior to the effective date of ASC Topic 805, the intangible assets recognized in the consolidated financial statements generally would have been measured at 80% of their fair value (80% fair value for the ownership interest acquired plus 20% carryover basis for the interests not acquired in that transaction, which for unrecognized intangible assets would be $0). In this case, all of the amortization expense of those intangible assets generally would have been attributed to the parent.

However, if the acquisition was completed after the effective date of ASC Topic 805, the intangible assets recognized in the consolidated financial statements would be measured at 100% of their fair value (with the corresponding 20% increase over the pre-ASC Topic 805 measurement being recognized as an increase in the noncontrolling interest). As a result, after the effective date of ASC Topic 805, 20% of the amortization expense would be attributed to the noncontrolling interest. It should be noted that net income attributable to the controlling interest would be the same as under the previous method.

Example 15.2: Parent and Partially Owned Subsidiary after the Effective Date of ASC Topic 805 and ASC Subtopic 810-10

Parent ABC acquired 100% of the ownership interests of Sub A in a single transaction on January 1, 20X9. The transaction was a business combination accounted for in accordance with ASC Topic 805.

Prior to the business combination, Sub A held a 75% ownership interest in Company X LP. Company X LP’s partnership agreement attributes net income (or loss) to the parent and noncontrolling interests based on a profit sharing arrangement. For the year ended December 31, 20X9, Company X LP had net income of $2,000. Based on the profit sharing arrangement Company X LP attributed 80% of net income to Sub A and 20% to noncontrolling interests. Assume that these attribution percentages apply at all income levels.
Assume that push-down accounting of Parent ABC’s basis was not elected in Company X LP’s separate financial statements. Parent ABC’s consolidated financial statements reflected an adjustment of $800 for additional depreciation expense related to its fair value adjustments to the net assets of Company X LP from the acquisition accounting.

For the year ended December 31, 20X9, Parent ABC determines the amount of the net income attributable to noncontrolling interests in its consolidated financial statements based on the profit sharing arrangement, illustrated as follows:

<table>
<thead>
<tr>
<th>Company X LP</th>
<th>Parent ABC Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company X LP net income</td>
<td>$2,000</td>
</tr>
<tr>
<td>Depreciation adjustment for stepped up bases of net assets of Company X LP</td>
<td>—</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$2,000</td>
</tr>
<tr>
<td>Attribution of net income:</td>
<td></td>
</tr>
<tr>
<td>Parent</td>
<td>$1,600(^1)</td>
</tr>
<tr>
<td>Noncontrolling interests</td>
<td>$400(^2)</td>
</tr>
</tbody>
</table>

As a result of the difference in bases in net assets between Parent ABC consolidated and Company X LP resulting from the business combination accounting, for the year ended December 31, 20X9, Company X LP will report net income attributable to noncontrolling interests of $400 in its stand-alone financial statements and Parent ABC will report net income attributable to noncontrolling interests in Company X LP of $240 in its consolidated financial statements.

\(^1\) $2,000 × 80% = $1,600
\(^2\) $2,000 × 20% = $400
\(^3\) $1,200 × 80% = $960
\(^4\) $1,200 × 20% = $240
Intercompany or intra-entity transactions are eliminated in the process of consolidating the subsidiary’s financial statements. If the subsidiary is a voting interest entity, the elimination of the intercompany profit or loss normally is allocated between the parent and the noncontrolling interests in proportion to their ownership interests or, if different, profit-sharing interests. In contrast, if the subsidiary is a variable interest entity, ASC paragraph 810-10-35-3 requires that the effects of intercompany eliminations be attributed entirely to the primary beneficiary (i.e., parent). The effect of attributing (for voting interest entities) or not attributing (for variable interest entities) the effects of eliminations to noncontrolling interests is illustrated in the following examples.

**Example 15.3: Attributing the Effect of the Elimination of Intercompany Transactions for Variable Interest Entities versus Voting Interest Entities**

**Scenario 1.** Company S has two investors, A and B. S is a variable interest entity. A and B hold 40% and 60%, respectively, of S’s voting interest. A is the primary beneficiary of S. For the current year, S purchased services from A at a cost of $25,000. There are no other intercompany transactions between A and S. S had net income for the year of $100,000. Because all of the elimination of the intercompany transaction is attributed to A, the allocation of S’s income to A in A’s consolidated financial statements would be $65,000 ($25,000 for intercompany fees + [$100,000 net income × 40%]). The noncontrolling interests (B) would be allocated $60,000 of S’s income in A’s consolidated financial statements ($100,000 net income x 60%).

**Scenario 2.** Assume the same facts as in Scenario 1 except that S is not a variable interest entity but A is still deemed to have a controlling financial interest in S. In this situation, the elimination of the intercompany transaction may be allocated proportionately to the parent (A) and the noncontrolling interests (B) in accordance with ASC paragraph 810-10-45-18 rather than entirely to the parent as is required by ASC paragraph 810-10-35-3 for the primary beneficiary of a VIE. If the parent chose to use the proportionate approach, S’s net income that is attributed to the parent in A’s consolidated financial statements would be $50,000 ([$100,000 net income + $25,000 elimination of intercompany fee] × 40%). The amount attributed to the noncontrolling interests would be $75,000 ([$100,000 net income + $25,000 elimination of intercompany fee] × 60%).

**Example 15.4: Attributing the Effect of the Elimination of Intercompany Transactions on Downstream Transactions**

Assume Company ABC sold inventory to Company XYZ (100% owned by Company ABC). The inventory was sold for $150,000 with a cost of $105,000. At the end of the 20X1 reporting period, Company XYZ had $30,000 of the intercompany acquired inventory on hand. Of the total intercompany profit of $45,000 related to the sale of inventory from Company ABC to Company XYZ, $9,000 relates to inventory on hand at year-end. During the reporting period ending in 20X2, Company XYZ sold the $9,000 of the intercompany-acquired inventory that was on hand at the end of 20X1 and there were no other intercompany inventory transactions.
<table>
<thead>
<tr>
<th>Account Type</th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$110,000</td>
<td>37,000</td>
<td>147,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From vendors</td>
<td>155,000</td>
<td>40,000</td>
<td>195,000</td>
</tr>
<tr>
<td>From intercompany</td>
<td>30,000</td>
<td></td>
<td>9,000</td>
</tr>
<tr>
<td>Investment in XYZ</td>
<td>100,000</td>
<td>100,000</td>
<td>—</td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>350,000</td>
<td>125,000</td>
<td>475,000</td>
</tr>
<tr>
<td></td>
<td>$780,000</td>
<td>243,000</td>
<td>914,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$355,000</td>
<td>123,000</td>
<td>478,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>250,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>175,000</td>
<td>20,000</td>
<td>186,000</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$780,000</td>
<td>243,000</td>
<td>914,000</td>
</tr>
</tbody>
</table>

1 Elimination of Parent’s investment in subsidiary and subsidiary’s beginning equity
2 Elimination of intercompany sales, cost of sales, and deferred profit held in ending inventory by Subsidiary

Balance sheet

<table>
<thead>
<tr>
<th>Account Type</th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$68,000</td>
<td>10,000</td>
<td>78,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>132,000</td>
<td>40,000</td>
<td>172,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From vendors</td>
<td>145,000</td>
<td>50,000</td>
<td>195,000</td>
</tr>
<tr>
<td>From intercompany</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in XYZ</td>
<td>100,000</td>
<td>100,000</td>
<td>—</td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>305,000</td>
<td>120,000</td>
<td>425,000</td>
</tr>
<tr>
<td></td>
<td>$750,000</td>
<td>220,000</td>
<td>970,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$285,000</td>
<td>80,000</td>
<td>365,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>250,000</td>
<td>100,000</td>
<td>100,000</td>
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<tr>
<td>Retained earnings</td>
<td>215,000</td>
<td>40,000</td>
<td>255,000</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$750,000</td>
<td>220,000</td>
<td>970,000</td>
</tr>
</tbody>
</table>

3 Elimination of Parent’s investment in subsidiary and subsidiary’s beginning equity
4 Confirmation of intercompany profit deferred from 20X1
Example 15.5: Sale of Inventory to Parent by a 75% Owned Subsidiary That Is not a Variable Interest Entity

Assume same facts as in Example 15.4 except that Company XYZ sold inventory to Company ABC and Company XYZ is 75% owned by Company ABC.

ABC Company and XYZ Company

Consolidation Worksheet as of period end 20X1

<table>
<thead>
<tr>
<th>Company ABC</th>
<th>Company XYZ</th>
<th>Consolidating Entries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement (20X1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$500,000</td>
<td>240,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(300,000)</td>
<td>(130,000)</td>
</tr>
<tr>
<td>Expenses</td>
<td>(190,000)</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Intercompany sales</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$10,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

NCI share of net income | 3 | 14,000 |
Parent’s share of net income |  | 52,000 |

Statement of Retained Earnings

Beginning balance (20X1) | $120,000 | — | 120,000 |
Net income | 10,000 | 65,000 | 14,000 | 4 | 52,000 |
Ending balance (20X1) | $130,000 | 65,000 |  |  | 172,000 |
### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>ABC</th>
<th>XYZ</th>
<th>Debit</th>
<th>Credit</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$65,000</td>
<td>11,000</td>
<td></td>
<td></td>
<td>76,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>110,000</td>
<td>37,000</td>
<td></td>
<td></td>
<td>147,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From vendors</td>
<td>155,000</td>
<td>105,000</td>
<td></td>
<td></td>
<td>260,000</td>
</tr>
<tr>
<td>From intercompany</td>
<td>30,000</td>
<td>9,000</td>
<td>2</td>
<td>21,000</td>
<td></td>
</tr>
<tr>
<td>Investment in S Co.</td>
<td>75,000</td>
<td>75,000</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>350,000</td>
<td>125,000</td>
<td></td>
<td></td>
<td>475,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$785,000</td>
<td>278,000</td>
<td></td>
<td></td>
<td>1,063,000</td>
</tr>
</tbody>
</table>

| Liabilities                    | $405,000  | 113,000   |       |        | 518,000      |
| NCI                            |           |           | 25,000| 1      | 39,000       |
| Common stock                   | 250,000   | 100,000   | 100,000| 1      | 250,000      |
| Retained earnings              | 130,000   | 65,000    |       |        | 172,000      |
| Total liabilities and equity   | $785,000  | 278,000   |       |        | 1,063,000    |

1. Elimination of Parent’s investment in subsidiary and subsidiary’s beginning equity
2. Elimination of intercompany sales, cost of sales, and deferred profit held in ending inventory by Subsidiary
3. Noncontrolling share of net income computed as \([(65,000 - 9,000) \times 25\%] = 14,000
4. Allocation of NCI share of net income to NCI in equity
5. Elimination of unconfirmed intercompany profit from ending consolidated retained earnings

### ABC Company and XYZ Company

#### Consolidation Worksheet as of period end 20X2

<table>
<thead>
<tr>
<th>Company</th>
<th>ABC</th>
<th>XYZ</th>
<th>Debit</th>
<th>Credit</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement (20X2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$710,000</td>
<td>240,000</td>
<td></td>
<td></td>
<td>950,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(350,000)</td>
<td>(130,000)</td>
<td>9,000</td>
<td>3</td>
<td>(471,000)</td>
</tr>
<tr>
<td>Expenses</td>
<td>(210,000)</td>
<td>(90,000)</td>
<td></td>
<td></td>
<td>(300,000)</td>
</tr>
<tr>
<td>Intercompany sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intercompany cost of sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$150,000</td>
<td>20,000</td>
<td></td>
<td></td>
<td>179,000</td>
</tr>
<tr>
<td>NCI share of net income</td>
<td></td>
<td></td>
<td></td>
<td>4</td>
<td>7,250</td>
</tr>
<tr>
<td>Parent’s share of net income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>186,250</td>
</tr>
</tbody>
</table>
### Statement of Retained Earnings

<table>
<thead>
<tr>
<th></th>
<th>(20X2)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$130,000</td>
<td>65,000</td>
<td>14,000</td>
<td>$2</td>
<td>172,000</td>
</tr>
<tr>
<td>Net income</td>
<td>150,000</td>
<td>20,000</td>
<td>7,250</td>
<td>9,000</td>
<td>171,750</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$280,000</td>
<td>85,000</td>
<td></td>
<td></td>
<td>343,750</td>
</tr>
</tbody>
</table>

### Balance Sheet

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$65,000</td>
<td>11,000</td>
<td></td>
<td></td>
<td>76,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>110,000</td>
<td>37,000</td>
<td></td>
<td></td>
<td>147,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From vendors</td>
<td>155,000</td>
<td>105,000</td>
<td></td>
<td></td>
<td>260,000</td>
</tr>
<tr>
<td>From intercompany</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in S Co.</td>
<td>75,000</td>
<td></td>
<td></td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>400,000</td>
<td>145,000</td>
<td></td>
<td></td>
<td>545,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$805,000</td>
<td>298,000</td>
<td></td>
<td></td>
<td>1,028,000</td>
</tr>
</tbody>
</table>

1 Elimination of Parent’s investment in subsidiary and subsidiary’s beginning equity
2 NCI Share of previous profits
3 Confirmation of intercompany profit deferred from 20X1
4 Noncontrolling share of net income computed as [(20,000 + 9,000) × 25%] = 7,250
5 Allocation of NCI share of net income to NCI

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$275,000</td>
<td>113,000</td>
<td></td>
<td></td>
<td>388,000</td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>25,000</td>
<td></td>
<td>14,000</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>250,000</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
<td>250,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>280,000</td>
<td>85,000</td>
<td></td>
<td></td>
<td>343,750</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$805,000</td>
<td>298,000</td>
<td></td>
<td></td>
<td>1,028,000</td>
</tr>
</tbody>
</table>

1 Elimination of Parent’s investment in subsidiary and subsidiary’s beginning equity
2 NCI Share of previous profits
3 Confirmation of intercompany profit deferred from 20X1
4 Noncontrolling share of net income computed as [(20,000 + 9,000) × 25%] = 7,250
5 Allocation of NCI share of net income to NCI

If XYZ is a variable interest entity, the income attributable to the NCI would be:

- 20X1: $65,000 × 25% = $16,250
- 20X2: $20,000 × 25% = $5,000
The income attributable to the parent would be:

20X1: \[(65,000 \times 75\%) - 9,000\] = 39,750
20X2: \[(20,000 \times 75\%) + 9,000\] = 24,000

A comparison of XYZ’s income allocated between the parent and the NCI if XYZ is a non-variable interest entity versus a variable interest entity is summarized below.

<table>
<thead>
<tr>
<th>Year</th>
<th>XYZ is a non-VIE</th>
<th></th>
<th>XYZ is a VIE</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>To Parent</td>
<td>To NCI</td>
<td>To Parent</td>
<td>To NCI</td>
</tr>
<tr>
<td>20X1</td>
<td>42,000</td>
<td>14,000</td>
<td>39,750</td>
<td>16,250</td>
</tr>
<tr>
<td>20X2</td>
<td>21,750</td>
<td>7,250</td>
<td>24,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

**ATTRIBUTION OF LOSSES IN EXCESS OF A SUBSIDIARY’S EQUITY**

**ASC Paragraph 810-10-45-21**

Losses attributable to the parent and the noncontrolling interest in a subsidiary may exceed their interests in the subsidiary’s equity. The excess, and any further losses attributable to the parent and the noncontrolling interest, shall be attributed to those interests. That is, the noncontrolling interest shall continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

**15.015** Prior to the effective date of ASC Subtopic 810-10, ARB 51 required that losses applicable to the noncontrolling interest in a subsidiary in excess of the equity of the noncontrolling interest be attributed to the parent, in view of the fact that the noncontrolling interest had no obligation to absorb such losses. However, the FASB concluded that, consistent with its conclusion that the noncontrolling interest is part of the equity of the consolidated group and participates in the risks and rewards of an investment in the subsidiary, the noncontrolling interest should be attributed its share of losses, even if this causes the noncontrolling interest to be a deficit.

**15.016** The FASB acknowledged in the Basis for Conclusions of Statement 160 that attribution of losses to a noncontrolling interest in excess of the equity of the noncontrolling interest creates an inconsistency between the parent’s accounting for the noncontrolling interest and an investor’s accounting for such investment. Thus, the noncontrolling interest in the consolidated financial statements might be a deficit, while under ASC Topic 323, *Investments—Equity Method and Joint Ventures*, the investment held by the investor would not be written down to less than $0 (assuming that the investor did not have an obligation to fund losses). Nevertheless, while acknowledging this inconsistency, the FASB observed that the investor’s accounting for an investment in a nonconsolidated entity was outside the scope of this project.
INCOME TAX EXPENSE

15.017 ASC Subtopic 810-10 does not change how entities determine income taxes under ASC Topic 740, *Income Taxes*. However, ASC Subtopic 810-10 requires the presentation of income taxes to require that income tax expense attributed to both the controlling and noncontrolling interest be included in consolidated income tax expense. Thus, net income attributable to noncontrolling interest is reflected in the consolidated income statement as an allocation of net income such that net income attributable to the noncontrolling interest is deducted from net income to arrive at net income attributable to controlling interest, presented on a net-of-tax basis. Consequently, an entity’s effective tax rate may change after the adoption of ASC Subtopic 810-10, particularly for subsidiaries that are pass-through entities that pay no income tax.

**Q&A 15.1: Financial Statement Presentation – Net Income Attributed to Noncontrolling Interest in Pass-Through Entities**

**Q.** ABC Corp. consolidates Subsidiary LLC (a limited liability corporation), a 90% owned subsidiary. ABC’s tax rate is 35%. Subsidiary LLC is a pass-through entity and is not subject to income taxes in its jurisdiction. Taxable income and losses flow through Subsidiary LLC to the owners of the entity and are included in the owners’ taxable income. Subsidiary LLC has $100,000 of pretax income and $0 of income tax expense. ABC’s income taxes include its share of Subsidiary LLC’s taxable income. ABC adopted ASC Subtopic 810-10 on January 1, 20X9.

Net income attributed to the noncontrolling interest is not deducted in determining net income under the provisions of ASC Subtopic 810-10 but rather is an allocation of net income and thus income tax expense in ABC’s consolidated income statement includes both income tax attributed to controlling and noncontrolling interests. If the noncontrolling interest is an interest in a pass-through entity, should the consolidated entity recognize tax expense on the income attributed to the noncontrolling interest and record a charge in lieu of tax to reflect a reduction for the portion related to the noncontrolling interest to achieve the same effective tax rate existing before ASC Subtopic 810-10?

**A.** No. ASC Subtopic 810-10 does not change how entities determine income taxes under ASC Topic 740. Therefore, income tax expense for pass-through Subsidiary LLC remains at $0. ABC continues to recognize income tax expense on its share of Subsidiary LLC’s income. However, the presentation of income taxes in the consolidated financial statements will change if prior to the adoption of ASC Subtopic 810-10 the entity deducts minority interests before arriving at income before income tax expense. If a consolidated entity has a noncontrolling interest in a pass-through subsidiary entity, income tax expense shown on the face of the consolidated income statement will not change because the income tax expense for that subsidiary will be $0. The effective tax rate, however, is affected as illustrated below (assume that ABC has no other income besides the income of Subsidiary LLC):
Before Adoption of ASC Subtopic 810-10

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less: Expenses</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Less: Minority interest share of earnings</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Income before income tax expense</td>
<td>90,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(31,500)</td>
</tr>
<tr>
<td>Net income</td>
<td>$58,500</td>
</tr>
</tbody>
</table>

After Adoption of ASC Subtopic 810-10

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less: Expenses</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Income before income tax expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(31,500)</td>
</tr>
<tr>
<td>Net income</td>
<td>$68,500</td>
</tr>
<tr>
<td>Less net income attributable to noncontrolling interest</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>$58,500</td>
</tr>
</tbody>
</table>

1 \($100,000 \times 10\%) - $0 income tax expense

Before the adoption of ASC Subtopic 810-10, in the example above the effective tax rate is 35\%(\$31,500 / $90,000). Subsequent to the adoption of ASC Subtopic 810-10 the effective tax rate is 31.5\%(\$31,500 / $100,000). The reduction in the effective tax rate is due to the fact that no tax expense is recognized on the earnings related to the noncontrolling interest in the pass-through entity while the pretax earnings attributed to the noncontrolling interest is recognized in net income. The entity should include the tax effect of the amount of income related to the pass-through entity attributable to noncontrolling interest in its reconciliation from the expected to actual income tax expense. See paragraphs 8.087 - 8.088 of KPMG’s *Accounting for Income Taxes, An analysis of FASB Statement 109 (ASC Topic 740), Second Edition*, for additional discussion on the reconciliation from expected to actual income tax expense.

If instead, for this example, the noncontrolling interest was in a subsidiary that was taxed at the same rate as ABC, the adoption of Statement 160 (ASC Subtopic 810-10) would not have an effect on the consolidated effective tax rate. However, because the income tax expense includes both income attributed to controlling and noncontrolling interests, the income tax expense recognized on the face of the income statement will change after the adoption of ASC Subtopic 810-10. See illustration below assuming the same facts above except that the noncontrolling interest is in a subsidiary that is taxable at 35\%. 

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Before Adoption of ASC Subtopic 810-10

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less: Expenses</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Less: Minority interest</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Income before income tax expense</td>
<td>90,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(31,500)</td>
</tr>
<tr>
<td>Net income</td>
<td>$58,500</td>
</tr>
</tbody>
</table>

After Adoption of ASC Subtopic 810-10

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less: Expenses</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Income before income tax expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>65,000</td>
</tr>
<tr>
<td>Less net income attributable to noncontrolling interest</td>
<td>(6,500)</td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>$58,500</td>
</tr>
</tbody>
</table>

2 (100,000 X 10%) - $3,500 income tax expense

This example assumes the subsidiary with the noncontrolling interest was taxable at the same rate as the consolidated entity. If the tax rate in that subsidiary’s jurisdiction was a different rate, the adoption of ASC Subtopic 810-10 will have an effect on the effective tax rate as well. Depending on the difference in the rate, the effect may be significantly less than with a noncontrolling interest in a subsidiary that is a pass-through entity.

Q&A 15.2: Financial Statement Presentation – Net Income Attributed to Noncontrolling Interest – Interim Periods

Q. ABC Corp. consolidates Subsidiary DEF, a 60% owned subsidiary. ABC’s tax rate is 35% and DEF’s tax rate is 45%. ABC adopted ASC Subtopic 810-10 on January 1, 20X9. Before the adoption of ASC Subtopic 810-10, ABC presented noncontrolling interest (minority interest) in the income statement as a reduction of income before income tax expense, thus presenting minority interest expense on a gross (pretax) basis, and therefore the tax expense associated with the minority interest’s share of DEF’s earnings was not reflected in the consolidated income tax expense. Previously, when determining its interim period tax calculation in accordance with ASC Topic 270, Interim Reporting, and ASC Subtopic 740-270, Income Taxes - Interim Reporting, ABC estimated pretax ordinary income after deducting the noncontrolling interest share of earnings.

Income attributed to the noncontrolling interest is not deducted in determining net income under the provisions of ASC Subtopic 810-10 and income tax expense will include both income tax attributed to controlling and noncontrolling interests. For the interim periods
subsequent to the adoption of ASC Subtopic 810-10, when determining the estimated annual effective tax rate, should ABC exclude income attributable to noncontrolling interest in its estimate of pretax ordinary income as defined by ASC Subtopic 740-270?

A. No. ASC Subtopic 740-270 defines estimated pretax ordinary income as pretax income excluding (1) extraordinary items, (2) discontinued operations, (3) cumulative effects of changes in accounting principles, and (4) significant unusual or infrequent items reported separately or reported net of their related tax effects. Income attributed to noncontrolling interest would be included in the ASC Subtopic 740-270 definition of ordinary income. ABC should include income attributed to noncontrolling interest in its estimate of pretax ordinary income when determining its annual effective tax rate for determining its tax provision in interim periods. Additionally, because net income attributed to the noncontrolling interest is deducted from net income to arrive at net income attributed to the controlling interest presented net of tax, ABC should apply the principles of ASC Topic 270 and ASC Subtopic 740-270 to determine the interim period tax attributed to DEF and the noncontrolling interest. ABC determines the estimated annual effective tax rate for DEF and applies that rate in determining the interim period tax provision for income of DEF and the noncontrolling interest in DEF’s income.

In this example, ABC determines (based on its estimated pretax ordinary income, including 100% of DEF’s pretax income) that its consolidated estimated annual effective tax rate to be applied in determining its interim period income tax provision is 40%. Income taxes allocated to the noncontrolling interest are based on DEF’s estimated pretax ordinary income for the year, as well as the estimated annual effective tax rate for DEF. DEF’s estimated annual effective tax rate is determined based on the enacted tax rate in its jurisdiction (45%). The estimated annual effective tax rate of DEF is used in determining its income tax provision, which is used in determining the net income attributed to noncontrolling interest. Net income attributed to noncontrolling interest is deducted from net income to arrive at net income attributed to ABC.

CHANGES IN A PARENT’S OWNERSHIP INTEREST IN A SUBSIDIARY

CHANGES IN A PARENT’S OWNERSHIP THAT DO NOT RESULT IN A LOSS OF CONTROL

ASC Paragraph 810-10-45-22

A parent’s ownership interest in a subsidiary might change while the parent retains its controlling financial interest in the subsidiary. For example, a parent’s ownership interest in a subsidiary might change if any of the following occur:

a. The parent purchases additional ownership interests in its subsidiary.

b. The parent sells some of its ownership interests in its subsidiary.

c. The subsidiary reacquires some of its ownership interests.
d. The subsidiary issues additional ownership interests.

**ASC Paragraph 810-10-45-23**

Changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent. Example 1 ([ASC paragraph 810-10-55-4B]) illustrates the application of this guidance.

15.018 Consistent with the FASB’s view that noncontrolling owners have an ownership interest in the consolidated entity, ASC Subtopic 810-10 requires that changes in a parent’s ownership interest while the parent retains control be accounted for as equity transactions. This is also consistent with the conclusions reached in ASC Topic 805 that obtaining control of a business is a significant economic event that results in the initial recognition and measurement of all of the assets acquired and liabilities assumed (i.e., full step-up) at the acquisition date, notwithstanding the continuing existence of a noncontrolling interest. Accordingly, no gain or loss is recognized as a result of changes in the parent’s ownership of a subsidiary if the parent continues to retain control after the transaction giving rise to the change. This conclusion (i.e., no additional step-up on acquisition of any noncontrolling interest after control was obtained and no gain or loss recognized on a sale of a partial ownership interest while retaining control) applies whether the controlling financial interest was obtained before or after the original effective date of Statement Nos. 141(R) and 160.

15.019 ASC Subtopic 810-10 is not clear on the treatment of transaction costs associated with transactions with noncontrolling interest while retaining control. ASC paragraph 810-10-45-23 directs that such transactions are accounted for as equity transactions, which could be read to mean that transaction costs are included within equity. Conversely, ASC paragraph 810-10-45-23 also states that “any difference between the fair value of the consideration . . . paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent.” Because transaction costs are not an element of the fair value of the consideration paid, this sentence could be read to mean that transaction costs should be expensed as incurred. Based on our understanding of views of the SEC staff and the FASB staff, we believe that entities should make a policy election in this regard that is consistently applied and, if material, disclosed in the footnotes.

15.020 For guidance on presenting transaction costs in the statement of cash flows, see chapter 18 of KPMG's Handbook, *Statement of cash flows.*

15.021 Three examples are provided in ASC Subtopic 810-10 to illustrate the accounting for changes in a parent’s ownership interest in a subsidiary that do not result in a loss of
control. The examples are exclusive of transaction costs, which would be accounted for as discussed in the preceding paragraph.

**Example 15.6: Sale by Parent of a Portion of Its Ownership Interest in a Subsidiary**

Subsidiary A has 10,000 shares of common stock outstanding, all of which are owned by its parent, ABC Corp. The carrying amount of Subsidiary A’s equity is $200,000. ABC sells 2,000 of its shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100% to 80%. That transaction is accounted for by recognizing a noncontrolling interest in the amount of $40,000 ($200,000 × 20%). The $10,000 excess of the cash received ($50,000) over the adjustment to the carrying amount of the noncontrolling interest ($40,000) is recognized as an increase in additional paid-in capital attributable to ABC. (If the parent is a not-for-profit entity, the $10,000 increase in additional paid-in capital in this example is recognized as an increase in net assets, generally unrestricted net assets.)

**Q&A 15.2a: Effect of Shareholder Loans on Noncontrolling Interest**

Company B is a subsidiary of Company A. Company B entered into recourse promissory notes with its employees (outside the scope of ASC Topic 718), who used the proceeds to purchase shares of Company B. Company A is now determining the effect of this transaction on noncontrolling interest in the consolidated financial statements.

**Q.** How should a full recourse loan on an employee purchase of shares of a subsidiary be treated in calculating noncontrolling interest?

**A.** This transaction has the following effect on Company A's consolidated financial statements:

- **Initial presentation** - Following the guidance in ASC paragraph 505-10-45-2, the promissory notes and issuance of Company B shares to employees are both recorded as adjustments to equity. As they result in dilution of Company A's interest in Company B, that equity adjustment is reflected in noncontrolling interest. Noncontrolling interest is increased for the issuance of new shares to employees and reduced with an offsetting deduction (i.e., contra) to noncontrolling interest for the promissory notes. As the promissory notes are repaid, the contra-noncontrolling interest is reduced.

- **Allocation of earnings** - The shares issued to employees have the same rights as all other issued shares. Therefore, the allocation of earnings between Company A's shareholders and noncontrolling interest should reflect the proportionate ownership interests and the allocation should not be adjusted to reflect the promissory notes.

- **Calculation of the dilution of Company A's interest in Company B** - As prescribed
by ASC paragraph 810-10-45-23, Company A is required to calculate an adjustment to equity when its ownership in Company B is diluted and it retains control. Company A is required to calculate the equity adjustment based on the difference between the fair value of the consideration received and the percentage adjustment to the carrying amount of noncontrolling interest, excluding the effect of the contra-noncontrolling interest associated with the related loan, with any difference recognized in equity attributable to parent.

If the promissory note is non-recourse, this guidance should not be applied because the issuance of equity to employees concurrent with a non-recourse loan is accounted for as an employee share option in accordance with ASC paragraph 718-10-25-4. Further guidance on the accounting for options of subsidiary shares is available at Q&A 1.13 in KPMG’s Share Based Payment.

**Example 15.7: Issuance of Additional Shares by a Subsidiary**

Subsidiary A has 10,000 shares of common stock outstanding. Of those shares, 9,000 are owned by its parent, ABC Co., and 1,000 are owned by other shareholders (a noncontrolling interest in Subsidiary A). The carrying amount of Subsidiary A’s equity is $300,000. Of that amount, $270,000 is attributable to ABC, and $30,000 is a noncontrolling interest in Subsidiary A. Subsidiary A issues 2,000 previously unissued shares to a third party for $120,000 in cash, reducing ABC’s ownership interest in Subsidiary A from 90% to 75% (9,000 shares owned by ABC ÷ 12,000 issued shares). Even though the percentage of ABC’s ownership interest in Subsidiary A is reduced when Subsidiary A issues shares to the third party, ABC’s investment in Subsidiary A increases to $315,000, calculated as 75% of Subsidiary A’s equity of $420,000 ($300,000 + $120,000). Therefore, ABC recognizes a $45,000 increase in its investment in Subsidiary A ($315,000 – $270,000) and a corresponding increase in its additional paid-in capital (that is, the additional paid-in capital attributable to ABC). In addition, the noncontrolling interest is increased to $105,000, calculated as 25% of $420,000. (If the parent is a not-for-profit entity, the $45,000 increase of additional paid-in capital in this example is recognized instead as an increase in net assets, generally unrestricted net assets.)

**ASC Paragraph 810-10-45-24**

A change in a parent’s ownership interest might occur in a subsidiary that has accumulated other comprehensive income. If that is the case, the carrying amount of accumulated other comprehensive income shall be adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity attributable to the parent. Example 1, Case C ([ASC] paragraph 810-10-55-4F) illustrates the application of this guidance.
Example 15.8: Acquisition by Parent of a Noncontrolling Interest of a Subsidiary That Has Other Comprehensive Income

Subsidiary A has 10,000 shares of common stock outstanding. Of those shares, 8,000 are owned by its parent, ABC Co., and 2,000 are owned by other shareholders (a noncontrolling interest in Subsidiary A). The carrying amount of the noncontrolling interest is $48,000, which includes $4,000 of accumulated other comprehensive income. ABC pays $30,000 in cash to purchase 1,000 shares held by the noncontrolling shareholders (50% of the noncontrolling interest), increasing its ownership interest from 80% to 90%. That transaction is recognized by reducing the carrying amount of the noncontrolling interest by $24,000 ($48,000 × 50%). The $6,000 excess of the cash paid ($30,000) over the adjustment to the carrying amount of the noncontrolling interest ($24,000) is recognized as a decrease in additional paid-in capital attributable to ABC. In addition, ABC’s share of accumulated other comprehensive income is increased by $2,000 ($4,000 × 50%) through a corresponding decrease in additional paid-in capital attributable to ABC.

Example 15.8a: Effect of Shareholder Loans on Noncontrolling Interest

Background

Company B is a subsidiary of Company A. Company B entered into recourse promissory notes with its employees, who used the proceeds to purchase shares of Company B. Because the note was fully recourse to the employee, the arrangement is not within the scope of ASC Topic 718. Company A is now calculating the effect of this transaction on noncontrolling interest in the consolidated financial statements.

Q. How should a full recourse loan on an employee purchase of shares of a subsidiary be treated in calculating noncontrolling interest?

A. This transaction has the following effect on Company A's consolidated financial statements:

- Initial and subsequent presentation - Following the guidance in ASC Topic 505 the promissory notes and issuance of Company B shares to employees are both recorded as adjustments to equity. NCI is increased for the issuance of new shares to employees and reduced with an offsetting deduction (i.e., contra) to NCI for the promissory notes. When or as the promissory notes are repaid, the contra NCI is reduced or eliminated leaving the increase in equity attributable to NCI.

- Allocation of earnings - The shares issued to employees have the same rights as all other issued shares. Therefore, the allocation of earnings between Company A's shareholders and NCI should reflect the proportionate ownership interests and should not be reduced by the contra with respect to the promissory notes.

- Calculation of the dilution of Company A's interest in Company B - As prescribed
by ASC Topic 810, Company A is required to calculate an adjustment to equity when its ownership in Company B is diluted and it retains control. Company A would calculate the equity adjustment based on the difference between the fair value of the consideration received and the percentage adjustment to the carrying amount of NCI, excluding the effect of the contra NCI associated with the related notes, with any difference recognized in equity (additional paid-in capital) attributable to parent.

Conversely, the issuance of equity to employees concurrent with a nonrecourse loan is accounted for as a share option under ASC paragraph 718-10-25-4. See Q&A 1.13 in KPMG’s *Share-Based Payment*, for additional guidance about the accounting for options on subsidiary shares.

**Downstream Mergers**

15.022 Another type of transaction sometimes used to effect the acquisition of noncontrolling interests is one in which a subsidiary exchanges its common shares for the outstanding voting common shares of its parent (usually referred to as a *downstream merger*). Those transactions should be accounted for as if the parent had exchanged its common shares for the noncontrolling interest in its subsidiary. Whether a parent acquires the noncontrolling interest of a subsidiary, or a subsidiary acquires its parent, the result is a single stockholder group, including the former noncontrolling interest holders, owning the consolidated net assets. The same would be true if a new corporation exchanged its common shares for the common shares of the parent and the common shares of the subsidiary held by the noncontrolling interests.

**Example 15.9: Downstream Merger**

ABC Corp. owns 70% of the outstanding voting common shares of DEF Corp. A downstream merger is planned, whereby DEF, the subsidiary, would acquire the assets of ABC.

**Questions:**

1. Would ABC, the parent, or DEF, the subsidiary, be the survivor company after the merger?
2. How would the transaction be accounted for?

**Responses:**

1. Whether the former parent or the former subsidiary is the surviving entity is a legal matter, not an accounting matter and, therefore, is not addressed in GAAP. However, as indicated in Paragraph 15.021, whether a parent acquires the noncontrolling interest in a subsidiary or a subsidiary acquires its parent, the end result after the transaction is that the consolidated net assets are owned by a single shareholder group that includes both the former shareholders of the
parent and the former shareholders of the noncontrolling interest in the subsidiary.

(2) The transaction should be accounted for as if the parent (ABC) had exchanged its common shares for the noncontrolling interest in its subsidiary (DEF). DEF should adjust its accounts to reflect any difference between the parent’s equity and the unamortized cost to the parent of its investment in the subsidiary. Likewise, DEF should adjust its shareholders’ equity to reflect the shareholders’ equity of the former parent, after giving effect to the acquisition of the former noncontrolling interest. The acquisition of the former noncontrolling interest should be reflected as an equity transaction, with the fair value of the consideration paid being offset first by eliminating the carrying amount of the noncontrolling interest, with any remaining difference being charged or credited to paid-in capital. If the resulting paid-in capital is less than the par or stated value of the capital stock of the survivor, an appropriate transfer should be made from retained earnings.

Allocation of Goodwill for Impairment Testing When Parent’s Ownership Interest Changes

15.023 When the parent’s ownership interest changes, but the parent retains control of the subsidiary, the change in ownership does not result in any adjustment to the carrying amount of the subsidiary’s assets or liabilities, including goodwill. However, for purposes of performing the goodwill impairment test, goodwill is attributed to the parent and the noncontrolling interest on a rational basis. See Goodwill Impairment Testing and Disposal of All or a Portion of a Reporting Unit When the Reporting Unit Is Less Than Wholly Owned in Section 22.

CHANGES IN A PARENT’S OWNERSHIP THAT RESULT IN A LOSS OF CONTROL

ASC Paragraph 810-10-40-4

A parent shall deconsolidate a subsidiary or derecognize a group of assets specified in [ASC] paragraph 810-10-40-3A as of the date the parent ceases to have a controlling financial interest in the subsidiary or group of assets. …

ASC Paragraph 810-10-55-4A

All of the following are circumstances that result in deconsolidation of a subsidiary under [ASC] paragraph 810-10-40-4:

a. A parent sells all or part of its ownership interest in its subsidiary, and as a result, the parent no longer has a controlling financial interest in the subsidiary.

b. The expiration of a contractual agreement that gave control of the subsidiary to the parent.
c. The subsidiary issues shares, which reduces the parent’s ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary.

d. The subsidiary becomes subject to the control of a government, court, administrator, or regulator.

15.024 When a parent ceases to have a controlling financial interest in a subsidiary, the parent no longer controls the subsidiary’s assets and liabilities and the parent-subsidiary relationship no longer exists. Accordingly, the parent discontinues the consolidation of the subsidiary, resulting in derecognition of the assets, liabilities, and equity components related to the subsidiary. In addition to noncontrolling interests, equity components related to the subsidiary include amounts previously recognized in other comprehensive income.

**ASC Paragraph 810-10-40-5**

If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in [ASC] Subtopic 845-10 [Nonmonetary Transactions - Overall], applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in [ASC] paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:
   1. The fair value of any consideration received
   2. 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
   3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.

b. The carrying amount of the former subsidiary’s assets and liabilities or the carrying amount of the group of assets.

15.025 Measuring the retained investment at fair value (instead of at its carrying amount prior to the transaction or event giving rise to deconsolidation) is consistent with the FASB’s view that the loss by a parent of a controlling financial interest in a subsidiary is a significant economic event that causes the parent-subsidiary relationship to cease, and an investor-investee relationship to begin. The parent therefore derecognizes the assets, liabilities, and equity components (including amounts previously recognized in other comprehensive income) related to the subsidiary. (Statement 160, par. B53) The FASB also noted that recognition of the retained investment at fair value is consistent with the requirements of ASC Topic 805, which requires an investor with an equity investment in an investee, on subsequently obtaining a controlling financial interest in the investee, to
remeasure its previously held noncontrolling investment at fair value and recognize a gain or loss. See additional discussion in *Additional Guidance on Accounting for Decreases in Ownership of a Subsidiary* beginning at Paragraph 15.027 for clarifications to the scope of ASC Subtopic 810-10 related to the decrease in ownership provisions of a parent’s interest in a subsidiary or group of assets.

**15.026** The following example illustrates the computation of the gain or loss that would be recognized on the deconsolidation of a subsidiary.

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**Example 15.10: Gain or Loss Recognized on Deconsolidation of a Subsidiary**

ABC Corp. owns 60% of the shares of DEF Corp. DEF Corp. constitutes a business. On January 1, 20Y0, ABC disposes of a 20% interest in DEF in exchange for cash consideration of $500 and loses control over DEF. At the date that ABC disposes of a 20% interest in DEF, the carrying amount of the net assets of DEF is $1,850, the equity attributable to the noncontrolling interest (including accumulated other comprehensive income of $30) is $700, and equity attributable to ABC (including accumulated other comprehensive income of $45) is $1,150 (i.e., the carrying amount of ABC’s controlling interest includes a control premium of $100). The fair value of ABC’s remaining 40% investment in DEF after the transaction is determined to be $1,000.

Determination of ABC’s gain or loss due to its loss of control of DEF:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (fair value of consideration received)</td>
<td>$ 500</td>
</tr>
<tr>
<td>Investment in DEF (fair value of retained noncontrolling interest)</td>
<td>1,000</td>
</tr>
<tr>
<td>Equity:</td>
<td></td>
</tr>
<tr>
<td>Carrying amount of noncontrolling interest (including other comprehensive income of $30)</td>
<td>700</td>
</tr>
<tr>
<td></td>
<td>2,200</td>
</tr>
<tr>
<td>Less: Carrying amount of DEF’s net assets</td>
<td>$ 1,850</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$ 350</td>
</tr>
<tr>
<td>Reclassification of other comprehensive income to earnings</td>
<td>$ 45</td>
</tr>
</tbody>
</table>

ABC would record the following entries to reflect its disposal of a 20% interest in DEF at January 1, 20Y0:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>500</td>
</tr>
<tr>
<td>Equity: Noncontrolling interest (including AOCI of $30)</td>
<td>700</td>
</tr>
<tr>
<td>Investment in DEF</td>
<td>1,000</td>
</tr>
<tr>
<td>Net assets of DEF (including goodwill)</td>
<td>1,850</td>
</tr>
<tr>
<td>Gain on sale of 20% interest in DEF</td>
<td>350</td>
</tr>
</tbody>
</table>
Reclassification of the AOCI would be classified in income statement based on the nature of AOCI.

The gain on loss of control represents the increase in the fair value of the retained 40% investment of $234 ($1,000 – (40/60 × $1,150), plus the $116 gain on the sale of the 20% interest disposed of ($500 – (20/60 × $1,150). Additionally, the $45 in AOCI is reclassified to earnings resulting from the elimination of accumulated other comprehensive income attributable to ABC.

Assuming that the remaining interest of 40% is accounted for under the equity method, the fair value of $1,000 represents the cost on initial recognition, and ASC Topic 323 applies going forward. When the retained interest is accounted for by the equity method, the former parent is required to perform a purchase price allocation related to its equity method investment in accordance with ASC Topic 323. See ASC Subtopic 323-10 for additional guidance on application of the equity method to investments obtained after the effective date of ASC Topic 805 and ASC Subtopic 810-10.

**ADDITIONAL GUIDANCE ON ACCOUNTING FOR DECREASES IN OWNERSHIP OF A SUBSIDIARY**

*15.027* ASUs 2014-09, *Revenue from Contracts with Customers*, and 2017-05, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, amended the scope of the guidance on decreases in ownership. The amendments more closely align the accounting for transactions within and outside the scope of ASC Subtopic 810-10. Most notably, the amendments require that entities measure a retained noncontrolling interest in a nonfinancial asset at fair value in a partial sale transaction. The amendments also supersede or amend industry specific guidance such as the guidance in ASC Section 360-20-40. The ASUs are effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. The guidance is effective for all other entities for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning after December 15, 2016. An entity may adopt these ASUs using the full retrospective or modified retrospective method. Under the modified retrospective method, entities recognize the cumulative effect of applying the new guidance at the date of initial application with no restatement of comparative periods. An entity is not required to apply the same approach for contracts with customers (e.g., transactions in the scope of ASC Topic 606, *Revenue from Contracts with Customers*) as it does for transactions with noncustomers (e.g., transactions in the scope of ASC Subtopic 610-20, *Other Income—Gains and Losses from Derecognition of Nonfinancial Assets*). See Chapter 16 of KPMG’s Handbook, Revenue Recognition, for further discussion of the effective dates and transition methods of the new guidance.
15.028 The following sections address the accounting for decreases in ownership of a subsidiary or a group of assets that constitutes a business or nonprofit activity both before and after the adoption of the ASUs.

**SCOPE OF GUIDANCE ON ACCOUNTING FOR DECREASES IN OWNERSHIP OF A SUBSIDIARY PRIOR TO ADOPTION OF ASU 2014-09 AND ASU 2017-05**

**ASC Paragraph 810-10-40-3A**

The deconsolidation and derecognition guidance in [ASC] Section [810-10-40] applies to the following:

a. A subsidiary that is a nonprofit activity or a business, except for either of the following:
   1. A sale of in substance real estate (for guidance on a sale of in substance real estate, see [ASC] Subtopic 360-20 or 976-605)
   2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see [ASC] Subtopic 932-360).

b. A group of assets that is a nonprofit activity or a business, except for either of the following:
   1. A sale of in substance real estate (for guidance on a sale of in substance real estate, see [ASC] Subtopic 360-20 or 976-605)
   2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see [ASC] Subtopic 932-360).

c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other [ASC] Topics that include, but are not limited to, all of the following:
   1. [ASC] Topic 605 on revenue recognition
   2. [ASC] Topic 845 on exchanges of nonmonetary assets
   3. [ASC] Topic 860 on transferring and servicing financial assets
   4. [ASC] Topic 932 on conveyances of mineral rights and related transactions
   5. [ASC] Topic 360 or 976 on sales of in substance real estate.

15.029 The scope exceptions specified in ASC paragraph 810-10-40-3A do not affect transactions in which an entity has a controlling financial interest in a subsidiary and increases its ownership interest in that subsidiary. That is, entities should apply the provisions of ASC Subtopic 810-10 for any increases in ownership of a subsidiary in which an entity has a controlling financial interest before and after the transaction.
regardless of whether the subsidiary is a business, nonprofit activity, in-substance real estate, or oil- and gas-producing activity (i.e., such transactions are accounted for within equity).

DECREASES IN OWNERSHIP OF A SUBSIDIARY OR A GROUP OF ASSETS THAT CONSTITUTE A BUSINESS OR NONPROFIT ACTIVITY

15.030 Transactions that involve a group of assets not in the form of a legal entity, but that meet the definition of a business, are within the scope of ASC Subtopic 810-10. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.) Therefore, the partial sale and deconsolidation provisions apply to groups of assets and subsidiaries that are businesses and nonprofit activities (even when those assets or nonprofit activities are not within a separate legal entity), unless those activities are in-substance real estate or oil- and gas-producing activities (see Paragraphs 15.033 through 15.035 for additional details).

15.031 Decreases in ownership of subsidiaries that are not businesses or nonprofit activities generally are not in the scope of the decrease-in-ownership requirements of ASC Subtopic 810-10. Instead, entities apply other accounting guidance such as accounting for transfers of financial assets, exchanges of nonmonetary assets, revenue recognition, sales of in-substance real estate, or oil- and gas-producing activities. Entities are required to evaluate the substance of the transaction and apply the applicable accounting guidance.

15.032 For a discussion of the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets that constitute a business or nonprofit activity, see subsection under Disclosures of Noncontrolling Interests, beginning at Paragraph 15.164.

DECREASES IN OWNERSHIP OF SUBSIDIARIES THAT ARE IN-SUBSTANCE REAL ESTATE OR OIL- AND GAS-PRODUCING ACTIVITIES

15.033 The scope of ASC Subtopic 810-10 excludes transactions involving the decrease in ownership of a subsidiary that is in-substance real estate. These transactions are accounted for in accordance with ASC Subtopic 976-605 and Section 360-20-40, which contain criteria for determining the method and timing of profit recognition on sales of real estate including partial sale transactions. The scope exception was provided because there is a conflict between the requirements of ASC Subtopic 976-605 and Section 360-20-40 and ASC Subtopic 810-10 for transactions resulting in the decrease in ownership of a subsidiary that is in-substance real estate. ASC Subtopic 976-605 and Section 360-20-40 apply to both direct investments in real estate and to investments in subsidiaries that are in-substance real estate.

15.034 To illustrate the different accounting consequences of the two Topics, assume a parent entity owns a 100% interest in a subsidiary that in-substance is an investment in real estate and sells a 60% interest in the 100%-owned subsidiary to a third party and
thereby losing control, partial gain recognition could still result under ASC Subtopic 976-605 and Section 360-20-40, but ASC Subtopic 810-10 would result in the deconsolidation of the subsidiary and 100% gain recognition.

15.035 The decrease-in-ownership guidance also provides a scope exception for oil- and gas-producing activities, regardless of whether those activities involve transactions that are businesses. Those transactions are accounted for in accordance with the industry-specific guidance applicable to oil- and gas-producing entities, such as ASC Subtopic 932-360, Extractive Activities—Oil and Gas - Property, Plant, and Equipment. The FASB included this scope exception because the decrease-in-ownership guidance in ASC Subtopic 810-10 would otherwise conflict with industry-specific guidance for oil- and gas-producing activities when there is continuing involvement and recognition of an immediate gain or loss could be prohibited by the industry-specific guidance.

15.036 Paragraph not used.

TRANSFER OF A SUBSIDIARY OR GROUP OF ASSETS THAT IS A BUSINESS OR NONPROFIT ACTIVITY TO AN EQUITY METHOD INVESTEES OR JOINT VENTURE

15.037 ASC Subtopic 810-10 applies to transactions in which an entity transfers an interest in a subsidiary or group of assets that constitutes a business, other than a subsidiary or group of assets that is in-substance real estate or oil- and gas-producing activities, to an equity method investee (including a joint venture) that results in loss of control of that subsidiary. For example, assume Company A has a 100% interest in a subsidiary that is a business and transfers the 100% interest in the subsidiary to Company A’s equity method investee, of which Company A currently owns a 30% interest, for cash. Under ASC Subtopic 810-10 the entire gain or loss is recognized because the transfer led to Company A’s loss of control and deconsolidation of the subsidiary. In contrast, if the transfer of a group of assets or subsidiary is not in the scope of ASC Subtopic 810-10, ASC Topic 323 requires that the gain or loss on the portion of the subsidiary retained through ownership of the equity method investee (i.e. the 30% interest) would not be recognized until the gain or loss has been realized through transactions outside of the group (i.e. with a third party).

15.038 Paragraph not used.

15.039 The transfer of a subsidiary or group of assets that constitutes a business, other than a subsidiary or group of assets that is in-substance real estate or oil- and gas-producing activities, in exchange for an interest in either an equity-method investee or joint venture is within the scope of ASC Subtopic 810-10. Accordingly, an entity is required to recognize the full gain in earnings, and the residual interest in the equity method investee or joint venture is measured at fair value (see Paragraphs 15.024 – 15.026).
TRANSFER OF A SUBSIDIARY OR GROUP OF ASSETS THAT IS NOT A BUSINESS OR NONPROFIT ACTIVITY TO AN EQUITY METHOD INVESTEE OR JOINT VENTURE

15.040 ASC paragraphs 845-10-30-25 through 30-25A provide that for an exchange of a nonmonetary asset (e.g., a subsidiary or group of assets that does not constitute a business and is not in-substance real estate or an oil- and gas-producing activity) for a noncontrolling ownership interest in a second entity, the new ownership interest received is accounted for using the equity method with partial gain (or loss) recognition applying (ASC paragraph 845-10-30-26). As such, in transactions that involve the transfer of a subsidiary or group of assets that does not constitute a business in exchange for a noncontrolling interest in another entity (e.g., an equity-method investment), partial gain recognition would be applied and the ownership interest received would be partially based on its fair value at the exchange date and partially based on the carryover amount of the subsidiary or group of assets surrendered. Furthermore, an exchange of a subsidiary or group of assets that does not constitute a business and is transferred to an investor’s existing equity-method investee for cash also is within the scope of ASC Topic 323, whereby partial gain recognition is required. Lastly, for transfers of a subsidiary or group of assets that does not constitute a business to a joint venture, investors should continue to account for these transfers under the accounting guidance in ASC Subtopics 845-10 and 970-323, whereby carryover basis of the transferred interest usually is required and gain recognition is permitted only in limited circumstances.

15.040a ASU 2017-05 supersedes the guidance in ASC Topic 845 on exchanges of a nonmonetary asset for a noncontrolling ownership interest in another entity. Entities with transactions that were previously accounted for under that guidance will need to determine the applicable guidance. See paragraphs 15.040b through 15.040i for a discussion of the scope after ASU 2017-05.

SCOPE OF GUIDANCE ON ACCOUNTING FOR DECREASES IN OWNERSHIP OF A SUBSIDIARY AFTER ADOPTION OF ASU 2014-09 AND ASU 2017-05

ASC Paragraph 810-10-40-3A (as amended)

The deconsolidation and derecognition guidance in [ASC] Section [810-10-40] applies to the following:

a. A subsidiary that is a nonprofit activity or a business, except for either of the following:
   1. Subparagraph superseded by Accounting Standards Update 2017-05.
   2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see [ASC] Subtopic 932-360).
3. A transfer of a good or service in a contract with a customer within the scope of [ASC] Topic 606.

b. A group of assets that is a nonprofit activity or a business, except for either of the following:

1. Subparagraph superseded by Accounting Standards Update 2017-05.
2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see [ASC] Subtopic 932-360).
3. A transfer of a good or service in a contract with a customer within the scope of [ASC] Topic 606.

c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other [ASC] Topics that include, but are not limited to, all of the following:

1. [ASC] Topic 606 on revenue recognition
2. [ASC] Topic 845 on exchanges of nonmonetary assets
3. [ASC] Topic 860 on transferring and servicing financial assets
4. [ASC] Topic 932 on conveyances of mineral rights and related transactions
5. [ASC] Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets

15.040b The scope exceptions specified in ASC paragraph 810-10-40-3A do not affect transactions in which an entity has a controlling financial interest in a subsidiary and increases its ownership interest in that subsidiary. That is, entities should apply the provisions of ASC Subtopic 810-10 for any increases in ownership of a subsidiary in which an entity has a controlling financial interest before and after the transaction, regardless of whether the subsidiary is a business, nonprofit activity, nonfinancial asset, or oil- and gas-producing activity (i.e. such transactions are accounted for within equity).

DECREASES IN OWNERSHIP OF A SUBSIDIARY OR A GROUP OF ASSETS THAT CONSTITUTE A BUSINESS OR NONPROFIT ACTIVITY

15.040c The deconsolidation and derecognition guidance in ASC Subtopic 810-10 applies to a subsidiary, or group of assets, that is a nonprofit activity or a business, except for a conveyance of oil and gas mineral rights (see Paragraph 15.044d) or a transfer of a good or service in a contract with a customer within the scope of ASC Topic 606. Therefore, the partial sale and deconsolidation provisions apply to those transactions even when the assets or nonprofit activities are not within a separate legal entity.

15.040d On adoption of ASU 2014-09 and ASU 2017-05, the new definition of a business in ASU 2017-01 is required to be applied. For additional information, see Paragraph 2.025.
DECREASES IN OWNERSHIP OF SUBSIDIARIES THAT ARE OIL- AND GAS-
PRODUCING ACTIVITIES

15.040e The decrease-in-ownership guidance provides a scope exception for oil- and gas-
producing activities, regardless of whether those activities involve transactions that are
businesses. Those transactions are accounted for in accordance with the industry-specific
guidance applicable to oil- and gas-producing entities, such as ASC Subtopic 932-360,
Extractive Activities—Oil and Gas - Property, Plant, and Equipment. The FASB included
this scope exception because the decrease-in-ownership guidance in ASC Subtopic 810-
10 would otherwise conflict with industry-specific guidance for oil- and gas-producing
activities when there is continuing involvement and recognition of an immediate gain or
loss could be prohibited by the industry-specific guidance.

TRANSFER OF A SUBSIDIARY OR GROUP OF ASSETS THAT IS NOT A BUSINESS
OR NONPROFIT ACTIVITY

15.040f The guidance applied to the decreases in ownership of a subsidiary or group of
assets that is not a business or non-profit activity depends on the nature of the assets
transferred and whether the counterparty is considered a customer. The entity applies
other guidance such as ASC Subtopic 610-20 for nonfinancial assets (including in-
substance nonfinancial assets), ASC Topic 860 for financial assets, ASC Topic 845 for
nonmonetary transactions or ASC Subtopic 932 for conveyances of mineral rights and
related properties. ASC Subtopic 810-10 still applies to the decrease in ownership of a
subsidiary when no other guidance applies to the transaction, even if the subsidiary is not
a business.

15.040g The transfer to a noncustomer of nonfinancial assets, in-substance nonfinancial
assets, or a subsidiary that holds only nonfinancial assets or in-substance nonfinancial
assets is in the scope of ASC Subtopic 610-20. See KPMG’s Revenue: Real estate for
further discussion of partial sale transactions in the scope of ASC Subtopic 610-20.

15.040h Entities are required to recognize a full gain or loss on a partial sale transaction
in the scope of ASC Subtopic 610-20. The retained noncontrolling interest is treated as
noncash consideration received and is remeasured to fair value. A noncontrolling interest
in another entity obtained in the exchange also would be measured at fair value. This
applies even if the retained investment or the newly acquired investment is an interest in
a joint venture.

15.040i ASU 2017-05 amended the guidance in ASC Subtopic 323 to require an entity to
recognize a full gain or loss in earnings when it transfers control of a distinct nonfinancial
asset to an equity method investee (including joint ventures). That is, the requirements in
ASC Topic 323 to eliminate a gain or loss on the portion of the nonfinancial asset or
subsidiary retained through ownership of the equity method investee do not apply to
transactions in the scope of ASC Subtopic 610-20.
ACCOUNTING BY VENTURE FOR JOINT VENTURE FORMATIONS (NEW BASIS OR CARRYOVER BASIS)

15.041 As discussed in Paragraph 1.011, the formation of a joint venture is excluded from the scope of ASC Topic 805. As a result, there have been questions in practice related to the accounting by the joint venture for contributions received from the joint venture investors. With the exception of the AICPA Issues Paper Joint Venture Accounting (7/17/79) and certain SEC guidance, there has been minimal authoritative guidance for the accounting by the joint venture itself. Historical practice has been that a joint venture generally recognized contributions at the investor’s basis (i.e., carry-over basis), unless certain conditions were met (e.g., an investor’s cash contribution that remains in the joint venture). However, based on the AICPA Issues Paper, nonpublic companies may adopt a policy using either fair value or carry-over basis. As further described in Paragraph 1.011, ASC Topic 805 should be applied to transactions where businesses are contributed to a jointly controlled entity that does not meet the definition of joint venture (in which case the other approaches described in this paragraph would not apply).

15.042 At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member acknowledged that the amendments to investor accounting in ASU 2010-02, Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification, raised questions about the joint venture’s accounting for contributions from the investors.1 While the SEC staff did not provide specific views about how the changes to investor accounting under ASU 2010-02 might affect the accounting by the joint venture, the SEC staff did acknowledge that there may be more instances in which it would be appropriate for the joint venture to record the contributions at fair value.

15.043 Based on informal discussions with the SEC staff, we understand that the SEC staff would not object if a joint venture recognized at fair value contributions by investors that are within the scope of ASC Subtopic 810-10 (see Paragraphs 15.027 through 15.040i). We believe this view is supported because a change-in-control event has occurred and therefore the investors recognize the contributed assets (businesses) at fair value before contributing to the joint venture. Accordingly, the investors’ basis is fair value to be carried over by the joint venture.

Contributions of Nonmonetary Assets that Are Not Businesses

15.044 We understand that the SEC staff would object to a joint venture recognizing at fair value contributions by investors that are outside the scope of the fair value provisions in ASC Subtopic 810-10 (e.g., groups of assets that do not constitute businesses). In those instances, companies should continue to follow the SEC staff’s historical practice for joint ventures (investor’s carry-over basis), unless certain conditions are met (e.g., an investor’s cash contribution that remains in the joint venture). This is due to the fact that the transfer of a subsidiary or group of assets that does not constitute a business in exchange for an interest in a joint venture is outside the scope of the fair value provisions of ASC Topic 810-10 for an investor. Consequently, the rationale described above
(Paragraph 15.043) for fair value treatment at the joint venture level would not apply for such transactions. It is possible that a joint venture could have a mixed accounting model with some of the contributed assets recognized at fair value (i.e., contributed assets constituting a business) and other contributed assets recognized at the investor’s carry-over basis (i.e., the contributed assets do not constitute a business).

**SELLER ACCOUNTING FOR CONTINGENT CONSIDERATION**

15.045 ASC Topic 805 addresses the acquirer’s accounting for contingent consideration transferred to a seller (i.e., former parent of the subsidiary) in a business combination. ASC Topic 805 requires an acquirer to recognize the acquisition-date fair value of any contingent consideration as part of the total consideration transferred to the seller in exchange for the acquiree. However, ASC Topic 805 does not address the seller’s accounting for contingent consideration received in the sale of a business.

15.046 Before ASC Topic 805 and ASC Subtopic 810-10, sellers generally accounted for contingent consideration when the contingency was resolved and the consideration was received or receivable, following the contingent gain accounting guidance in ASC Topic 450, *Contingencies*, unless the contingent consideration was within the scope of ASC Topic 815, *Derivatives and Hedging*, and accounted for as a derivative.

15.047 ASC Subtopic 810-10 requires a parent that loses a controlling financial interest and deconsolidates a subsidiary (see Paragraphs 15.027 through 15.040i) to recognize a gain or loss measured as the difference between (a) the sum of the fair value of “any consideration received,” the fair value of a retained investment in the former subsidiary, and the carrying amount of any noncontrolling interests in the former subsidiary, and (b) the carrying amount of the former subsidiary’s assets and liabilities. The inclusion of “any consideration received” raised the question of how a seller in a business combination should measure contingent consideration in the sale of a subsidiary.

15.048 In June and September 2009, the EITF was asked to address the seller’s accounting for the initial and subsequent measurement of contingent consideration. The Task Force discussed whether contingent consideration should initially be measured by a former parent at fair value as part of the consideration received to sell a subsidiary, or if a seller should continue to follow the contingent gain accounting guidance in ASC Topic 450. The Task Force acknowledged that until the issue is addressed, there may be diversity in practice in how sellers in a business combination account for contingent consideration. We also acknowledge that there may be diversity in practice depending on how companies interpret the provisions of ASC Subtopic 810-10 related to contingent consideration and any consideration received. In any event, however, companies should be consistent in their approach and provide sufficient disclosures for such transactions in order to help financial statement users understand the seller’s accounting treatment for contingent consideration.
WHETHER TO COMBINE MULTIPLE TRANSACTIONS

ASC Paragraph 810-10-40-6

A parent may cease to have a controlling financial interest in a subsidiary through two or more arrangements (transactions). Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

a. They are entered into at the same time or in contemplation of one another.
b. They form a single transaction designed to achieve an overall commercial effect.
c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
d. One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

15.049 The requirement for a parent to determine whether it should account for multiple arrangements as a single transaction is included in ASC Subtopic 810-10 because the requirement for a parent to recognize a gain or loss when a subsidiary is deconsolidated could motivate it to structure a transaction or arrangement into multiple steps to maximize gains or minimize losses. This possibility is illustrated in the following example, which is based on the discussion in paragraph B56 of Statement 160.

Example 15.11: Multiple Transactions

Parent Co. has a controlling financial interest in Subsidiary A by owning 70% of its ownership interests. Parent Co. intends to sell all of its 70% interest in Subsidiary A. Parent Co. could initially sell 19% of its ownership interest in Subsidiary A without loss of control and then, soon afterwards, sell the remaining 51% and lose control. Alternatively, Parent Co. could sell all of its 70% interest in Subsidiary A in one transaction. In the first case, unless the transactions are determined to be linked, the gain or loss on the sale of the 19% interest would be recognized in equity, whereas the gain or loss from the sale of the remaining 51% interest would be recognized in net income. In the second case, the whole amount of the gain or loss on the sale of the 70% interest would be recognized in net income.

15.050 The FASB noted that the opportunity to conceal losses through structuring this type of transaction is reduced by the requirements of ASC Topic 350, Intangibles—Goodwill and Other, which requires testing for impairment of goodwill, and ASC Topic
360, Property, Plant, and Equipment, which requires testing for the impairment of long-lived asset groups in certain circumstances, including when there is a current expectation that it is more likely than not that an asset group will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. When it is more likely than not a parent will sell all or a portion of its ownership interest in a transaction that will result in a loss of control of the subsidiary, impairment testing of the goodwill and long-lived assets of that subsidiary must be performed, and any related loss must be recognized, before the accounting for the loss of control of that subsidiary.

15.051 The FASB concluded that the principal risk is minimizing gains, which entities are unlikely to try to do. In any event, it decided that the possibility of structuring could be overcome by requiring entities to consider whether multiple arrangements should be accounted for as a single transaction.

15.052 The guidance in ASC Subtopic 810-10 on linkage provides a list of indicators to be considered, rather than detailed examples. In some instances, it will be clear that a series of transactions are linked and should be accounted for as a single transaction, while in other instances it may not be clear and considerable judgment will be required in making the determination. In general, we believe that the less time there is between transactions the more likely it is that the transactions should be combined for accounting purposes.

OTHER ASPECTS

EARNINGS PER SHARE CONSIDERATIONS

15.053 Although amounts for both the parent and the noncontrolling interest are reported in consolidated net income, the FASB concluded that the presentation of earnings-per-share data is for the benefit of the parent’s shareholders. Accordingly, ASC Topic 260 provides that earnings-per-share data is calculated based on amounts attributable to the parent’s owners. See illustration in Example 15.26, taken from ASC paragraphs 810-10-55-4H through 55-4M, of the presentation of earnings-per-share when there are noncontrolling interests.

STATEMENT OF CASH FLOWS

15.054 For guidance on presenting transactions with noncontrolling interests in the statement of cash flows, see chapter 18 of KPMG's Handbook, Statement of cash flows.

15.055-15.059 Not used.
TRANSLATION OF FOREIGN CURRENCY – SALE, EXCHANGE, OR LIQUIDATION OF AN INVESTMENT IN A FOREIGN ENTITY

15.060 The following represents selected guidance from KPMG’s Guide to Accounting for Foreign Currency (Section 4.1), related to certain transactions accounted for under ASC Subtopic 810-10 and ASC Topic 830.

COMPLETE SALE OR SUBSTANTIAL LIQUIDATION OF AN INVESTMENT IN A FOREIGN ENTITY

15.061 Translation adjustments reported in accumulated other comprehensive income can be viewed as unrealized gains or losses. According to ASC paragraph 830-30-40-1, the amount attributable to a foreign entity included in the translation adjustment component of accumulated other comprehensive income in stockholders’ equity should be reported as part of the gain or loss upon the complete sale or on complete or substantially complete liquidation of that foreign entity. Accordingly, accounting records should be maintained in a manner that will allow the identification of that portion of the cumulative translation adjustment that relates to each investment, particularly foreign entities, because the amount related to each investment should be reported in the income statement as part of the gain or loss on sale or liquidation of the investment.

15.062 The cumulative translation adjustment that is a part of the net gain or loss on the complete sale or on complete or substantially complete liquidation of an investment in a foreign entity should be reported in the income statement in the same period in which the gain or loss on sale or liquidation is recognized under generally accepted accounting principles. ASC paragraph 830-30-40-4 indicates that this provision of ASC Topic 830 does not alter the period in which a gain or loss on disposal of part or all of a net investment is recognized under generally accepted accounting principles. Accordingly, if an entity expects a loss on the disposal of a foreign entity, it should report the portion of the cumulative translation adjustment that relates to that foreign entity in the income statement as part of the loss on disposal in the same period it reports the transaction in the income statement. This requirement was confirmed in ASC paragraphs 830-30-45-13 through 45-15.

SALE OF PART OF AN INVESTMENT IN A CONSOLIDATED FOREIGN ENTITY

15.063 Entities should follow the guidance in ASC Subtopic 810-10 to determine the accounting for translation adjustments reported in accumulated other comprehensive income when an entity sells part of its ownership interest in a consolidated foreign entity. Under ASC Subtopic 810-10, the accounting treatment for the translation adjustment is determined based on whether or not the parent retains a controlling financial interest in the foreign entity on completion of the partial sale.

15.064 If the parent retains a controlling financial interest in the foreign entity after the partial sale, the parent would account for the sale as an equity transaction under ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be
recognized in earnings. Accordingly, ASC paragraph 830-30-40-3 states that no cumulative translation adjustment is released into net income for a partial sale when the parent retains a controlling financial interest. In these situations, we believe that a pro rata share of the cumulative translation adjustment related to the interest sold should be transferred from the cumulative translation adjustment account reported in accumulated other comprehensive income to the noncontrolling interest account at the time of the sale. Reclassifying a pro rata share of the translation adjustment account to the noncontrolling interest account at the time of the sale is consistent with (a) the guidance in ASC paragraph 810-10-45-23, which indicates that transactions where the parent retains control are equity in nature (e.g., movement in translation adjustments should be between equity accounts) and (b) the accounting under ASC Subtopic 810-10 of allocating accumulated other comprehensive income (including translation adjustment) accounts between the controlling interest and noncontrolling interests during each reporting period going forward.

15.065 In situations where the parent does not retain a controlling financial interest in the foreign entity as a result of a partial sale, the parent would deconsolidate the foreign entity in accordance with ASC paragraph 810-10-40-5 and record a gain or loss related to (1) the retained interest held by the parent in the foreign entity and (2) the equity interest that was sold. Accordingly, the entire balance within the parent's cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of sale because the parent no longer has control in accordance with ASC paragraph 810-10-40-4A, regardless of whether or not the parent has significant influence over the foreign entity.

OTHER EVENTS THAT MAY RESULT IN THE LOSS OF A CONTROLLING FINANCIAL INTEREST OF AN INVESTMENT IN A FOREIGN ENTITY

15.066 In addition to the sale of all or part of its ownership interest, ASC paragraphs 810-10-15-10 and 55-4A describe other circumstances that may preclude consolidation or result in the parent losing its controlling financial interest in a foreign subsidiary. The examples include:

- Subsidiaries in legal reorganization or bankruptcy;
- The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary;
- Cases where the powers of a shareholder with a majority voting interest are restricted by certain approval or veto rights held by minority shareholders;
- The expiration of a contractual arrangement that provided the parent with a controlling financial interest;
- Issuance of shares by the subsidiary that dilutes the parent’s ownership interest so that the parent no longer has a controlling financial interest;
- Situations where the subsidiary becomes subject to the control of a government, court, administrator, or regulator.

15.067 When the parent does not retain a controlling financial interest in the foreign entity because, for example, of one of the reasons described in Paragraph 15.066, it would deconsolidate the foreign entity and record a gain or loss in accordance with ASC paragraph 810-10-40-5 if the foreign entity is in the scope of ASC Subtopic 810-10 (see Paragraphs 15.027 through 15.040i). Even though the parent does not sell any of its equity interests in the foreign entity in these situations, any translation adjustment balance within the parent’s cumulative translation adjustment account related to the foreign entity being deconsolidated should be recognized in earnings at the time of deconsolidation in accordance with ASC paragraph 810-10-40-4A because the parent no longer has control.

Q&A 15.3: Initial Public Offering of Shares in a Foreign Subsidiary

Q. How should an entity account for the cumulative translation adjustment when there is an initial public offering of stock in a foreign subsidiary?

A. As discussed in Paragraph 15.065, if the entity retains a controlling financial interest in the foreign subsidiary after the transaction, the parent would account for the IPO as an equity transaction under ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be recognized in earnings. In accordance with ASC paragraph 830-30-40-3, it would be inappropriate to recognize any of the cumulative translation adjustment in earnings at the time of sale because the enterprise retains a controlling financial interest in the foreign subsidiary after the transaction.

In situations where the entity does not retain a controlling financial interest in the foreign subsidiary as a result of an IPO, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss related to (1) the retained interest it holds in the foreign subsidiary and (2) the equity interest that was sold. In accordance with ASC paragraph 810-10-40-4A, the entire balance within the entity’s cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of sale, because the entity no longer has control (regardless of whether or not the parent has significant influence over the foreign subsidiary).

Example 15.12: Loss of Control on a Foreign Subsidiary’s Bankruptcy Filing

ABC Corp. (U.S. dollar functional currency entity) owns a 100% equity interest in Subsidiary X (Philippine peso functional currency entity) as of December 31, 20X1. Subsequent to year end, Subsidiary X files for bankruptcy in its local jurisdiction. As a result of the filing, the bankruptcy court, rather than management of ABC, has control over all operational and strategic decisions of Subsidiary X. ASC paragraph 810-10-55-4A states that deconsolidation is required when “…the subsidiary becomes subject to the
control of a government, court, administrator, or regulator.” ASC paragraph 810-10-15-10 indicates that controlling financial interests may not exist if a subsidiary is in bankruptcy or legal reorganization. Because ABC no longer holds a controlling financial interest after the bankruptcy filing (even though it still holds a 100% equity interest in Subsidiary X), management deconsolidates Subsidiary X and records a gain or loss pursuant to ASC paragraph 810-10-40-5. At the time of the bankruptcy filing, ABC has a cumulative translation gain of $1,000,000 in its cumulative translation adjustment account related to Subsidiary X.

In this example, the entire cumulative translation gain of $1,000,000 within ABC’s cumulative translation adjustment account should be recognized in earnings at the time of deconsolidation in accordance with ASC paragraph 810-10-40-4A because ABC no longer has control, even though it retains a 100% equity interest in Subsidiary X.

SALE OF, OR PART OF, AN EQUITY METHOD INVESTMENT IN A FOREIGN ENTITY

15.068 Under ASC paragraph 830-30-40-2, if an entity sells part of its equity method investment in a foreign entity, a pro rata portion of the cumulative translation adjustment attributable to that investment should be recognized in measuring the gain or loss on sale.

15.069 As discussed in Paragraph 15.061, if the entity sells its entire equity method investment in a foreign entity, it recognizes all of the cumulative translation adjustment balance attributable to that investment in measuring the gain or loss on sale. Based on the guidance in ASC paragraph 830-30-40-1A, the sale of an investment in a foreign entity includes events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (also referred to as a step acquisition). Accordingly, any cumulative translation adjustment related to an equity method investment that is a foreign entity would be released into earnings as part of the gain or loss upon the acquirer obtaining control of the acquiree in a step acquisition.

15.070 ASC paragraph 323-10-40-1 states that an equity method investor should account for a share issuance by an investee as if the investor had sold a proportionate share of its investment and that any gain or loss associated with the share issuance should be recognized in earnings. In these situations, we also believe that the investor should recognize a pro rata portion of the cumulative translation adjustment attributable to the proportionate reduction in the investor's interest in measuring the gain or loss on sale.
Example 15.13: Sale of Part of an Equity Method Investment in a Foreign Entity When Significant Influence Is Retained

Company A (functional U.S. dollar entity) owns a 45% equity interest in Entity X (functional Philippine peso entity) as of December 31, 201X. While Company A lacks a controlling financial interest in Entity X, it has the ability to exercise significant influence over its operating and/or financial decisions.

Accordingly, Company A accounts for its investment using the equity method under ASC Topic 323. After year-end, Company A sells one-third of its equity interest in Entity X to Company B, which is an independent third party. Because Company A retains significant influence after the sale (i.e., it retains a 30% equity interest in Entity X), it continues to account for its investment under the equity method. At the time of the sale, Company A has a cumulative translation gain of $1,000,000 within the cumulative translation adjustment account related to the equity method investment.

In accordance with ASC paragraph 830-30-40-2, a pro rata portion of the accumulated translation adjustment attributable to Entity X should be recognized in earnings at the time of the sale. In this case, one-third of the cumulative translation adjustment balance, or $333,000, would be recognized in earnings.

Example 15.14: Sale of Part of an Equity Method Investment in a Foreign Entity When Significant Influence Is Not Retained

Assume the same facts as in Example 15.13, except that Company A only retains a 5% cost method investment in Entity X after the sale (i.e., Company A no longer has significant influence over Entity X). At the time significant influence is lost (e.g., upon the sale of its partial interest in Entity X), it would recognize a pro rata portion of the accumulated translation adjustment attributable to Entity X in earnings. In this case, Company A would recognize 88.9% (40%/45%) of the cumulative translation adjustment balance, or $889,000 in earnings. The remaining carrying amount of the investment under the equity method becomes the carrying amount under the cost method. When transitioning from equity method accounting to the cost method, ASC paragraph 323-10-35-39 requires Company A to offset the remaining $111,000 cumulative translation adjustment balance related to its investment in Entity X against the carrying amount of the investment (i.e., its cost method investment) at the time significant influence is lost. To the extent the offset (i.e., cumulative translation adjustment amounts) results in a carrying amount of the investment that is less than zero (i.e., the remaining cumulative translation adjustment balance is a credit amount greater than the cost method investment), Company A should (a) reduce the carrying amount of the investment to zero and (b) record the remaining amount in income.
SALE OF A FOREIGN ENTITY’S NET ASSETS

15.071 Parent entities may enter into transactions to sell a group of net assets within a consolidated foreign entity to an independent third party while retaining 100% equity interest in the subsidiary. In many cases, the disposition of the net asset group would not constitute a substantial liquidation of the foreign subsidiary (e.g., the net assets sold would be less than 90% of the foreign subsidiary’s net assets). However, if the group of net assets sold is in the scope of ASC Subtopic 810-10 (see Paragraphs 15.027 through 15.040i), the parent entity would derecognize the group of assets and record a gain or loss on the sale in accordance with ASC paragraph 810-10-40-5.

15.072 If the parent has a cumulative translation adjustment balance associated with the foreign entity, that the parent would need to determine whether the sale represents a complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided.

15.073 According to ASC paragraph 810-10-40-4A, when a parent ceases to have a controlling financial interest in a subsidiary or group of assets within a foreign entity, the parent is required to apply the guidance in ASC Subtopic 830-30 to determine whether to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. If the sale does not represent a complete or substantially complete liquidation of a foreign entity, then no amount of the cumulative translation should be released into earnings.

Example 15.15: Exchange of Net Assets within a Foreign Entity for an Interest in a Joint Venture or Equity Method Investment

Background. ABC Corp. (U.S. dollar functional currency entity) owns a 100% equity interest in Subsidiary X (Philippine peso functional currency entity) as of December 31, 20X1. Subsequent to year end, ABC exchanges a group of net assets within Subsidiary X that constitutes a business for an interest in a joint venture or equity method investment for which ABC is one of the owners. ABC retains a 100% equity interest in Subsidiary X subsequent to the net asset sale. Additionally, the net assets sold comprise approximately 25% of Subsidiary X’s total net assets and therefore the exchange does not constitute a substantial liquidation of the investment in Subsidiary X as contemplated in ASC paragraph 830-30-40-1. Upon the exchange and resulting derecognition of the assets and liabilities sold, ABC recognizes a gain or loss related to the portion of Subsidiary X’s total net assets transferred in net income in accordance with ASC paragraph 810-10-40-5. At the time of the exchange, ABC has a cumulative translation gain of $1,000,000 within its cumulative translation adjustment account related to Subsidiary X’s operations.

Q. How should ABC account for the $1,000,000 cumulative translation gain at the time of the exchange of the group of net assets in Subsidiary X for an interest in a joint venture or equity method investment?
A. ABC would not release any cumulative translation adjustment into net income because the sale of net assets within Subsidiary X does not represent a complete or substantially complete liquidation of Subsidiary X.

EXCHANGE OF INVESTMENTS IN FOREIGN ENTITIES

15.074 Entities may enter into transactions to exchange an investment in a consolidated foreign entity or a foreign entity accounted for by the equity method for a controlling or noncontrolling equity interest in another entity. The transaction’s specific facts and circumstances should be evaluated to determine whether the cumulative translation adjustment balance attributable to the investment exchanged should be (1) recognized in earnings or (2) transferred from the cumulative translation adjustment account to the noncontrolling interests account at the time of the exchange. The accounting treatment for the cumulative translation adjustment balance is dependent on many factors, including whether the entity retains a controlling financial interest in the investment exchanged subsequent to the transfer. The scenarios below illustrate the accounting for the cumulative translation adjustment balance on the exchange of the investment in the consolidated subsidiary or equity method investment for a controlling or noncontrolling interest in another entity. The accounting for other transactions involving the exchange of investments in foreign entities will depend on the facts and circumstances.

- **Exchange of a Consolidated Foreign Subsidiary for a Controlling Financial Interest in an Unrelated Entity.** A parent exchanges its controlling equity interest in an unrelated entity that conducts either the same or a different line of business and the parent has no direct or indirect ownership in the previously controlled foreign subsidiary after the transfer. Because the parent no longer has a controlling financial interest in the foreign subsidiary, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss. Where control of a subsidiary is lost, the parent should recognize the entire balance within its cumulative translation adjustment account related to the foreign subsidiary in earnings at the time of exchange in accordance with ASC paragraph 810-10-40-4A.

- **Exchange of a Consolidated Foreign Subsidiary for a Controlling Financial Interest in the Entity to Which the Foreign Subsidiary Was Transferred.** A parent exchanges its controlling equity interest in a foreign subsidiary for a 60% controlling financial equity interest in the entity to which the foreign subsidiary was transferred. This entity may conduct the same or a different line of business from the parent. Because the parent retained a controlling financial interest in the foreign subsidiary after the exchange, it would account for the exchange as an equity transaction pursuant to ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be recognized in earnings. As discussed in Paragraph 15.063, we believe that a pro rata share of the cumulative translation adjustment attributable to the noncontrolling interests (in this case, 40%) should be transferred from the cumulative translation adjustment account reported in
accumulated other comprehensive income to the noncontrolling interest account at the time of the exchange.

- **Exchange of a Consolidated Foreign Subsidiary for a Noncontrolling Financial Interest in the Entity to Which the Foreign Subsidiary Was Transferred.** A parent exchanges its controlling equity interest in a foreign subsidiary for a 40% noncontrolling equity interest in the entity to which the foreign subsidiary was transferred. Because the parent no longer has a controlling financial interest in the foreign subsidiary, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss. As discussed in Paragraph 15.063, the entire balance within the parent’s cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of exchange because the parent no longer has control of the former subsidiary.

- **Exchange of an Equity Method Investment in a Foreign Entity for an Equity Method Investment in an Unrelated Entity.** An investor exchanges its equity method investment in a foreign entity for a different equity method investment held by an unrelated third party and the parent will have no continuing involvement or ownership in the investment exchanged. Additionally, all requirements of ASC Topic 860 for sale accounting treatment have been met. Because the parent has no remaining interest in the equity method investment exchanged, we believe it should recognize the entire balance within its cumulative translation adjustment account related to the equity method investment in earnings at the time of exchange.

**Example 15.16: Contribution of Foreign Operations to a Consolidated Variable Interest Entity**

**Background.** Company A (U.S. dollar functional currency entity) owns a 100% equity interest in Subsidiary X (Philippine peso functional currency entity) as of December 31, 20X1. For various business reasons, Company A contributes 100% of the outstanding equity interests in Subsidiary X to a third-party entity (ABC Corp.). After considering the guidance in ASC Subtopic 810-10, Company A determines that ABC Corp. is a variable interest entity and that it is the primary beneficiary and would therefore be required to consolidate ABC. Generally, ASC paragraph 810-10-30-1 requires the primary beneficiary of a VIE to measure the assets, liabilities and noncontrolling interests of a VIE at their fair values on initial consolidation. However, ASC paragraph 810-10-30-3 states that the primary beneficiary should “…measure assets and liabilities that is has transferred to the VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers.” After considering this guidance, Company A does not recognize a gain or loss on the transfer of Subsidiary X to ABC Corp. because it retained control of the subsidiary by virtue of being ABC’s primary beneficiary. At the time of the transfer, Company A has a cumulative translation gain of $1,000,000 within its
cumulative translation adjustment account related to Subsidiary X’s operations.

Q. How should Company A account for the $1,000,000 cumulative translation gain within its cumulative translation adjustment account at the time that Subsidiary X is transferred to ABC Corp?

A. We believe that the entire cumulative translation gain within Company A’s cumulative translation adjustment account, even though Company A transferred its 100% equity interest in Subsidiary X, should remain in the cumulative translation adjustment account at the time of the transfer. ASC paragraph 830-30-40-1 states that on sale or a substantially complete liquidation, the amount remaining within the cumulative translation adjustment account should be recognized as part of the gain or loss recorded for the period in which the sale or liquidation occurs. However, because no gain or loss is being recognized on the transfer, we believe that it would be inappropriate to recognize the cumulative translation gain in earnings. Additionally, because Company A retains its controlling financial interest in Subsidiary X both before and after the transfer, this position is also consistent with ASC paragraph 810-10-45-23, which states that changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary are accounted for as an equity transaction with no gain or loss recognized.

We also believe that Company A should transfer the amount of the cumulative translation adjustment balance attributable to the noncontrolling interest holders from the cumulative translation adjustment account to the noncontrolling interests account at the time of the transfer. Allocating and reclassifying a pro rata share of the cumulative translation adjustment account to the noncontrolling interests account at the time of the sale (i.e., in this case, 100% of the cumulative translation adjustment balance or $1,000,000) is consistent with the guidance in ASC paragraph 810-10-45-23, which indicates that transactions where the parent retains control are equity in nature (e.g., movement in the cumulative translation adjustment balance should be between equity accounts). Furthermore, the fact that the cumulative translation adjustment balance relates to noncontrolling interests in a VIE does not affect the conclusion. As stated in ASC paragraph 810-10-35-3 “…the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests.”
Further, the redemption rights may represent a put right held by the noncontrolling interest holder or a combination of puts and calls. The strike price of the redemption feature may be a fixed amount, it may equal the fair value of the underlying noncontrolling interest shares, or it may vary based on a formula or other factors. In some circumstances, the intent of a redemption feature is to facilitate delivery of all of the shares to the controlling interest holder at a later date (i.e., a financing or delayed delivery mechanism) for liquidity, tax, or other reasons. In other circumstances, the redemption features represent a protective right granted to the noncontrolling interest holders and/or a method for the controlling interest holder to limit transferability of the noncontrolling interest (i.e., by requiring that any sale of noncontrolling interest shares be to the controlling interest holder or to the subsidiary).

15.076 ASC Subtopic 810-10 does not specifically address the accounting for redeemable noncontrolling interests that are required to be presented outside of permanent equity pursuant to ASC Section 480-10-S99 and related guidance, including ASC paragraph 480-10-S99-2.

15.077 Not used.

15.078 The discussion below provides guidance on the interaction between ASC Section 480-10-S99 and ASC Subtopic 810-10 for redeemable noncontrolling interests. There are also a number of examples illustrating the implementation of that guidance (see Examples Illustrating the Accounting for Redeemable Noncontrolling Interests, below). Additionally, supplemental guidance on accounting for noncontrolling interests of real estate investment trusts (REITs) that are potentially subject to ASC Section 480-10-S99 after adoption of ASC Subtopic 810-10 due to redemption/exchange rights that are present in typical umbrella partnership real estate investment trust (UPREIT) structures is detailed in Application of ASC Section 480-10-S99 to Redeemable Noncontrolling Interests of Certain Real Estate Entities, below.

DETERMINING WHETHER REDEEMABLE NONCONTROLLING INTERESTS SHOULD BE CLASSIFIED AS LIABILITIES OR AS EQUITY INSTRUMENTS

15.079 ASC Subtopic 810-10 does not impact the determination of whether redeemable noncontrolling interests should be classified as a liability or as an equity instrument. That determination can be complex, requires consideration of numerous pieces of accounting literature, and often involves significant judgment that depends on the facts and circumstances of the particular situation. The general framework for determining classification of a redeemable noncontrolling interest has been summarized in the five-step process described below. Steps 1 - 4 address whether redeemable noncontrolling interests should be classified as liabilities or equity and provide a high-level overview of existing guidance in ASC Topic 480, Distinguishing Liabilities from Equity, ASC paragraphs 480-10-55-53 through 55-63, and ASC Topic 815. Those steps are not affected by an entity’s adoption of ASC Subtopic 810-10. The remainder of the discussion below provides guidance on the application of ASC Section 480-10-S99 and related guidance to redeemable noncontrolling interests that are not classified as liabilities after adoption of ASC Subtopic 810-10 (Step 5).
15.080 Step 1: Evaluate whether the redemption feature is a freestanding financial instrument or is embedded in the noncontrolling interest shares.

15.081 If an entity concludes that a feature that requires (or may require) it to redeem a noncontrolling interest is a freestanding financial instrument (e.g., a freestanding put option on the noncontrolling interest shares), it should be accounted for as a liability under ASC paragraphs 480-10-25-8, 25-10, and 25-12 and is generally measured at fair value each period with changes in fair value reported in earnings.\(^2\) If the entity concludes that a feature that requires (or may require) it to redeem a noncontrolling interest is embedded in the noncontrolling interest shares, the analysis should proceed to Step 2.

\(^2\)Physically settled forward contracts to purchase a fixed number of the issuer’s equity shares in exchange for cash are measured at the present value of the amount to be paid at settlement. Those contracts are not considered derivative instruments for purposes of applying ASC Topic 815. See ASC paragraphs 480-10-35-3 and 815-10-15-74(d).

15.082 Determining whether a feature is freestanding or embedded may require significant judgment; entities should document their analysis and the rationale for their conclusion. Guidance on evaluating whether a feature is freestanding or embedded is provided in Section 6 of KPMG’s publication, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity: An Analysis of FASB Statement No. 150 (ASC Topic 480).

15.083 Some freestanding features to redeem noncontrolling interests that are classified as liabilities (or assets in some circumstances) under ASC Topic 480 are also derivative instruments and should be accounted for in accordance with ASC paragraphs 480-10-25-8, 25-10, and 25-12. Such derivative instruments are measured at fair value each period with changes in fair value reported in earnings. Fair value is also the subsequent measurement attribute for most instruments that are accounted for as liabilities under ASC paragraphs 480-10-25-8, 25-10, and 25-12. However, freestanding derivative instruments within the scope of ASC Topic 815 can be designated as hedging instruments in qualifying hedging relationships. Additionally, freestanding features to redeem noncontrolling interests that are derivative instruments within the scope of ASC Topic 815 are subject to the disclosure requirements of that Statement and its related interpretations.

15.084 Step 2: Evaluate whether the redeemable noncontrolling interests are mandatorily redeemable financial instruments within the scope of ASC Topic 480.

15.085 If an entity concludes that a redemption feature embedded in the noncontrolling shares causes those shares to be mandatorily redeemable financial instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6, then those noncontrolling interests should be accounted for as liabilities in accordance with that Statement. If the entity concludes that (a) the redemption feature does not cause the noncontrolling shares to be mandatorily redeemable financial instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6 or (b) the noncontrolling shares are mandatorily redeemable financial instruments but qualify for one of the indefinite deferrals specified in ASC paragraph 480-10-65-1, the analysis should proceed to Step 3.
An instrument issued in the form of a share is a *mandatorily redeemable* financial instrument if it embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. ASC paragraphs 480-10-25-4 and 25-6 require entities to classify mandatorily redeemable instruments as liabilities unless the redemption is required to occur only upon the liquidation or termination of the issuer. ASC Section 480-10-65 indefinitely defers the effective date of ASC Topic 480 for the following types of financial instruments:

(a) Mandatorily redeemable noncontrolling interests that are required to be redeemed only on liquidation or termination of the subsidiary that issued those instruments (this indefinite deferral applies to all entities, including SEC registrants); and

(b) Mandatorily redeemable financial instruments issued by non-SEC registrants that are not redeemable on fixed dates for amounts that are fixed or determined by reference to specified indices.

In effect, the indefinite deferrals described above provide a scope exception from the application of ASC Topic 480 for those instruments. Indefinite deferral (a) above applies to mandatorily redeemable noncontrolling interests *when redemption will only be required upon liquidation or termination of the subsidiary*: it does not scope out other mandatorily redeemable noncontrolling interests from the classification guidance in ASC Topic 480. However, ASC Section 480-10-65 does specify that the measurement guidance in ASC Topic 480 is indefinitely deferred for all mandatorily redeemable noncontrolling interests that were issued before November 5, 2003. In other words, a mandatorily redeemable noncontrolling interest issued before November 5, 2003 that will be redeemed *before* liquidation or termination of the subsidiary would be classified as a liability under ASC Topic 480, but would be measured each period based on the guidance in other applicable U.S. GAAP (e.g., ASC Subtopic 810-10).

Guidance on evaluating whether a share is a mandatorily redeemable financial instrument and whether an indefinite deferral in ASC Section 480-10-65 applies is provided in Sections 3 and 12, respectively, of KPMG’s Statement 150 (ASC Topic 480) Guide.

**Step 3: Evaluate whether the noncontrolling interests should be accounted for as debt obligations under ASC paragraphs 480-10-55-53 through 55-63.**

If an entity concludes in Step 3 that noncontrolling interest shares with embedded put and call options are subject to the guidance in ASC paragraphs 480-10-55-53 through 63, the noncontrolling interest should be accounted for as a debt obligation under that guidance. If the entity concludes in Step 3 that noncontrolling interest shares with embedded put and call options are not subject to the guidance in ASC paragraphs 480-10-55-53 through 55-63, the noncontrolling interest in its entirety should not be classified as a liability and the analysis should proceed to Step 4.

The original consensus continues to apply to transactions in which a controlling interest is obtained (or noncontrolling interests are issued) and the noncontrolling interests contain embedded put and call options with the following terms:
• The parent (or the subsidiary) has a call option to purchase the noncontrolling interest at a fixed price at a stated future date, and
• The noncontrolling interest holder has a put option to sell the noncontrolling interest to the parent (or the subsidiary) under those same terms.

15.092 For transactions with those characteristics, ASC paragraphs 480-10-55-53 through 55-63 require that the embedded put and call options be viewed on a combined basis with the noncontrolling interest and accounted for as a debt obligation. In those circumstances, ASC paragraphs 480-10-55-53 through 55-63 clarify that the resulting instrument is not a derivative subject to ASC Topic 815.

15.093 In some circumstances, it may be appropriate for a noncontrolling interest with embedded puts and calls to be classified as a debt obligation in its entirety based on the guidance in ASC paragraphs 480-10-55-53 through 55-63, even though the puts and calls may not have a fixed strike price or be exercisable at a stated future date. However, if the puts and calls are exercisable for a strike price equal to the then-current fair value of the underlying noncontrolling interest shares, classification of the noncontrolling interest as a debt obligation would not be appropriate. Judgment is required when evaluating whether the substance of the arrangement is a debt obligation and all relevant facts and circumstances should be considered in making that determination.

15.094 Step 4: Evaluate whether the embedded redemption feature should be separated from the noncontrolling interest and accounted for as a derivative under ASC Topic 815.

15.095 ASC paragraph 815-15-25-1 and its related interpretations provide guidance on determining whether embedded features should be separated from a host contract and accounted for as derivatives. Regardless of whether the embedded redemption feature is required to be separately accounted for as a derivative under ASC Topic 815, the analysis should proceed to Step 5.

15.096 Step 5: Apply ASC Section 480-10-S99 and related guidance.

The remainder of the guidance below and the accompanying illustrative examples address the application of ASC Section 480-10-S99 to redeemable noncontrolling interests and explain how that guidance interacts with ASC Subtopic 810-10.

CLASSIFICATION OF REDEEMABLE INSTRUMENTS UNDER ASC SECTION 480-10-S99 AND THE APPLICABILITY OF THAT GUIDANCE TO REDEEMABLE NONCONTROLLING INTERESTS

15.097 ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity in the balance sheet of an SEC registrant if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. ASC Section 480-10-S99 further clarifies that similar guidance applies to redeemable equity instruments other than preferred shares (e.g., common shares, noncontrolling interests, share-based payment arrangements, and certain other equity-related contracts), provided that those instruments are not classified as liabilities under ASC Topic 480 or other applicable U.S. GAAP. Consequently, equity-classified noncontrolling interests with embedded redemption features will continue to be
presented outside of permanent equity by SEC registrants, even after adoption of ASC Subtopic 810-10.

3 The terms stock or shares include various forms of ownership that may not take the legal form of securities (for example, partnership and LLC interests).

15.098 Some redeemable instruments, including some redeemable noncontrolling interests, may require or permit the entity to satisfy redemptions by delivering its own shares. For those instruments, the guidance in ASC paragraphs 815-40-25-7 through 25-35 should be used to evaluate whether the entity controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement of the contract (see ASC paragraph 480-10-S99-3A(6)). If an entity concludes, after evaluating the conditions in ASC paragraphs 815-40-25-7 through 25-35, that it has the ability to satisfy redemptions by delivering its shares, then the guidance in EITF D-98 would not apply. However, if an entity concludes that it does not control settlement by delivery of its own shares, cash settlement is assumed and the redeemable instruments would be subject to the guidance in EITF D-98. (See Application of ASC Section 480-10-S99 to Redeemable Noncontrolling Interests of Certain Real Estate Entities below, for additional discussion about the conditions in ASC paragraphs 815-40-25-7 through 25-35).

APPLICABILITY OF ASC SECTION 480-10-S99 AND RELATED GUIDANCE TO NON-SEC REGISTRANTS

Classification Guidance

15.099 Although classification of redeemable instruments outside of permanent equity under ASC paragraph 480-10-S99-2 and ASC Section 480-10-S99 is only required for SEC registrants, we believe it would generally be considered preferable for non-SEC registrants to follow an accounting policy of presenting redeemable equity instruments, including redeemable noncontrolling interests, outside of permanent equity. A non-SEC registrant’s presentation of redeemable noncontrolling interests within permanent equity or within temporary equity (i.e., in the mezzanine between liabilities and equity) is an accounting policy election.

Measurement Guidance

15.100 Except in circumstances in which redeemable instruments are required to be classified as liabilities under applicable guidance (e.g., Subtopic 480-10 and its related interpretations), U.S. GAAP does not provide guidance regarding the issuer’s measurement of those instruments for non-SEC registrants. We believe that it generally would be appropriate for non-SEC registrants to apply the measurement guidance contained in ASC Section 480-10-S99 and ASC paragraph 480-10-S99-2 to redeemable equity instruments, including redeemable noncontrolling interests, even if those instruments are classified within permanent equity on the entity’s balance sheet.

Measurement of Redeemable Noncontrolling Interests Subject to ASC Section 480-10-S99 and Related Guidance after Adoption of ASC Subtopic 810-10

Initial Measurement of Redeemable Noncontrolling Interests Recognized in a Business Combination
15.101 Under ASC Section 480-10-S99, the initial measurement of a redeemable equity instrument (including a redeemable noncontrolling interest) is its fair value at the date of issue. That initial measurement attribute is consistent with the initial measurement of noncontrolling interests in a business combination that is consummated after adoption of ASC Topic 805 (see additional discussion in ASC paragraph 805-20-30-1).

**Subsequent Measurement of Redeemable Noncontrolling Interests**

15.102 Under ASC Subtopic 810-10, the recorded amount of a noncontrolling interest in a subsidiary is adjusted each period for (a) comprehensive income (loss) that is attributed to the noncontrolling interest, (b) dividends to the noncontrolling interest, and (c) changes in a parent’s ownership interest in the subsidiary while the parent retains its controlling financial interest. As such, the recorded amount pursuant to ASC Subtopic 810-10 generally will not equal the fair value of the noncontrolling interest except upon initial recognition in a business combination accounted for in accordance with ASC Topic 805.

15.103 Under ASC Section 480-10-S99, the subsequent measurement of redeemable instruments in the issuer’s financial statements depends on whether those instruments are redeemable currently or in the future (including instruments that will be redeemable solely after the passage of time or upon the occurrence of a contingent event). The subsequent measurement guidance in ASC Section 480-10-S99 is as follows: If redeemable currently (i.e., at the option of the holder), the instrument should be adjusted to its maximum redemption amount at each balance sheet date. The redemption amount at each balance sheet date should include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant. If the maximum redemption amount is based on the fair value of the equity instrument at the redemption date, the amount reported outside of permanent equity should be calculated based on the fair value of the equity instrument as of the balance sheet date.

- If the instrument is not redeemable currently (e.g., because a contingency has not been met), and it is not probable that the instrument will become redeemable, subsequent adjustment is not necessary until it is probable that the instrument will become redeemable. In that case, the entity is required to disclose why it is not probable that the instrument will become redeemable.

- If the instrument is not redeemable currently (e.g., because a contingency has not been met), but it is probable that the instrument will become redeemable (or it is known that the instrument will become redeemable at a specified future date based on its contractual terms), either of the following accounting methods is an acceptable accounting policy:

  (a) Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates and are accounted for prospectively, and disclosed, in accordance with ASC Topic 250, Accounting Changes and Error Corrections.
Recognize changes in the redemption value (for example, fair value) as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method views the end of the reporting period as if it were also the redemption date for the instrument.

**15.104** Regardless of the accounting method applied (see items (a) and (b) above), reductions in the carrying amount of an equity instrument (including a noncontrolling interest) from the application of ASC Section 480-10-S99 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the equity instrument from the application of ASC Section 480-10-S99. That is, the carrying amount of the equity instrument should not be reduced below its originally recorded amount at issuance (as discussed in the following paragraph, the minimum carrying amount for a redeemable noncontrolling interest is its current measurement amount under ASC Subtopic 810-10, which may differ from its originally recorded amount at issuance). However, this guidance is effectively nullified for a noncontrolling interest to the extent the decrease is from the attribution of losses (or potentially a dividend to the noncontrolling interest). The accounting method should be consistently applied and disclosed in the notes to the financial statements. Moreover, disclosure of the redemption value of the instrument as if it were currently redeemable is required for registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.

**15.105** The subsequent measurement of redeemable noncontrolling interests should be the greater of the amount determined under ASC Subtopic 810-10 or ASC Section 480-10-S99. Adjustments to reflect the current period change in the excess, if any, of a redeemable noncontrolling interest’s ASC Section 480-10-S99 measurement amount over its ASC Subtopic 810-10 measurement amount should be recorded against permanent equity. The classification of those adjustments within equity (i.e., as an adjustment to retained earnings or additional paid-in capital) depends on the entity’s accounting policy, as discussed in the following section.

**Q&A 15.4: Subsequent Measurement of Redeemable Noncontrolling Interests When the Amounts Determined under ASC Subtopic 810-10 and ASC Section 480-10-S99 Have Declined after Issuance**

The subsequent measurement of redeemable noncontrolling interests presented in temporary equity should be the greater of the amount determined under ASC Subtopic 810-10 or ASC Section 480-10-S99. However, ASC subparagraph 480-10-S99-16(e) also indicates the carrying amount should not be reduced below its originally recorded amount recognized at issuance.

In certain circumstances the subsequent measurement of redeemable noncontrolling interests determined under ASC Subtopic 810-10 may be less than the original amount recognized at issuance due to the attribution of losses. Similarly, the amount determined under ASC Section 480-10-S99 may be less than the initial amount recognized at issuance based on declines in the contractual redemption price.
Q. How should an issuer subsequently measure a non-mandatorily redeemable noncontrolling interest if the amounts determined under ASC Subtopic 810-10, and ASC Section 480-10-S99 are less than the original amount of the noncontrolling interest recognized at issuance?

A. We believe ASC Subtopic 810-10 establishes the minimum carrying amount of redeemable noncontrolling interests. That is, an issuer should first attribute net income or loss of the subsidiary to the noncontrolling interest under ASC Subtopic 810-10, which may reduce the carrying amount below the original amount recognized at issuance. After applying that guidance, the issuer should then determine whether any increases to the adjusted carrying amount of the redeemable noncontrolling interests are necessary under ASC Section 480-10-S99.

Example 1

Issuer initially recognized $100 of redeemable noncontrolling interest in temporary equity on January 1 (the issuance date). The noncontrolling interest is not redeemable currently but will become redeemable at a specified future date based on its contractual terms. Issuer elects to recognize the changes in the redemption value as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period under ASC paragraph 480-10-S99-15.

The redemption value of the noncontrolling interest at December 31 is $90 based on its contractual terms. Based on the subsidiary's performance, $20 of net loss is attributed to the noncontrolling interest under ASC Subtopic 810-10.

Issuer determines that the redeemable noncontrolling interest should be measured at $90 at December 31. Issuer first attributes the net loss to the noncontrolling interest under ASC Subtopic 810-10 reducing the carrying amount to $80. Issuer then adjusts the carrying amount to $90, the amount determined under ASC Section 480-10-S99, which is greater than the amount determined under ASC Subtopic 810-10.

Example 2

Assume the same facts as in Example 1, except that the redemption value of the noncontrolling interest at December 31 is $60 based on its contractual terms.

Issuer determines that the redeemable noncontrolling interest should be measured at $80 at December 31. Issuer first attributes the net loss to the noncontrolling interest under ASC Subtopic 810-10 reducing the carrying amount to $80. A further reduction to $60 is not permitted because the ASC Section 480-10-S99 amount is less than the ASC Subtopic 810-10 amount.

15.106 The measurement guidance in ASC Section 480-10-S99 applies to redeemable noncontrolling interests regardless of whether the redemption amount is based on the fair value of the underlying shares or some other amount.
RECORDING CHANGES IN THE CARRYING AMOUNT OF REDEEMABLE NONCONTROLLING INTERESTS FROM THE APPLICATION OF ASC SECTION 480-10-S99 AND THE EFFECTS OF THOSE ADJUSTMENTS ON BASIC AND DILUTED EARNINGS PER SHARE

15.107 ASC paragraph 810-10-45-23 requires that changes in a parent’s ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not affect net income or comprehensive income in the consolidated financial statements. Similarly, adjustments to the carrying amount of redeemable noncontrolling interests from the application of ASC Section 480-10-S99 do not impact net income or comprehensive income in the consolidated financial statements. Rather, ASC Section 480-10-S99 specifies that adjustments to the carrying amount of a redeemable noncontrolling interest from its application “are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital).” ASC Section 480-10-S99 does not specify the circumstances in which adjustments resulting from its application should be recorded to retained earnings versus additional paid-in capital. We believe that one acceptable accounting policy would be for an entity to record adjustments to noncontrolling interests from the application of ASC Section 480-10-S99 in retained earnings only to the extent that those adjustments increase or decrease the numerator of earnings per share calculations. Under that approach, any remaining adjustments to noncontrolling interests from the application of ASC Section 480-10-S99 (i.e., adjustments from the application of ASC Section 480-10-S99 that do not increase or decrease the numerator of earnings per share calculations) would be recorded in additional paid-in capital. (See discussion below for guidance on the determination of adjustments to the numerator of earnings per share calculations from the application of ASC Section 480-10-S99 to noncontrolling interests.) Other accounting policies for recording adjustments to the carrying amount of noncontrolling interests from the application of ASC Section 480-10-S99 also may be acceptable.

15.108 In the absence of retained earnings (i.e., the entity has an accumulated deficit), adjustments to the carrying amount of noncontrolling interests from the application of ASC Section 480-10-S99 generally should be recorded in additional paid-in capital. However, once additional paid-in capital is reduced to zero, subsequent adjustments to the carrying amount of noncontrolling interests from the application of ASC Section 480-10-S99 should be recorded as adjustments to the entity’s accumulated deficit. The following paragraphs describe the guidance set forth in ASC Section 480-10-S99 for determining the earnings per share effects of applying its guidance to redeemable noncontrolling interests (see ASC paragraph 480-10-S99-3A(22)).

Noncontrolling Interests in the Form of Preferred Instruments

15.109 The effect on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest in the form of a preferred instrument depends on whether (a) the preferred instrument is the only noncontrolling interest in the subsidiary and (b) the redemption feature embedded in the preferred instrument was issued, or is guaranteed, by the parent. If there are no other noncontrolling interests in the subsidiary that issued redeemable preferred stock, then the entire adjustment to the carrying amount of that noncontrolling interest from the
application of ASC Section 480-10-S99 would reduce or increase the numerator of the
parent’s earnings per share calculations (i.e., income available to common stockholders
of the parent).

15.110 If there is a noncontrolling interest in the subsidiary in addition to the
noncontrolling interest in the form of preferred instruments (i.e., a noncontrolling interest
in the form of common instruments), then the effect on the numerator of the parent’s
earnings per share calculations depends on whether the redemption feature embedded in
the preferred instrument was issued, or is guaranteed, by the parent. If the redemption
feature embedded in the preferred instrument was not issued, and is not guaranteed, by
the parent, then the adjustment to the carrying amount of that noncontrolling interest from
the application of ASC Section 480-10-S99 should be attributed between the parent and
the other noncontrolling interest (i.e., the noncontrolling interest in the form of common
instruments) in accordance with ASC paragraph 260-10-55-20, for purposes of
determining income available to common stockholders of the parent. However, if the
redemption feature embedded in the preferred instrument was issued, or is guaranteed, by
the parent, then the entire adjustment to the carrying amount of that noncontrolling
interest from the application of ASC Section 480-10-S99 would reduce or increase the
numerator of the parent’s earnings per share calculations (i.e., income available to
common stockholders of the parent).

Noncontrolling Interests in the Form of Common Instruments

15.111 Adjustments to the carrying amount of a noncontrolling interest issued in the form
of a common equity instrument to reflect a fair value redemption feature do not impact
earnings per share. However, ASC Section 480-10-S99 states “Common stock that is
redeemable based on a specified formula is considered to be redeemable at fair value if
the formula is designed to equal or reasonably approximate fair value. The SEC staff
believes that a formula based solely on a fixed multiple of earnings (or other similar
measure) is not considered to be designed to equal or reasonably approximate fair value.”
(Emphasis added.) Based on this guidance, we believe that it may be rare for a
redemption amount that is determined based on a fixed formula to be considered a fair
value redemption feature. Consequently, common instruments that are redeemable for an
amount based on a formula, including redeemable noncontrolling interests in the form of
common instruments, will generally require adjustments to the numerator of the parent’s
earnings per share calculations.

15.112 Adjustments to the carrying amount of a noncontrolling interest issued in the form
of a common instrument under ASC Section 480-10-S99 to reflect a non-fair value
redemption feature affect earnings per share (i.e., income available to common
stockholders of the parent); however, the manner in which those adjustments reduce or
increase the numerator of earnings per share calculations may differ. If the terms of the
redemption feature are not reflected in the attribution of net income under ASC paragraph
810-10-45-20, application of the two-class method at the subsidiary level is necessary in
order to determine net income available to common stockholders of the parent. (See
discussion in the following section regarding the attribution of net income (loss) and
comprehensive income (loss) to the parent and the holders of redeemable noncontrolling
interests.) When a noncontrolling interest in the form of a common instrument is
redeemable for an amount other than fair value, there are two acceptable approaches for
determining the numerator adjustment to earnings per share calculations under the two-class method. Those acceptable methods are for the entity to:

(a) Adjust the numerator of earnings per share calculations for the current period change in the excess of the noncontrolling interest’s ASC Section 480-10-S99 measurement amount over its ASC Subtopic 810-10 measurement amount (referred to in this document as the gross changes approach to applying the two-class method) or

(b) Adjust the numerator of earnings per share calculations for the current period change in the excess of the noncontrolling interest’s ASC Section 480-10-S99 measurement amount over the greater of (1) its ASC Subtopic 810-10 measurement amount or (2) its fair value (referred to in this document as the kicker approach to applying the two-class method).

15.113 Regardless of the approach to applying the two-class method for noncontrolling interests in the form of common instruments with non-fair value redemption features, decreases in the carrying amount of the noncontrolling interest resulting from the application of ASC Section 480-10-S99 should only increase the numerator of earnings per share calculations to the extent that such increases represent recoveries of amounts charged to the numerator of earnings per share calculations in previous periods. As discussed above in the subsection on Subsequent Measurement of Redeemable Noncontrolling Interests, an entity should measure a redeemable noncontrolling interest at the greater of its measurement amount determined under ASC Subtopic 810-10 or ASC Section 480-10-S99. As a result of applying that subsequent measurement guidance to noncontrolling interests in the form of common instruments with non-fair value redemption features that were initially recognized after adoption of the March 2008 updates to ASC Section 480-10-S99, increases to the numerator of earnings per share calculations (i.e., numerator adjustments resulting from decreases in the excess, if any, of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount) would not exceed the cumulative amounts previously charged to the numerator of earnings per share calculations.

15.114 The numerator of a parent entity’s earnings per share calculations excludes earnings that are allocated to noncontrolling interests under ASC Subtopic 810-10, regardless of whether those noncontrolling interests are redeemable.

ATTRIBUTION OF NET INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS) TO THE PARENT AND THE HOLDERS OF REDEEMABLE NONCONTROLLING INTERESTS

15.115 ASC Subtopic 810-10 requires net income or loss and other comprehensive income be attributed to the parent and noncontrolling interests, even when the losses exceed the noncontrolling interests in the subsidiary’s equity. ASC Subtopic 810-10 does not provide prescriptive guidance on the attribution of net income (loss) and comprehensive income (loss) to the parent and the noncontrolling interest. The following paragraphs provide guidance and discuss accounting policy alternatives for reflecting adjustments to the carrying amount of redeemable noncontrolling interests from the
application of ASC Section 480-10-S99 in the determination of net income (loss) to
common stockholders of the parent.

Noncontrolling Interests in the Form of Preferred Instruments

15.116 For redeemable noncontrolling interests in the form of preferred instruments, we
believe that adjustments to the carrying amount resulting from the application of ASC
Section 480-10-S99 should be reflected in the attribution of net income (loss) and
comprehensive income (loss) to the parent and noncontrolling interest. ASC Section 810-
10-40 states that “in the consolidated financial statements, dividends on a subsidiary’s
preferred stock, whether mandatorily redeemable or not, would be included in
noncontrolling interest as a charge against income.” However, under ASC Subtopic 810-
10, consolidated net income includes the net income attributed to the noncontrolling
interest. Changes in the carrying amount of preferred stock from the application of ASC
Section 480-10-S99 should be treated in a manner similar to preferred stock dividends
(see ASC paragraph 480-10-S99-3A(20)). Therefore, we believe that those changes
should be reflected in the attribution of consolidated net income and consolidated
comprehensive income between the parent and the noncontrolling interest.

Noncontrolling Interests in the Form of Common Instruments

15.117 For noncontrolling interests in the form of common instruments with a
redemption feature equal to the fair value of the underlying common shares, adjustments
to the carrying amount resulting from the application of ASC Section 480-10-S99 do not
affect the numerator of basic and diluted EPS calculations and should not be included in
the attribution of net income (loss) and comprehensive income (loss) to the parent and the
noncontrolling interest. However, for noncontrolling interests in the form of common
instruments with a non-fair value redemption feature, the presentation of adjustments
resulting from the application of ASC Section 480-10-S99 that affect earnings available
to common stockholders is an accounting policy election. For those noncontrolling
interests, entities can elect to reflect any increase or decrease in earnings available to
common stockholders resulting from the application of the two-class method either (a) in
the attribution of net income (loss) and comprehensive income (loss) to the parent and the
noncontrolling interest or (b) as an adjustment to the numerator of the parent’s earnings
per share calculations (see ASC Section 480-10-S99 for additional discussion of the
presentation alternatives described in this paragraph).

CHANGES IN A PARENT’S OWNERSHIP INTEREST WHEN CONTROL IS
RETIAINED

Application of ASC Subtopic 810-10 and ASC Section 480-10-S99 When a Parent’s
Ownership Interest Increases

15.118 A parent’s ownership interest increases when (a) the parent acquires shares from
noncontrolling interest holders, (b) the subsidiary issues new shares and the parent
purchases proportionately more than noncontrolling interest holders, or (c) the subsidiary
reacquires shares and the parent sells proportionately less than noncontrolling interest
holders. Increases in a parent’s ownership interest after the parent obtains a controlling
financial interest are accounted for as equity transactions. When a parent’s ownership
interest increases, the guidance in ASC Subtopic 810-10 requires that the carrying amount of the noncontrolling interest be decreased to reflect the increase in the parent’s ownership in the book value of the subsidiary. Any difference between the fair value of the consideration paid and the amount by which the noncontrolling interest is decreased is recognized in equity (i.e., additional paid-in capital), with no gain or loss recognized in net income or comprehensive income. Similarly, if a redeemable noncontrolling interest is acquired by the parent, we believe any difference between the purchase price and the carrying amount of the redeemable noncontrolling interest on the date of acquisition (i.e., the greater of its ASC Subtopic 810-10 measurement amount or its ASC Section 480-10-S99 measurement amount) should be recognized in equity with no gain or loss recognized in net income or comprehensive income.

Application of ASC Subtopic 810-10 and ASC Section 480-10-S99 When a Parent’s Ownership Interest Decreases

15.119 A parent’s ownership interest decreases when (a) the parent sells shares to noncontrolling interest holders, (b) the subsidiary issues new shares and the parent purchases proportionately less than noncontrolling interest holders, or (c) the subsidiary reacquires shares and the parent sells proportionately more than noncontrolling interest holders. Decreases in a parent’s ownership interest while the parent retains its controlling financial interest are accounted for as equity transactions. When a parent’s ownership interest decreases, the carrying amount of the noncontrolling interest is increased to reflect the decrease in the parent’s ownership in the book value of the subsidiary. Any difference between the fair value of the consideration received and the amount by which the noncontrolling interest is increased is recognized in equity (e.g., additional paid-in capital), with no gain or loss recognized in net income or comprehensive income.

15.120 The initial ASC Subtopic 810-10 measurement amount of a redeemable noncontrolling interest after a transaction in which the parent decreases its ownership interest while retaining control may differ from the initial ASC Section 480-10-S99 measurement amount (fair value). That difference would equal the amount recognized in equity (i.e., additional paid-in capital) under ASC Subtopic 810-10 for the difference between the fair value of the consideration received and the amount by which the noncontrolling interest is increased. At the end of the reporting period in which the transaction occurred, the redeemable noncontrolling interest that arose from the transaction in which the parent decreased its ownership would be measured at the greater of the ASC Subtopic 810-10 measurement amount or the ASC Section 480-10-S99 measurement amount. However, because ASC Section 480-10-S99 specifies that the initial measurement of redeemable instruments should be fair value, we believe that the difference between the noncontrolling interest’s initial carrying amount under ASC Subtopic 810-10 and its fair value upon initial recognition should not be charged against the numerator of earnings per share calculations for that period, even if the entity uses the gross changes approach to applying the two-class method.

DECONSOLIDATION OF A SUBSIDIARY

15.121 ASC Subtopic 810-10 provides guidance on the measurement of the gain or loss that is recognized in net income when a parent deconsolidates a subsidiary. That gain or
loss calculation is affected by the carrying amount of any noncontrolling interest in the former subsidiary (see ASC paragraph 810-10-40-5). ASC Section 480-10-S99 specifies that the carrying amount of a noncontrolling interest for purposes of determining the gain or loss upon deconsolidation should be its carrying amount under ASC Subtopic 810-10. Consequently, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC Section 480-10-S99 should be eliminated in the same manner in which they were initially recorded (i.e., by recording a credit to equity of the parent) immediately prior to deconsolidation of the subsidiary. ASC Section 480-10-S99 does not specify whether an entity should increase the numerator of earnings per share calculations when eliminating previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC Section 480-10-S99 upon deconsolidation of a subsidiary.

15.122 ASC Section 480-10-S99 specifies that entities are encouraged to disclose the amount credited to equity of the parent upon deconsolidation of a subsidiary.

RECLASSIFICATIONS OF NONCONTROLLING INTERESTS INTO PERMANENT EQUITY

15.123 If classification of a noncontrolling interest as temporary equity is no longer required (e.g., the redemption feature lapses or there is a modification of the terms of the instrument to eliminate the redemption feature), the existing carrying amount of the noncontrolling interest should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Upon reclassification of a noncontrolling interest from temporary equity to permanent equity when a noncontrolling interest is no longer redeemable, any excess of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount at the reclassification date should not be reversed (see ASC paragraph 480-10-S99-3A (18)). Consequently, any excess of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount immediately prior to reclassification would remain as a component of the noncontrolling interest’s carrying amount until the parent increases its ownership percentage or the subsidiary is deconsolidated. If the parent increases its ownership percentage, the excess ASC Section 480-10-S99 adjustment should be reduced in proportion to the percentage reduction in the noncontrolling interest in the same manner in which it was initially recorded (i.e., by recording a credit to equity of the parent). If the parent deconsolidates the subsidiary, the entire excess ASC Section 480-10-S99 adjustment should be eliminated in the same manner in which it was initially recorded (i.e., by recording a credit to equity of the parent).

Paragraphs 15.124 through 15.127 have been deleted and are intentionally left blank.

EXAMPLES ILLUSTRATING THE ACCOUNTING FOR REDEEMABLE NONCONTROLLING INTERESTS

15.128 The discussion below contains examples illustrating the application of ASC Section 480-10-S99 to redeemable noncontrolling interests after adoption of ASC
Subtopic 810-10. These examples should be read in conjunction with the discussion above, Accounting for Redeemable Noncontrolling Interests. The examples do not address the accounting for arrangements involving freestanding redemption features (e.g., put options) that are separately accounted for as liabilities under ASC Topic 480, arrangements with embedded redemption features that cause the noncontrolling interests to be accounted for as liabilities (i.e., mandatorily redeemable financial instruments) under ASC Topic 480, arrangements that are accounted for as debt obligations under ASC Section 480-10-55, or arrangements in which the embedded redemption feature is required to be separated from the noncontrolling interest and accounted for as a derivative under ASC Topic 815.

EXAMPLES INVOLVING THE ACQUISITION OF A CONTROLLING INTEREST IN A SUBSIDIARY

15.129 The following examples illustrate the accounting for the acquisition of a controlling interest in a subsidiary when the noncontrolling interest is redeemable.

Example 15.17: Purchase of a Controlling Interest; Noncontrolling Interest Contains an Embedded Redemption Feature (Formula-Based Redemption Amount)

Company X (acquirer) purchases 75% of Subsidiary A from Company Y (seller) for $1.5 million on January 1, 20X1. The transaction is structured as follows: (a) Company Y transfers all of the outstanding shares of Subsidiary A to a newly formed entity (NewCo) in exchange for 25,000 Class B common shares and (b) Company X transfers $1.5 million to NewCo in exchange for 75,000 Class A common shares. The Class A and B shares are identical in all respects, except that the terms of the Class B shares (a) provide Company Y with the ability to require NewCo to purchase its Class B shares on the seventh anniversary after the acquisition date (put option) and (b) provide NewCo with the right to purchase its Class B shares from Company Y at any time after the fifth anniversary of the acquisition date (call option). The embedded put and call options have the same strike prices, which are determined based on a fixed multiple of Subsidiary A’s trailing EBITDA.

Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to recognize changes in the redemption amount immediately as they occur (i.e., adjust the carrying amount of the instrument to its current redemption amount at the end of each reporting period). Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital. For incremental adjustments to the carrying amount of redeemable noncontrolling interests in the form of common instruments under ASC Section 480-10-S99, Company X’s accounting policy is to reflect those adjustments directly in earnings per share calculations to the extent that they increase or decrease the numerator. That is, Company X does not include those ASC Section 480-10-S99 adjustments in the attribution of net
income (loss) and comprehensive income (loss) to the parent and noncontrolling interest.

During the interim periods of 20X1, NewCo’s net income (loss) and comprehensive income (loss) were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Net Income (Loss)</th>
<th>Other Comprehensive Income (Loss)</th>
<th>Comprehensive Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X1</td>
<td>320,000</td>
<td>(20,000)</td>
<td>300,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>160,000</td>
<td>40,000</td>
<td>200,000</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>360,000</td>
<td>(60,000)</td>
<td>300,000</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>(120,000)</td>
<td>20,000</td>
<td>(100,000)</td>
</tr>
</tbody>
</table>

At the acquisition date, the fair value of the redeemable noncontrolling interest was $450,000. At the end of each interim period of 20X1, the fair values of the underlying noncontrolling interest shares (exclusive of the redemption feature) were as follows: $540,000 at March 31, 20X1; $580,000 at June 30, 20X1; $700,000 at September 30, 20X1; and $620,000 at December 31, 20X1. At the end of each interim period of 20X1, the redemption amounts of the redeemable noncontrolling interests were as follows: $550,000 at March 31, 20X1; $560,000 at June 30, 20X1; $690,000 at September 30, 20X1; and $645,000 at December 31, 20X1.

1 The $20 price per unit paid by Company X in the acquisition ($1.5 million ÷ 75,000 Class A shares) differs from the $18 fair value per unit of the noncontrolling interest ($450,000 ÷ 25,000 Class B shares) because of (a) the put and call options embedded in the noncontrolling interest and (b) a control premium paid by Company X.

During the interim periods of 20X1, NewCo’s net income (loss) and comprehensive income (loss) were attributed to the 25% noncontrolling interest under ASC Subtopic 810-10 as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Net Income (Loss) to Noncontrolling Interest</th>
<th>Other Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Noncontrolling Interest ASC Subtopic 810-10 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1 (acquisition)</td>
<td>450,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>80,000</td>
<td>(5,000)</td>
<td>75,000</td>
<td>525,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>40,000</td>
<td>10,000</td>
<td>50,000</td>
<td>575,000</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>90,000</td>
<td>(15,000)</td>
<td>75,000</td>
<td>650,000</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>(30,000)</td>
<td>5,000</td>
<td>(25,000)</td>
<td>625,000</td>
</tr>
</tbody>
</table>

For each interim period of 20X1, the carrying amounts of the redeemable noncontrolling interests, the excess, if any, of the ASC Section 480-10-S99 measurement amounts over the ASC Subtopic 810-10 measurement amounts, and the change in that excess from the prior period were as follows:
### ASC Section 480-10-S99 Balance in Excess of ASC Subtopic 810-10 Balance

<table>
<thead>
<tr>
<th>Date</th>
<th>ASC Subtopic 810-10 Balance</th>
<th>ASC Section 480-10-S99 Balance</th>
<th>Carrying Amount</th>
<th>ASC Section 480-10-S99 Balance in Excess of ASC Subtopic 810-10 Balance</th>
<th>Increase (Decrease) in the Excess, if any, of ASC Section 480-10-S99 Balance Over ASC Subtopic 810-10 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1 (acquisition)</td>
<td>450,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>525,000</td>
<td>550,000</td>
<td>550,000</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>575,000</td>
<td>560,000</td>
<td>575,000</td>
<td>N/A</td>
<td>(25,000)</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>650,000</td>
<td>690,000</td>
<td>690,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>625,000</td>
<td>645,000</td>
<td>645,000</td>
<td>20,000</td>
<td>(20,000)</td>
</tr>
</tbody>
</table>

### Earnings per Share

The noncontrolling interest in this example is in the form of common interests (i.e., Class B common shares). However, the redemption formula is based on a fixed multiple of trailing EBITDA, which is not a fair value redemption. Additionally, Company X does not include ASC Section 480-10-S99 adjustments in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest. Accordingly, application of the two-class method is necessary to reflect those ASC Section 480-10-S99 adjustments in the numerator of earnings per share calculations. As discussed above, two acceptable methods for determining the numerator adjustment under the two-class method for noncontrolling interests (in the form of common ownership interests) that are redeemable for amounts other than fair value are the gross changes approach and the kicker approach. The following table compares the measurement amount of the redeemable noncontrolling interest under ASC Section 480-10-S99 to the fair value of the redeemable noncontrolling interests for purposes of applying the kicker approach to determine the numerator adjustment for earnings per share calculations under the two-class method.
The ASC Subtopic 810-10 balance of the noncontrolling interest exceeds its fair value by $5,000 at December 31, 20X1, which may indicate that certain assets of the subsidiary are impaired. This example assumes that no impairment charge was required to be recognized under applicable U.S. GAAP.

The amount of the numerator adjustment under the two-class method in earnings per share calculations for the interim periods during 20X1 depends on whether the entity’s accounting policy is to apply the gross changes approach or the kicker approach. Under the gross changes approach to applying the two-class method, Company X would adjust the numerator of its earnings per share calculations to reflect the increase (decrease) in the excess, if any, of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount. Under the kicker approach to applying the two-class method, Company X would adjust the numerator of its earnings per share calculations to reflect the increase (decrease) in the excess, if any, of the ASC Section 480-10-S99 measurement amount over the greater of (a) the ASC Subtopic 810-10 measurement amount or (b) the fair value of the noncontrolling interest. The adjustments to the numerator of earnings per share calculations that would be reflected under the two-class method for each period using the gross changes approach and the kicker approach are summarized in the following table. Calculations of those amounts are presented above in the previous two tables.

<table>
<thead>
<tr>
<th>Date</th>
<th>Gross Changes Approach</th>
<th>Kicker Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X1</td>
<td>25,000</td>
<td>10,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>(25,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>40,000</td>
<td>—</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>(20,000)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

**Initial Measurement**

Under the guidance in both ASC Topic 805 and ASC Section 480-10-S99, the initial measurement of the noncontrolling interest (i.e., the Class B shares) should be its acquisition date fair value of $450,000.

**Subsequent Measurement**

**March 31, 20X1**

For the period ended March 31, 20X1, NewCo’s comprehensive income was $300,000, which was allocated as follows: $225,000 (75%) to the controlling interest and $75,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $525,000 as of March 31, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $550,000 at that date. That measurement under ASC Section 480-10-S99 represents a $25,000 excess over the ASC Subtopic 810-10 measurement amount at the end of the reporting period in which the noncontrolling interest was initially recognized. Consequently, the following entry would be recorded at March 31, 20X1 (after allocating
comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $550,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99. (This entry assumes that Company X uses the kicker approach to applying the two-class method; if the gross changes approach were used, there would be no allocation to additional paid-in capital (i.e., the entire ASC Section 480-10-S99 adjustment to the noncontrolling interest would be recorded with an offsetting adjustment to retained earnings).)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>15,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>25,000</td>
</tr>
</tbody>
</table>

(To increase carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $550,000 redeemable noncontrolling interest balance as of March 31, 20X1 should be presented outside of permanent equity.

June 30, 20X1

For the period ended June 30, 20X1, NewCo’s comprehensive income was $200,000, which was allocated as follows: $150,000 (75%) to the controlling interest and $50,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $575,000 as of June 30, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $560,000 at that date. The measurement under ASC Subtopic 810-10 ($575,000) exceeds the measurement under ASC Section 480-10-S99 ($560,000), so the noncontrolling interest should be recorded at its ASC Subtopic 810-10 measurement amount. At the end of the preceding period (March 31, 20X1), the ASC Section 480-10-S99 measurement amount exceeded the ASC Subtopic 810-10 measurement amount by $25,000. Consequently, the following entry would be recorded at June 30, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $575,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99. (This entry assumes that Company X uses the kicker approach to applying the two-class method; if the gross changes approach were used, there would be no allocation to additional paid-in capital (i.e., the entire ASC Section 480-10-S99 adjustment to the noncontrolling interest would be recorded with an offsetting adjustment to retained earnings).)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>25,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>15,000</td>
</tr>
</tbody>
</table>

(To reduce carrying amount of the noncontrolling interest to its measurement amount under ASC Subtopic 810-10.)
The entire $575,000 redeemable noncontrolling interest balance as of June 30, 20X1 should be presented outside of permanent equity.

**September 30, 20X1**

For the period ended September 30, 20X1, NewCo’s comprehensive income was $300,000, which was allocated as follows: $225,000 (75%) to the controlling interest and $75,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $650,000 as of September 30, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $690,000 at that date. The measurement under ASC Section 480-10-S99 ($690,000) exceeds the measurement under ASC Subtopic 810-10 ($650,000), so the noncontrolling interest should be recorded at its ASC Section 480-10-S99 measurement amount. At the end of the preceding period (June 30, 20X1), the ASC Subtopic 810-10 measurement amount exceeded the ASC Section 480-10-S99 measurement amount. Consequently, the following entry would be recorded at September 30, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $690,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99. (This entry assumes that Company X uses the kicker approach to applying the two-class method; if the gross changes approach were used, there would be no allocation to additional paid-in capital (i.e., the entire ASC Section 480-10-S99 adjustment to the noncontrolling interest would be recorded with an offsetting adjustment to retained earnings).)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>40,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>40,000</td>
</tr>
</tbody>
</table>

(To increase carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $690,000 redeemable noncontrolling interest balance as of September 30, 20X1 should be presented outside of permanent equity.

**December 31, 20X1**

For the period ended December 31, 20X1, NewCo’s comprehensive loss was $100,000, which was allocated as follows: $75,000 (75%) to the controlling interest and $25,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $625,000 as of December 31, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $645,000 at that date. That measurement under ASC Section 480-10-S99 represents a $20,000 excess over the ASC Subtopic 810-10 measurement amount. In the prior period (September 30, 20X1), the ASC Section 480-10-S99 measurement amount exceeded the ASC Subtopic 810-10 carrying amount by $40,000. Consequently, the following entry would be recorded at December 31, 20X1 (after allocating comprehensive loss for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $645,000, which is the greater of the measurement under ASC
Subtopic 810-10 or ASC Section 480-10-S99. (This entry assumes that Company X uses the kicker approach to applying the two-class method; if the gross changes approach were used, there would be no allocation to additional paid-in capital (i.e., the entire ASC Section 480-10-S99 adjustment to the noncontrolling interest would be recorded with an offsetting adjustment to retained earnings).)

Noncontrolling interest 20,000
Retained earnings 20,000
Additional paid-in capital 40,000

(To reduce carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $645,000 redeemable noncontrolling interest balance as of December 31, 20X1 should be presented outside of permanent equity.

Example 15.18: Purchase of a Controlling Interest; Noncontrolling Interest Contains an Embedded Redemption Feature (Fair-Value Redemption Amount)

Company X (acquirer) purchases 75% of Subsidiary A from Company Y (seller) for $1.5 million on January 1, 20X1. The transaction is structured as follows: (a) Company Y transfers all of the outstanding shares of Subsidiary A to a newly formed entity (NewCo) in exchange for 25,000 Class B common shares and (b) Company X transfers $1.5 million to NewCo in exchange for 75,000 Class A common shares. The Class A and B shares are identical in all respects, except that the terms of the Class B shares (a) provide Company Y with the ability to require NewCo to purchase its Class B shares on the seventh anniversary after the acquisition date (put option) and (b) provide NewCo with the right to purchase its Class B shares from Company Y at any time after the fifth anniversary of the acquisition date (call option). The embedded put and call options are both exercisable for an amount equal to the fair value of the underlying shares at the redemption date.

Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to recognize changes in the redemption amount immediately as they occur (i.e., adjust the carrying amount of the instrument to its current redemption amount at the end of each reporting period). Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital.

During the interim periods of 20X1, NewCo’s net income (loss) and comprehensive income (loss) were as follows:
### Net Income (Loss)

<table>
<thead>
<tr>
<th>Date/Period</th>
<th>Net Income (Loss)</th>
<th>Other Comprehensive Income (Loss)</th>
<th>Comprehensive Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X1</td>
<td>320,000</td>
<td>(20,000)</td>
<td>300,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>160,000</td>
<td>40,000</td>
<td>200,000</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>360,000</td>
<td>(60,000)</td>
<td>300,000</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>(120,000)</td>
<td>20,000</td>
<td>(100,000)</td>
</tr>
</tbody>
</table>

At the acquisition date, the fair value of the redeemable noncontrolling interest was $450,000. At the end of each interim period of 20X1, the fair values of the underlying noncontrolling interest shares (exclusive of the redemption feature) were as follows: $540,000 at March 31, 20X1; $580,000 at June 30, 20X1; $700,000 at September 30, 20X1; and $620,000 at December 31, 20X1.

1 The $20 price per unit paid by Company X in the acquisition ($1.5 million ÷ 75,000 Class A shares) differs from the $18 fair value per unit of the noncontrolling interest ($450,000 ÷ 25,000 Class B shares) primarily because of a control premium paid by Company X.

During the interim periods of 20X1, NewCo’s net income (loss) and comprehensive income (loss) were attributed to the 25% noncontrolling interest under ASC Subtopic 810-10 as follows:

<table>
<thead>
<tr>
<th>Date/Period</th>
<th>Net Income (Loss) to Noncontrolling Interest</th>
<th>Other Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Noncontrolling Interest ASC Subtopic 810-10 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1 (acquisition)</td>
<td>80,000</td>
<td>(5,000)</td>
<td>75,000</td>
<td>450,000</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>40,000</td>
<td>10,000</td>
<td>50,000</td>
<td>525,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>90,000</td>
<td>(15,000)</td>
<td>75,000</td>
<td>575,000</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>(30,000)</td>
<td>5,000</td>
<td>(25,000)</td>
<td>625,000</td>
</tr>
</tbody>
</table>

For each interim period of 20X1, the carrying amounts of the redeemable noncontrolling interests, the excess, if any, of the ASC Section 480-10-S99 measurement amounts over the ASC Subtopic 810-10 measurement amounts, and the change in that excess from the prior period were as follows:
The ASC Subtopic 810-10 balance of the noncontrolling interest exceeds its fair value by $5,000 at December 31, 20X1, which may indicate that certain assets of the subsidiary are impaired. This example assumes that no impairment charge was required to be recognized under applicable U.S. GAAP.

**Earnings per Share**

The noncontrolling interest in this example is in the form of common interests (i.e., Class B common shares). Additionally, the noncontrolling interest is redeemable for an amount equal to the fair value of the underlying noncontrolling interest shares at the redemption date. Consequently, adjustments to the carrying amount of the redeemable noncontrolling interests to reflect the measurement guidance in ASC Section 480-10-S99 do not affect earnings per share.

**Initial Measurement**

Under the guidance in both ASC Topic 805 and ASC Section 480-10-S99, the initial measurement of the noncontrolling interest (i.e., the Class B shares) should be its acquisition date fair value of $450,000.

**Subsequent Measurement**

**March 31, 20X1**

For the period ended March 31, 20X1, NewCo’s comprehensive income was $300,000, which was allocated as follows: $225,000 (75%) to the controlling interest and $75,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $525,000 as of March 31, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $540,000 at that date. That measurement under ASC Section 480-10-S99 represents a $15,000 excess over the ASC Subtopic 810-10 measurement amount at the end of the reporting period in which the noncontrolling interest was initially recognized. Consequently, the following entry would be recorded at March 31, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $540,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99:

<table>
<thead>
<tr>
<th>Date</th>
<th>ASC Subtopic 810-10 Balance</th>
<th>ASC Section 480-10-S99 Balance</th>
<th>Carrying Amount</th>
<th>ASC Section 480-10-S99 Balance in Excess of ASC Subtopic 810-10 Balance</th>
<th>Increase (Decrease) in the Excess, if any, of ASC Section 480-10-S99 Balance Over ASC Subtopic 810-10 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 1, 20X1 (acquisition)</td>
<td>450,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar 31, 20X1</td>
<td>525,000</td>
<td>540,000</td>
<td>540,000</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>575,000</td>
<td>580,000</td>
<td>580,000</td>
<td>5,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Sept 30, 20X1</td>
<td>650,000</td>
<td>700,000</td>
<td>700,000</td>
<td>50,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Dec 31, 20X1</td>
<td>625,000</td>
<td>620,000</td>
<td>625,000</td>
<td>N/A</td>
<td>(50,000)</td>
</tr>
</tbody>
</table>

2 The ASC Subtopic 810-10 balance of the noncontrolling interest exceeds its fair value by $5,000 at December 31, 20X1, which may indicate that certain assets of the subsidiary are impaired. This example assumes that no impairment charge was required to be recognized under applicable U.S. GAAP.
The entire $540,000 redeemable noncontrolling interest balance as of March 31, 20X1 should be presented outside of permanent equity.

June 30, 20X1

For the period ended June 30, 20X1, NewCo’s comprehensive income was $200,000, which was allocated as follows: $150,000 (75%) to the controlling interest and $50,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $575,000 as of June 30, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $580,000 at that date. That measurement under ASC Section 480-10-S99 represents a $5,000 excess over the ASC Subtopic 810-10 measurement amount. In the prior period (March 31, 20X1), the ASC Section 480-10-S99 measurement amount exceeded the ASC Subtopic 810-10 carrying amount by $15,000. Consequently, the following entry would be recorded at June 30, 20X1 (after allocating comprehensive loss for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $580,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>10,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>10,000</td>
</tr>
</tbody>
</table>

(To reduce carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $580,000 redeemable noncontrolling interest balance as of June 30, 20X1 should be presented outside of permanent equity.

September 30, 20X1

For the period ended September 30, 20X1, NewCo’s comprehensive income was $300,000, which was allocated as follows: $225,000 (75%) to the controlling interest and $75,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $650,000 as of September 30, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $700,000 at that date. That measurement under ASC Section 480-10-S99 represents a $50,000 excess over the ASC Subtopic 810-10 measurement amount. In the prior period (June 30, 20X1), the ASC Section 480-10-S99 carrying amount exceeded the ASC Subtopic 810-10 carrying amount by $5,000. Consequently, the following entry would be recorded at September 30, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the
noncontrolling interest at $700,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>45,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>45,000</td>
</tr>
</tbody>
</table>

(To increase carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $700,000 redeemable noncontrolling interest balance as of September 30, 20X1 should be presented outside of permanent equity.

**December 31, 20X1**

For the period ended December 31, 20X1, NewCo’s comprehensive loss was $100,000, which was allocated as follows: $75,000 (75%) to the controlling interest and $25,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $625,000 as of December 31, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $620,000 at that date. The measurement under ASC Subtopic 810-10 ($625,000) exceeds the measurement under ASC Section 480-10-S99 ($620,000), so the noncontrolling interest should be recorded at its ASC Subtopic 810-10 measurement amount. At the end of the preceding period (September 30, 20X1), the ASC Section 480-10-S99 measurement amount exceeded the ASC Subtopic 810-10 measurement amount by $50,000. Consequently, the following entry would be recorded at December 31, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $625,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>50,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>50,000</td>
</tr>
</tbody>
</table>

(To reduce carrying amount of the noncontrolling interest to its measurement amount under ASC Subtopic 810-10.)

The entire $625,000 redeemable noncontrolling interest balance as of December 31, 20X1 should be presented outside of permanent equity.

**Example 15.19: Purchase of a Controlling Interest; Noncontrolling Interest in the Form of Redeemable Preferred Stock (Redeemable for Stated Value Plus Accumulated Unpaid Dividends)**

On January 1, 20X1, Company X purchased 1,000 shares of Company Y’s preferred stock for $603,000 ($603 per share), representing 50% of the investee’s total preferred shares outstanding. The preferred shares have an aggregate stated value of $1.0 million ($1,000 per share) and entitle the holder to cumulative dividends at a rate of 8%, payable semi-annually. Additionally, the preferred shares contain an embedded put option that provides...
the holder with the ability to sell the shares back to the issuer at any time after December 31, 20X9 (9 years from the date of issuance) for an amount equal to the stated value of the shares plus accumulated, unpaid dividends. The preferred shares do not provide for a mandatory redemption date. The redeemable preferred shares are accounted for as equity instruments (i.e., temporary equity) by Company Y (the issuer). However, Company X (the investor) accounted for the preferred shares as available-for-sale debt securities pursuant to the guidance in ASC Topic 320, Investments—Debt and Equity Securities. From January 1, 20X1 through December 31, 20X4, Company Y did not declare any dividends on the preferred shares (i.e., the dividends accumulated as an increase to the redemption amount). During that 4-year period, Company X recognized $357,000 of dividend income in earnings based on the implied effective yield at inception of 12%. The fair value of the preferred shares was $797,000 at December 31, 20X4 and $163,000 of unrealized losses on the shares were recorded by Company X in accumulated other comprehensive income as of that date. Additionally, no other-than-temporary impairment losses were recognized by Company X on the preferred shares during the 4-year period ended December 31, 20X4.

1 The $163,000 unrealized loss is the difference between the $797,000 fair value and the accreted value of $960,000, which was determined based on an implied effective yield at inception of 12%. The calculations of the accreted value and dividend income in this example also assume that (a) the shares will be put back to the issuer on December 31, 20X9, the earliest redemption date, and (b) the cumulative preferred stock dividends will be paid upon redemption (i.e., they will not be declared and paid prior to the redemption date). Different assumptions might be appropriate in other situations depending on the specific facts and circumstances.

On January 1, 20X5, Company X acquired 100% of Company Y’s outstanding common stock for $10.0 million cash and accounts for the transaction as a business combination using the acquisition method under ASC Topic 805.

For instruments that will become redeemable at the holder’s option solely after the passage of time for an amount equal to the stated value plus accumulated, unpaid dividends, Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to accrete changes in redemption value from the date of issuance to the earliest redemption date using the interest method. Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital. Changes to the carrying amount of redeemable noncontrolling interests in the form of preferred instruments from the application of ASC Section 480-10-S99 are reflected in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest.

**Earnings per Share**

The noncontrolling interest in this example is in the form of preferred shares. Accordingly, changes to the carrying amount of that redeemable noncontrolling interest from the application of ASC Section 480-10-S99 increase or decrease income available to common stockholders of the parent. However, because increases (decreases) to the carrying amount of the redeemable noncontrolling interest are reflected in the attribution
of Company Y’s net income (loss) between the parent and noncontrolling interest, no additional adjustments are made to the numerator in earnings per share calculations. (Note: Because the preferred stock issued by Company Y is the only noncontrolling interest in that subsidiary after its acquisition by Company X, income available to common stockholders of the parent is not affected by whether the redemption feature embedded in Company Y’s preferred shares is guaranteed by Company X.)

**Initial Measurement**

Under ASC Topic 805, the amount of goodwill from Company X’s acquisition of Company Y on January 1, 20X5 is measured as the excess of (a) over (b) below:

- a. The aggregate of:
  - (1) The $10.0 million of cash consideration transferred to the shareholders of Company Y
  - (2) The $797,000 fair value of the noncontrolling interest in the acquiree (50% of Company Y’s outstanding preferred shares, which are held by other investors)
  - (3) The $797,000 acquisition date fair value of the acquirer’s previously held equity interest in Company Y (50% of Company Y’s outstanding preferred shares, which are held by Company X). (Note: The $163,000 unrealized loss recognized in other comprehensive income prior to the acquisition must be reclassified and recognized in earnings as a loss at the acquisition date (see ASC paragraph 805-10-25-10).)

- b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with ASC Topic 805.

ASC Topic 805 requires that the initial measurement of the noncontrolling interest in the business combination (i.e., 50% of Company Y’s outstanding preferred shares, which are held by other investors) be its acquisition date fair value of $797,000. That requirement is consistent with the guidance in ASC Section 480-10-S99, which specifies that the initial measurement attribute for redeemable instruments is fair value.

**Subsequent Measurement**

Consistent with Company X’s accounting policy, the $797,000 initial fair value of the redeemable noncontrolling interest on January 1, 20X5 should be accreted to its redemption value on December 31, 20X9 using the interest method. Company X (the acquirer) intends for Company Y’s cumulative preferred stock dividends to be paid upon redemption (i.e., they will not be declared and paid prior to the redemption date, consistent with Company Y’s preacquisition dividend policy). Accordingly, the $797,000 initial fair value should be accreted to the $1,720,000 redemption amount at December 31, 20X9 ($1.0 million stated value plus $720,000 of dividends accumulated on preferred shares held by third parties between the January 1, 20X1 original issuance date and the December 31, 20X9 redemption date).

20X5

The following entry would be recorded during 20X5 (the first year following the acquisition date) to reflect accretion of the redeemable noncontrolling interest under ASC
Section 480-10-S99. In subsequent years, application of the interest method will cause the amount of annual accretion to increase.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>132,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>132,000</td>
</tr>
</tbody>
</table>

(To increase carrying amount of the noncontrolling interest during 20X5 to its measurement amount under ASC Section 480-10-S99)

The entire $929,000\(^2\) redeemable noncontrolling interest balance as of December 31, 20X5 should be presented outside of permanent equity.

\(^2\) The $132,000 of accretion during 20X5 and the $929,000 accreted value at year-end were determined based on an implied effective yield at the January 1, 20X5 acquisition date of 16%. The calculations of the accreted value and 20X5 accretion in this example also assume that (a) the shares will be put back to the issuer on December 31, 20X9, at the earliest redemption date, and (b) the cumulative preferred stock dividends will be paid upon redemption (i.e., they will not be declared and paid prior to the redemption date). Different assumptions might be appropriate in other situations depending on the specific facts and circumstances.

EXAMPLE INVOLVING A DECREASE IN THE PARENT’S OWNERSHIP INTEREST WHILE MAINTAINING CONTROL

15.130 The following example illustrates the accounting for a decrease in the parent’s ownership interest while maintaining control when the noncontrolling interest is redeemable. In this example, the parent’s ownership interest decreases because the subsidiary issues common shares to other investors. However, the accounting treatment in this example would also apply to transactions in which a parent’s ownership interest decreases, while maintaining control, because (a) the parent sells a portion of its holdings in a subsidiary to other investors or (b) the subsidiary reacquires a portion of its outstanding equity shares from its parent.

Example 15.20: Sale of Redeemable Noncontrolling Interests While Maintaining Control (Formula-Based Redemption Amount)

Subsidiary A has 75,000 shares of Class A common stock outstanding, all of which are owned by its parent, Company X. On January 1, 20X1, Subsidiary A issues 25,000 shares of Class B common stock to Company Y, an unrelated investor, for $450,000, which reduces Company X’s ownership from 100% to 75%. Immediately before the sale, the carrying amount (book value) of Subsidiary A’s equity was $1.0 million, which included $40,000 in accumulated other comprehensive income. The Class A and B common shares are identical in all respects, except that the Class B common stock contains an embedded put option that provides Company Y with the ability to require Subsidiary A to repurchase its Class B shares on the seventh anniversary after the acquisition date. The strike price of the embedded put option is determined based on a fixed multiple of Subsidiary A’s trailing revenue.
Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to recognize changes in the redemption amount immediately as they occur (i.e., adjust the carrying amount of the instrument to its current redemption amount at the end of each reporting period). Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital. For incremental adjustments to the carrying amount of redeemable noncontrolling interests in the form of common instruments under ASC Section 480-10-S99, Company X’s accounting policy is to reflect those adjustments directly in earnings per share calculations to the extent that they increase or decrease the numerator. That is, Company X does not include those ASC Section 480-10-S99 adjustments in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest.

On March 31, 20X1, the redemption amount of the redeemable noncontrolling interest was $550,000.

For the interim period ended March 31, 20X1, Subsidiary A’s net income (loss) and comprehensive income (loss) were as follows:

<table>
<thead>
<tr>
<th>Net Income (Loss)</th>
<th>Other Comprehensive Income (Loss)</th>
<th>Comprehensive Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$320,000</td>
<td>(20,000)</td>
<td>300,000</td>
</tr>
</tbody>
</table>

Under ASC Subtopic 810-10, the noncontrolling interest would initially be measured at $362,500 ($1.45 million book value of Subsidiary A after the share issuance × 25%) at the January 1, 20X1 issuance date. On that date, the fair value of the noncontrolling interest was $450,000 (equal to the transaction price in this example). On March 31, 20X1, the fair value of the underlying noncontrolling interest shares (exclusive of the redemption feature) was $540,000. For the interim period ended March 31, 20X1, Subsidiary A’s net income (loss) and comprehensive income (loss) were attributed to the 25% noncontrolling interest as follows:

<table>
<thead>
<tr>
<th>Net Income (Loss) to Noncontrolling Interest</th>
<th>Other Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Comprehensive Income (Loss) to Noncontrolling Interest</th>
<th>Noncontrolling Interest ASC Subtopic 810-10 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1 (acquisition)</td>
<td></td>
<td></td>
<td>362,500</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>80,000</td>
<td>75,000</td>
<td>437,500</td>
</tr>
</tbody>
</table>

On March 31, 20X1, the carrying amount of the redeemable noncontrolling interests, the excess of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount, and the change in that excess from the prior period were as follows:
Earnings per Share

The noncontrolling interest in this example is in the form of common interests (i.e., Class B common stock). However, the redemption formula is based on a fixed multiple of trailing revenue, which is not a fair value redemption. Additionally, Company X does not include ASC Section 480-10-S99 adjustments in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest. Accordingly, application of the two-class method is necessary to reflect those ASC Section 480-10-S99 adjustments in the numerator of earnings per share calculations. As discussed in Accounting for Redeemable Noncontrolling Interests earlier in this section, two acceptable methods for determining the numerator adjustment under the two-class method for noncontrolling interests (in the form of common ownership interests) that are redeemable for amounts other than fair value are the gross changes approach and the kicker approach. The following table compares the measurement amount of the redeemable noncontrolling interest under ASC Section 480-10-S99 to the fair value of the redeemable noncontrolling interests for purposes of applying the kicker approach to determine the numerator adjustment for earnings per share calculations under the two-class method.

<table>
<thead>
<tr>
<th>January 1, 20X1 (acquisition)</th>
<th>362,500</th>
<th>March 31, 20X1</th>
<th>437,500</th>
<th>550,000</th>
<th>550,000</th>
<th>112,500</th>
<th>112,500</th>
</tr>
</thead>
</table>

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two-class method, Company X would adjust the numerator of its earnings per share calculations to reflect the increase (decrease) in the excess, if any, of the ASC Section 480-10-S99 measurement amount over the greater of (a) the ASC Subtopic 810-10 measurement amount or (b) the fair value of the noncontrolling interest. The adjustments to the numerator of earnings per share calculations that would be reflected under the two-class method for each period using the gross changes approach and the kicker approach are summarized in the following table. Calculations of those amounts for the interim period ended March 31, 20X1 are presented above in the previous two tables.

<table>
<thead>
<tr>
<th>Charges (Credits) to Numerator of Earnings per Share Calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Changes Approach</td>
</tr>
<tr>
<td>25,000 *</td>
</tr>
</tbody>
</table>

*The $25,000 charge to the numerator of Company X’s earnings per share calculations under the gross changes approach to applying the two-class method represents the $112,500 excess of the ASC Section 480-10-S99 measurement amount over the ASC Subtopic 810-10 measurement amount at the end of the period, less the $87,500 excess of the fair value of the noncontrolling interest over its ASC Subtopic 810-10 measurement amount at initial recognition (which occurred earlier in the current period).

**Initial Measurement**

As indicated above, the noncontrolling interest would initially be measured at $362,500 ($1.45 million book value of Subsidiary A after the share issuance × 25%) under ASC Subtopic 810-10, before considering the guidance in ASC Section 480-10-S99. The $87,500 excess of cash received over the amount recorded for the noncontrolling interest is recorded as an increase to Company X’s additional paid-in capital (i.e., no gain is recorded in the income statement). Additionally, accumulated other comprehensive income of Company X is decreased by $10,000, which represents the carrying amount of Subsidiary A’s accumulated other comprehensive income related to the ownership interest sold to the noncontrolling shareholders ($40,000 × 25% = $10,000), and additional paid-in capital of Company X is increased by a corresponding amount. The journal entry to record the sale of Subsidiary A’s redeemable shares to noncontrolling shareholders is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>450,000</td>
</tr>
<tr>
<td>AOCl (Company X)</td>
<td>10,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>362,500</td>
</tr>
<tr>
<td>Additional paid-in capital (Company X)</td>
<td>97,500</td>
</tr>
</tbody>
</table>

(To record issuance of subsidiary’s shares under ASC Subtopic 810-10.)
Subsequent Measurement

March 31, 20X1

For the period ended March 31, 20X1, Subsidiary A’s comprehensive income was $300,000, which was allocated as follows: $225,000 (75%) to the controlling interest and $75,000 (25%) to the noncontrolling interest. The resulting measurement of the noncontrolling interest under ASC Subtopic 810-10 was $437,500 as of March 31, 20X1. Under the guidance in ASC Section 480-10-S99, the noncontrolling interest would be measured at $550,000 at that date. That measurement under ASC Section 480-10-S99 represents a $112,500 excess over the ASC Subtopic 810-10 carrying amount at the end of the reporting period in which the noncontrolling interest was initially recognized. Consequently, the following entry would be recorded at March 31, 20X1 (after allocating comprehensive income for the period between the controlling interest and noncontrolling interest) to measure the noncontrolling interest at $550,000, which is the greater of the measurement under ASC Subtopic 810-10 or ASC Section 480-10-S99. (This entry assumes that Company X uses the kicker approach to applying the two-class method; if the gross changes approach were used, additional paid-in capital would have been reduced by $87,500 and retained earnings would have been reduced by $25,000.)

1 As noted above, the fair value of the noncontrolling interest at initial recognition exceeded its initial carrying amount under ASC Subtopic 810-10 by $87,500. That initial difference should not be charged against the numerator of earnings per share calculations for the period.

Retained earnings 10,000
Additional paid-in capital 102,500
Noncontrolling interest 112,500

(To increase the carrying amount of the noncontrolling interest to its measurement amount under ASC Section 480-10-S99)

The entire $550,000 redeemable noncontrolling interest balance as of March 31, 20X1 should be presented outside of permanent equity.

EXAMPLE INVOLVING AN INCREASE IN THE PARENT’S OWNERSHIP INTEREST WHILE MAINTAINING CONTROL

15.131 The following example illustrates the accounting for an increase in the parent’s ownership interest while maintaining control when the noncontrolling interest is redeemable. In this example, the parent’s ownership interest increases because the parent purchases shares in the subsidiary from other investors. However, the accounting treatment in this example would also apply to transactions in which a parent’s ownership interest increases, while maintaining control, because (a) the parent acquires additional shares from a subsidiary or (b) the subsidiary reacquires a portion of its outstanding equity shares from holders of noncontrolling interests.
Example 15.21: Acquisition of Redeemable Noncontrolling Interests While Maintaining Control (Formula-Based Redemption Amount)

Subsidiary A is a partnership that has 120,000 common shares outstanding, consisting of 90,000 Class A shares (75% of all outstanding common shares) and 30,000 Class B shares (25% of all outstanding common shares). Company X, its parent, owns all of the Class A shares and the 30,000 Class B shares are held by unrelated investors. The Class A and B common shares are identical in all respects, except that the Class B shares contain an embedded put option that provides the holders of those shares with the ability to require Subsidiary A to purchase the Class B shares on specified future dates. The strike price of that embedded put option (i.e., the redemption price) is determined using a formula based on a fixed multiple of Subsidiary A’s trailing EBITDA.

Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to recognize changes in the redemption amount immediately as they occur (i.e., adjust the carrying amount of the instrument to its current redemption amount at the end of each reporting period). Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital. For incremental adjustments to the carrying amount of redeemable noncontrolling interests in the form of common instruments under ASC Section 480-10-S99, Company X’s accounting policy is to reflect those adjustments directly in earnings per share calculations to the extent that they increase or decrease the numerator. That is, Company X does not include those ASC Section 480-10-S99 adjustments in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest.

On January 1, 20X3, when the formula-based redemption price of the Class B shares is equal to $25 per unit, one of the noncontrolling interest holders exercises its put option and Subsidiary A reacquires 20,000 of its Class B shares (representing 2/3 of the shares held by noncontrolling interests) from that noncontrolling interest holder for $500,000 cash. Subsidiary A’s reacquisition of 20,000 Class B shares increases Company X’s ownership interest in Subsidiary A from 75% to 90%. Immediately prior to the reacquisition, the measurement amount of the noncontrolling interest in Subsidiary A under ASC Subtopic 810-10 was $600,000, which included $30,000 in accumulated other comprehensive income, and the measurement amount under ASC Section 480-10-S99 was $750,000 (i.e., $25 per Class B unit). Accordingly, the noncontrolling interest was recorded at its ASC Section 480-10-S99 measurement amount of $750,000 immediately prior to the acquisition.

**Earnings per Share**

The acquisition of redeemable noncontrolling interests for an amount equal to their carrying amount under ASC Section 480-10-S99 would not result in an adjustment to the numerator of earnings per share calculations. Additionally, adjustments to the numerator of earnings per share calculations that were recorded in prior periods should not be reversed. However, if the facts in this example were changed such that the transaction...
that increased Company X’s ownership interest occurred between reporting dates, then a final measurement of the noncontrolling interest should be performed under ASC Subtopic 810-10 and ASC Section 480-10-S99 immediately prior to that transaction. In that circumstance, the final increase or decrease to the carrying amount of the noncontrolling interest under ASC Section 480-10-S99 would be reflected in the numerator of Company X’s earnings per share calculations based on the entity’s policy for applying the two-class method (i.e., the gross changes method or the kicker method).

**Initial Measurement**

Subsidiary A’s reacquisition of shares held by the noncontrolling interest is accounted for as an equity transaction in the consolidated financial statements of Company X. Under ASC Subtopic 810-10 and ASC Section 480-10-S99, the noncontrolling interest would be reduced by $500,000, which is equal to the sum of (a) a $400,000 reduction based on the guidance in ASC Subtopic 810-10 ($600,000 ASC Subtopic 810-10 measurement × the 2/3 reduction in shares held by the noncontrolling interest) and (b) a $100,000 reduction for the excess ASC Section 480-10-S99 carrying amount over the ASC Subtopic 810-10 measurement (($750,000 - $600,000) × 2/3 reduction in shares held by the noncontrolling interest). In this example, the $500,000 reacquisition price was equal to the $500,000 carrying amount of the noncontrolling interest immediately prior to the transaction. Accordingly, the only adjustment to Company X’s additional paid-in capital relates to the $20,000 increase in accumulated other comprehensive income attributable to the parent as a result of the transaction ($30,000 × 2/3 = $20,000). The journal entry in Company X’s consolidated financial statements to record Subsidiary A’s reacquisition of 2/3 of its redeemable shares held by noncontrolling shareholders is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>500,000</td>
</tr>
<tr>
<td>Additional paid-in capital (Company X)</td>
<td>20,000</td>
</tr>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
<tr>
<td>AOCI (Company X)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

(To record Subsidiary A’s reacquisition of redeemable shares.)

The $250,000 redeemable noncontrolling interest balance remaining after this transaction, representing 10% of Subsidiary A’s outstanding shares, should continue to be presented outside of permanent equity.

### EXAMPLE INVOLVING THE DECONSOLIDATION OF A SUBSIDIARY

**15.132** The following example illustrates the accounting for a decrease in a parent’s ownership interest that results in the parent losing control and deconsolidating the subsidiary. In this example, the parent’s ownership interest decreases because the parent sells a portion of its holdings in the subsidiary to other investors. However, the accounting treatment in this example would also apply to other transactions in which a parent’s ownership interest decreases, resulting in a loss of control, including transactions in which (a) the subsidiary issues shares to other investors or (b) the subsidiary reacquires a portion of its outstanding equity shares from its parent.
Example 15.22: Parent’s Sale of a Subsidiary’s Shares That Results in a Loss of Control and Deconsolidation of the Subsidiary; There Is a Redeemable Noncontrolling Interest in the Subsidiary Prior to the Sale (Formula-Based Redemption Amount)

Subsidiary A has 120,000 common shares outstanding, consisting of 90,000 Class A shares (75% of all outstanding common shares) and 30,000 Class B shares (25% of all outstanding common shares). Company X, its parent, owns all of the Class A shares and the 30,000 Class B shares are held by unrelated investors. The Class A and B common shares are identical in all respects, except that the Class B shares contain an embedded put option that provides the holders of those shares with the ability to require Subsidiary A to purchase the Class B shares on specified future dates. The strike price of that embedded put option (i.e., the redemption price) is determined using a formula based on a fixed multiple of Subsidiary A’s trailing revenue.

Company X’s accounting policy for subsequent measurement under ASC Section 480-10-S99 is to recognize changes in the redemption amount immediately as they occur (i.e., adjust the carrying amount of the instrument to its current redemption amount at the end of each reporting period). Additionally, Company X’s accounting policy for recording adjustments to redeemable instruments resulting from the guidance in ASC Section 480-10-S99 is to classify adjustments that affect the numerator of earnings per share calculations as increases or decreases to retained earnings and to classify adjustments that do not affect earnings per share as increases or decreases to additional paid-in capital. For incremental adjustments to the carrying amount of redeemable noncontrolling interests in the form of common instruments under ASC Section 480-10-S99, Company X’s accounting policy is to reflect those adjustments directly in earnings per share calculations to the extent that they increase or decrease the numerator. That is, Company X does not include those ASC Section 480-10-S99 adjustments in the attribution of net income (loss) and comprehensive income (loss) to the parent and noncontrolling interest.

On January 1, 20X3, Company X sold 66,000 Class A shares of Subsidiary A to a group of unrelated investors for $2.4 million (approximately $36 per share), reducing its ownership interest in Subsidiary A to 20% (i.e., 24,000 Class A shares continue to be held by Company X). Company X lost control of Subsidiary A as a result of the sale and is required to deconsolidate that entity. Immediately prior to the sale, the measurement amount of the noncontrolling interest in Subsidiary A under ASC Subtopic 810-10 was $600,000, which included $30,000 in accumulated other comprehensive income, and the measurement amount under ASC Section 480-10-S99 was $750,000 (i.e., the formula-based redemption price was $25 per Class B share). The noncontrolling interest was recorded at its ASC Section 480-10-S99 measurement amount of $750,000 immediately prior to the acquisition because that amount exceeded the $600,000 ASC Subtopic 810-10 measurement.

Immediately prior to the sale of Class A common shares by Company X that resulted in a loss of control, the fair value of the underlying noncontrolling interest shares (exclusive of the redemption feature) was $1.0 million. Additionally, Subsidiary A’s balance sheet was as follows immediately prior to that transaction (amounts reflect the push-down of
Company X’s acquisition accounting adjustments from its investments in Subsidiary A in earlier periods:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Identifiable assets</strong></td>
<td>$ 2,300,000</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>800,000</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>(900,000)</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td>$ 2,200,000</td>
</tr>
</tbody>
</table>

The fair value of the remaining 24,000 Class A common shares of Subsidiary A that continue to be held by Company X after the sale was $700,000 immediately after the transaction. Company X concludes that its remaining investment in 24,000 Class A common shares provides it with significant influence over the operating and financial policies of Subsidiary A.

**Earnings per Share**

ASC Section 480-10-S99 specifies that the carrying amount of the noncontrolling interest for purposes of determining the gain or loss upon deconsolidation should be the carrying amount under ASC Subtopic 810-10. Consequently, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC Section 480-10-S99 should be eliminated in the same manner in which they were initially recorded (i.e., by recording a credit to equity of the parent) immediately prior to deconsolidation of the subsidiary. ASC Section 480-10-S99 does not specify whether an entity should increase the numerator of earnings per share calculations when eliminating previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC Section 480-10-S99 upon deconsolidation of a subsidiary. For purposes of this example, it is assumed that Company X has not increased the numerator of its earnings per share calculations as a result of its elimination of previously recorded adjustments from the application of ASC Section 480-10-S99.

**Initial Measurement (Deconsolidation)**

As discussed above, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of ASC Section 480-10-S99 should be eliminated in the same manner in which they were initially recorded (i.e., by recording a credit to equity of the parent) immediately prior to deconsolidation of the subsidiary. Consequently, the $750,000 carrying amount of the noncontrolling interest should be reduced to its $600,000 measurement amount under ASC Subtopic 810-10 before calculating the gain or loss from the transaction.

Under ASC Subtopic 810-10, Company X should account for the deconsolidation of Subsidiary A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:
a. The aggregate of:

(1) The $2.4 million of cash consideration received from the sale of 66,000 Class A common shares of Subsidiary A

(2) The $700,000 fair value of the retained noncontrolling investment in Subsidiary A (24,000 Class A common shares)

(3) The $600,000 ARB 51 (ASC Subtopic 810-10) carrying amount of the noncontrolling interest in Subsidiary A (including the $30,000 of accumulated other comprehensive income attributable to the noncontrolling interest) immediately prior to deconsolidation

b. The $2.2 million carrying amount of Subsidiary A’s assets and liabilities immediately prior to deconsolidation.

The following journal entries should be recorded by Company X to (a) eliminate previously recorded adjustments to the carrying amount of the redeemable noncontrolling interest from the application of ASC Section 480-10-S99 and (b) record the sale of shares in Subsidiary A to unrelated investors and deconsolidate that entity. Accumulated other comprehensive income previously allocated to the noncontrolling interest must be reclassified and recognized in earnings upon deconsolidation.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>150,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>150,000</td>
</tr>
<tr>
<td>(To eliminate previously recorded adjustments to measure the noncontrolling interest under ASC Section 480-10-S99)</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>2,400,000</td>
</tr>
<tr>
<td>Noncontrolling interest (ASC Subtopic 810-10)</td>
<td>600,000</td>
</tr>
<tr>
<td>Investment in Subsidiary A</td>
<td>700,000</td>
</tr>
<tr>
<td>Net assets of Subsidiary A</td>
<td>2,200,000</td>
</tr>
<tr>
<td>Gain</td>
<td>1,500,000</td>
</tr>
<tr>
<td>AOCI (Subsidiary A)</td>
<td>30,000</td>
</tr>
<tr>
<td>Gain on reclassification of amounts from AOCI</td>
<td>30,000</td>
</tr>
<tr>
<td>(To record the sale of shares in Subsidiary A and the deconsolidation of that entity.)</td>
<td></td>
</tr>
</tbody>
</table>

**Subsequent Measurement (Retained Noncontrolling Investment)**

Because Company X concludes that its remaining investment in 24,000 shares of Class A common stock give it the ability to exercise significant influence over the operating and financial policies of Subsidiary A, that investment should be accounted for under the equity method pursuant to the guidance in ASC Topic 323.

**Paragraph 15.133 and Example 15.23 have been deleted and intentionally left blank.**
PRESENTATION OF REDEEMABLE NONCONTROLLING INTERESTS IN CONSOLIDATED FINANCIAL STATEMENTS OF SEC REGISTRANTS

15.134 ASC paragraph 810-10-50-1A and the SEC’s technical amendments to Rule 3-04 of Regulation S-X, Changes in Other Stockholders’ Equity, require registrants to reconcile total equity at the beginning of the period to total equity at the end of the period. However, ASR 268 and SEC Financial Reporting Release No. 211, Redeemable Preferred Stock, prohibit including redeemable equity in any financial statement caption titled total equity. Therefore, SEC registrants with redeemable noncontrolling interests, redeemable preferred stock, or other redeemable equity classified outside of permanent equity should not include these items in any total or subtotal financial statement caption that includes (a) the nonredeemable equity of the parent company shareholders and/or (b) nonredeemable noncontrolling interests.

15.135 At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff identified the following two potentially acceptable presentations to satisfy the requirements of ASR 268/FRR 211 and ASC paragraph 810-10-55-1A:

- Provide a column for redeemable noncontrolling interests in the equity reconciliation, but exclude the related amounts from any total column. In that case, the reconciliation could include a row for net income or a supplemental table identifying the allocation of net income and other comprehensive income among controlling interests, nonredeemable noncontrolling interests, and redeemable noncontrolling interests (see Example 15.24), or
- Exclude redeemable noncontrolling interests from the equity reconciliation, but provide a supplemental table, either in the notes to the financial statements or the “statement of changes in equity and noncontrolling interests,” reconciling the beginning and ending balance of redeemable noncontrolling interests. In that case, the caption net income in the equity reconciliation could note parenthetically the amounts related to redeemable noncontrolling interests (see Example 15.25).
Example 15.24: Consolidated Statement of Changes in Equity by an Entity with Redeemable Noncontrolling Interests (Option 1)

<table>
<thead>
<tr>
<th>Adjustments and Net Income</th>
<th>Redeemable Noncontrolling Interest</th>
<th>Total</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Retained Earnings</th>
<th>Common Stock</th>
<th>Paid-In Capital</th>
<th>Nonredeemable Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Adjustment of redeemable equity to redemption value 1.0</td>
<td>(1.0)</td>
<td>(1.0)</td>
<td>140.0</td>
<td>10.0</td>
<td>150.0</td>
<td>60.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Purchase of sub shares from NCI</td>
<td>(28.0)</td>
<td></td>
<td>2.0</td>
<td>(10.0)</td>
<td>(20.0)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OCI</td>
<td>1.0</td>
<td>6.0</td>
<td>6.0</td>
<td>5.0</td>
<td>1.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CS dividends</td>
<td>(20.0)</td>
<td>(20.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>27.0</td>
<td>408.0</td>
<td>47.0</td>
<td>159.0</td>
<td>17.0</td>
<td>150.0</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Or (in lieu of memo column):

- Net income attributable to redeemable noncontrolling interests $1.0
- Net income attributable to nonredeemable noncontrolling interests 1.0
- Net income attributable to controlling interests 40.0
- **Total** $42.0
### Example 15.25: Consolidated Statement of Changes in Equity by an Entity with Redeemable Noncontrolling Interests (Option 2)

<table>
<thead>
<tr>
<th>ABC Co. Shareholders</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Common Stock</th>
<th>Paid-In Capital</th>
<th>Nonredeemable Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Comprehensive Income</td>
<td>Retained Earnings</td>
<td>140.0</td>
</tr>
<tr>
<td>Beginning Adjustment of redeemable equity to redemption value</td>
<td>(1.0)</td>
<td>(1.0)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of sub shares from NCI</td>
<td>(28.0)</td>
<td>2.0</td>
<td>(10.0)</td>
<td>(20.0)</td>
</tr>
<tr>
<td>Net income</td>
<td>41.0</td>
<td>41.0</td>
<td>40.0</td>
<td>1.0</td>
</tr>
<tr>
<td>OCI</td>
<td>6.0</td>
<td>6.0</td>
<td>5.0</td>
<td>1.0</td>
</tr>
<tr>
<td>CS dividends</td>
<td>(20.0)</td>
<td>(20.0)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>408.0</td>
<td>47.0</td>
<td>159.0</td>
<td>17.0</td>
</tr>
</tbody>
</table>

1 Excludes $1.0 attributable to redeemable noncontrolling interest

Note: Beginning redeemable noncontrolling interests of $24.0 + Net income attributable to redeemable noncontrolling interests of $1.0 + Adjustment to redemption value of $1.0 + allocation of OCI of $1.0 = Ending redeemable noncontrolling interests of $27.0.

Example 15.23 variation (schedule to be included with statement of changes in equity or in notes to the financial statements)

### Redeemable Noncontrolling Interests

<table>
<thead>
<tr>
<th></th>
<th>Redeemable Noncontrolling Interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Adjustment of redeemable equity to redemption value</td>
<td>$24.0</td>
</tr>
<tr>
<td>Net income</td>
<td>1.0</td>
</tr>
<tr>
<td>OCI</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$27.0</strong></td>
</tr>
</tbody>
</table>

15.136 Consistent with the presentation of redeemable noncontrolling interests in the consolidated balance sheet, which is required to be presented outside of permanent equity, an SEC registrant is not permitted to include redeemable noncontrolling interests amounts in any caption that totals with the entity’s permanent equity. The example consolidated statements of changes in equity presented above are acceptable because they satisfy the requirement of ASC paragraph 810-10-50-1A for an entity to reconcile the beginning and ending balances of equity attributable to noncontrolling interests (which applies to both redeemable and nonredeemable noncontrolling interests), while they do
not include redeemable noncontrolling interests in any caption that totals with permanent equity components.

APPLICATION OF ASC SECTION 480-10-S99 TO REDEEMABLE NONCONTROLLING INTERESTS OF CERTAIN REAL ESTATE ENTITIES

15.137 The discussion below provides supplemental guidance on accounting for noncontrolling interests of REITs that are potentially subject to ASC Section 480-10-S99 after adoption of ASC Subtopic 810-10 due to redemption/exchange rights that are present in a typical UPREIT structure (as described in the following section). Additionally, the consolidated financial statements of REITs and other real estate entities often involve noncontrolling interests that are subject to other types of contractual redemption features (e.g., noncontrolling interests subject to put/call arrangements and puttable units issued by a subsidiary). As previously discussed, an entity must consider the guidance in ASC Topic 815, ASC Topic 480, and ASC Section 480-10-55 in determining the accounting for a redeemable noncontrolling interest. Provided that the redeemable noncontrolling interest is not accounted for as a liability in its entirety and the redemption feature is not separately accounted for as a liability under that guidance, the entity must evaluate whether the noncontrolling interests are subject to the guidance in ASC Section 480-10-S99 and related guidance, including ASC paragraph 480-10-S99-2 and ASR 268. If the noncontrolling interests are within the scope of this guidance, they would continue to be presented outside of permanent equity by SEC registrants, even after adoption of ASC Subtopic 810-10.

15.138 The discussion below does not address the evaluation of whether redemption/exchange rights are derivative instruments within the scope of ASC Topic 815.

BACKGROUND ON REDEMPTION/EXCHANGE RIGHTS IN TYPICAL UPREIT STRUCTURES

15.139 Publicly traded REITs often employ a structure referred to as an umbrella partnership real estate investment trust (UPREIT). In a typical UPREIT transaction, an operating partnership is formed by a sponsor. The sponsor and/or its related entities contribute real estate properties and related debt to the operating partnership in exchange for a limited partnership interest in the operating partnership. Concurrent with the formation of the operating partnership, a REIT invests proceeds from a public offering in exchange for a controlling interest (general partner) in the operating partnership; the sponsor retains a noncontrolling interest in the operating partnership. Because of its controlling financial interest, the REIT consolidates the operating partnership in its financial statements.

15.140 In a typical UPREIT structure, the publicly traded REIT is the sole general partner of the operating partnership and also generally holds the majority of the limited partnership interests of the operating partnership. In such a structure, the REIT generally has no other assets, liabilities, or operations other than its interest in the operating partnership. Additionally, the REIT and the operating partnership generally share the same executive officers. The REIT’s general and limited partnership interests in the
operating partnership entitle it to share in cash distributions from, and in the profits and losses of, the operating partnership in proportion to its percentage interest. The REIT’s interests also entitle it to vote on all matters requiring a vote of the limited partners. The operating partnership units generally receive distributions on the same basis as the dividends received by the REIT shareholders.

15.141 When an UPREIT purchases real estate properties after its formation, sellers often receive common units in the operating partnership as consideration for the assets. Such transactions generally do not trigger a taxable gain for the seller relating to the sale of appreciated real estate properties until the operating units are exchanged for shares of the REIT (as described below) or sold.

15.142 The noncontrolling interest holders in the operating partnership, which include the sponsor and subsequent sellers of real estate properties to the operating partnership, have the right to redeem their interests for an amount per unit that is equal to the market value of a share of the REIT’s common stock. A sponsor’s ability to exercise this redemption right generally begins only after a negotiated lock-out period after formation of the entity. The noncontrolling interest holders are not required, as a legal or practical matter, to exercise their redemption rights at any time. However, if a noncontrolling interest holder exercises its redemption right, the REIT can satisfy the redemption request by delivering one REIT share for each operating partnership unit that is redeemed. If REIT shares are not delivered, either the operating partnership or the REIT (depending on the terms of the operating partnership agreement and other related agreements) would be required to satisfy the redemption in cash (or other assets) with an equivalent value to those shares. The REIT generally has no assets other than its interest in the operating partnership and would obtain the cash to satisfy a cash redemption obligation through an intercompany transfer from the operating partnership. Accordingly, the accounting guidance described herein on redeemable noncontrolling interests applies even in circumstances in which the related agreements specify that a cash redemption payment would be made by the REIT, rather than the operating partnership.

15.143 Certain operating partnerships may also issue preferred units to third parties that can be exchanged for preferred shares of the REIT in the same manner as described in the preceding paragraphs. The accounting guidance described herein on redeemable noncontrolling interests applies to both common and preferred units of an operating partnership.

15.144 Common and preferred units of an operating partnership that are held by the REIT (the controlling interest holder) generally are not subject to redemption pursuant to the operating partnership agreement or other related agreements.

EVALUATION OF WHETHER ASC SECTION 480-10-S99 APPLIES TO NONCONTROLLING INTERESTS OF A REIT DUE TO REDEMPTION/EXCHANGE RIGHTS IN AN UPREIT STRUCTURE

15.145 As previously discussed, ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity in the balance sheet of an SEC registrant if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the
occurrence of an event that is not solely within the control of the issuer. ASC Section 480-10-S99 further clarifies that similar guidance applies to redeemable equity instruments other than preferred shares (e.g., common shares, noncontrolling interests, share-based payment arrangements, and certain other equity-related contracts), provided that those instruments are not classified as liabilities under ASC Topic 480 or other applicable U.S. GAAP.

For purposes of the guidance discussed in this document, the terms stock or shares include various forms of ownership that may not take the legal form of securities (for example, partnership and LLC interests).

15.146 A noncontrolling interest holder’s right to redeem its interests for an amount per unit that is equal to the market value of a share of the REIT’s common stock must be evaluated to determine whether the noncontrolling interest is subject to ASC Section 480-10-S99 in the consolidated financial statements of the REIT. As discussed above, the REIT can elect to satisfy a redemption request by delivering one REIT share for each operating partnership unit that is redeemed. If the REIT does not elect to settle by delivering its shares, then either the operating partnership or the REIT would be required to satisfy the redemption in cash (or other assets) with an equivalent value to those shares. When an entity can satisfy redemptions by delivering its own shares, the guidance in ASC paragraphs 815-40-25-7 through 25-35, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” should be used to evaluate whether the entity controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement of the contract (see ASC paragraph 480-10-S99-3A(5)). If a REIT concludes, after evaluating the conditions in ASC paragraphs 815-40-25-7 through 25-35, that it has the ability to satisfy redemptions of the operating partnership units by delivering its shares, then the guidance in ASC Section 480-10-S99 would not apply. However, if a REIT concludes that it does not control settlement by delivery of its own shares, cash settlement is assumed and the noncontrolling interests that are subject to the holder’s redemption right would be subject to the guidance in ASC Section 480-10-S99.

15.147 ASC paragraphs 815-40-25-7 through 25-35 specify that all of the following conditions must be met for an entity to conclude that it has the ability to settle a contract by delivering shares:

- The contract permits settlement in unregistered shares.
- The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of shares during the maximum period the contract could remain outstanding.
- The contract explicitly limits the number of shares required to be delivered in a share settlement.
- There are no required cash payments to the counterparty in the event the company fails to make timely filings with the SEC.
- There is no requirement to make cash payments to the counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with a full return of
the amount due (i.e., there are no potential cash payments required under *top-off or make-whole provisions*).

- The contract requires net-cash settlement only in specific circumstances in which holders of shares underlying the contract also would receive cash in exchange for their shares.
- No provisions of the contract indicate that the counterparty has rights that rank higher than those of a shareholder.
- There is no contractual requirement in the contract to post collateral at any point or for any reason.

**15.148** The specific terms of the noncontrolling interest holders’ redemption/exchange rights often vary between entities, so it is necessary to consider all of the above conditions when evaluating whether a noncontrolling interest in a particular UPREIT structure is subject to the guidance in ASC Section 480-10-S99. For example, ASC Section 815-40-25 specifies that the events or actions necessary to deliver registered shares are not controlled by an entity; therefore, except in the circumstances described in the following sentence, if an instrument provides for share settlement only by delivering registered shares, it is assumed that the entity will be required to settle in cash. However, if an instrument involves the delivery of shares at settlement that are registered as of the inception of the instrument and there are no further timely filing or registration requirements, then a requirement to deliver registered shares would not preclude the entity from asserting that it has the ability to share-settle the instrument. Consequently, in circumstances in which the terms of a particular structure permit the REIT to satisfy redemptions of operating units only by delivery of cash or registered shares, the REIT would conclude that settlement in shares is not within its control and ASC Section 480-10-S99 would apply to the noncontrolling interests subject to the redemption/exchange rights, unless the REIT shares that would be delivered to satisfy future redemptions are already registered and are not subject to future timely filing or registration requirements.

**15.149** Entities should also consider regulatory requirements that may limit the percentage ownership of individual shareholders in a REIT when evaluating whether settlement in REIT shares upon redemption of operating partnership units is within the entity’s control. When a REIT would be precluded from satisfying a redemption of operating partnership units entirely in its shares because doing so would exceed a regulatory limitation on a particular shareholder’s ownership interest in the REIT, then the guidance in ASC Section 480-10-S99 should be applied to the operating units held by that shareholder that are in excess of the maximum number that could be settled in REIT shares upon redemption without exceeding that limitation.

**SUBSEQUENT MEASUREMENT OF REDEEMABLE NONCONTROLLING INTERESTS SUBJECT TO ASC SECTION 480-10-S99 OF A REIT DUE TO REDEMPTION/EXCHANGE RIGHTS IN AN UPREIT STRUCTURE**

**15.150** If an entity concludes that a redeemable noncontrolling interest is subject to the guidance in ASC Section 480-10-S99, then the subsequent measurement guidance in that ASC Section should be applied in the REIT’s financial statements. As discussed in that
document, the subsequent measurement of redeemable noncontrolling interests should be the greater of the amount determined under ASC Subtopic 810-10 or ASC Section 480-10-S99. Adjustments to reflect the current period change in the excess, if any, of a redeemable noncontrolling interest’s measurement amount under ASC Section 480-10-S99 over its measurement amount under ASC Subtopic 810-10 should be recorded against the REIT’s permanent equity (retained earnings or additional paid-in capital).

15.151 In a typical UPREIT structure, the amount payable upon redemption of a common operating partnership unit would generally equal the fair value of that unit because the redemption amount is equal to the fair value of a common REIT share, which would have the same value as the operating partnership unit provided that the REIT has no other assets, liabilities, or operations other than its interest in the operating partnership. The measurement guidance in ASC Section 480-10-S99 applies to redeemable noncontrolling interests regardless of whether the redemption amount is based on the fair value of the underlying shares or some other amount.

EARNINGS PER SHARE FOR REDEEMABLE NONCONTROLLING INTERESTS OF A REIT SUBJECT TO ASC SECTION 480-10-S99 DUE TO REDEMPTION/EXCHANGE RIGHTS IN AN UPREIT STRUCTURE

Noncontrolling Interests in the Form of Preferred Operating Partnership Units

15.152 The effect on income available to common stockholders of a REIT arising from adjustments to the carrying amount of a noncontrolling interest in the form of a preferred operating partnership unit that is subject to ASC Section 480-10-S99 due to redemption/exchange rights depends on whether (a) the preferred unit is the only noncontrolling interest in the operating partnership and (b) the redemption/exchange feature embedded in the preferred unit was issued, or is guaranteed, by the REIT. If there are no other noncontrolling interests in the operating partnership that issued redeemable preferred units, then the entire adjustment to the carrying amount of that noncontrolling interest from the application of ASC Section 480-10-S99 would reduce or increase the numerator of the REIT’s earnings per share calculations (i.e., income available to common stockholders of the REIT).

15.153 If there is a noncontrolling interest in the operating partnership in addition to the noncontrolling interest in the form of preferred units (i.e., a noncontrolling interest in the form of common units), which would be expected in a typical UPREIT structure, then the effect on the numerator of the REIT’s earnings per share calculations depends on whether the redemption feature embedded in the preferred units was issued, or is guaranteed, by the parent. If the redemption feature embedded in the preferred units was not issued, and is not guaranteed, by the REIT, then the adjustment to the carrying amount of that noncontrolling interest from the application of ASC Section 480-10-S99 should be attributed between the REIT and the other noncontrolling interest (i.e., the noncontrolling interest in the form of common operating partnership units) in accordance with paragraph 62 and Illustration 7 of ASC paragraph 260-10-55-20 for purposes of determining income available to common stockholders of the REIT. However, if the redemption feature embedded in the preferred units was issued, or is guaranteed, by the REIT, then the entire adjustment to the carrying amount of that noncontrolling interest from the application of
ASC Section 480-10-S99 would reduce or increase the numerator of the REIT’s earnings per share calculations (i.e., income available to common stockholders of the REIT).

*Noncontrolling Interests in the Form of Common Operating Partnership Units*

15.154 Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common equity instrument to reflect a fair value redemption feature do not impact earnings per share. As discussed above, the amount payable upon redemption of an operating partnership unit in a typical UPREIT structure, would generally equal the fair value of that unit because the redemption amount is equal to the fair value of a REIT share, which would have the same value as the operating partnership unit provided that the REIT has no other assets, liabilities, or operations other than its interest in the operating partnership.

**CHANGES IN A REIT’S OWNERSHIP INTEREST IN THE OPERATING PARTNERSHIP OF A TYPICAL UPREIT STRUCTURE WHEN CONTROL IS RETAINED**

*Application of ASC Subtopic 810-10 and ASC Section 480-10-S99 When a REIT’s Ownership Interest in the Operating Partnership Increases or Decreases*

15.155 Increases and decreases in a REIT’s ownership interest while the REIT retains its controlling financial interest are accounted for as equity transactions under ASC Subtopic 810-10. When a REIT’s ownership interest in an operating partnership increases or decreases, the guidance in ASC Subtopic 810-10 requires that the carrying amount of the noncontrolling interest be adjusted based on the change in the parent’s ownership in the book value of the operating partnership. Any difference between the fair value of the consideration paid or received and the amount by which the noncontrolling interest is decreased or increased is recognized in the REIT’s equity (i.e., additional paid-in capital), with no gain or loss in net income or comprehensive income.

15.156 If a REIT’s ownership interest in a consolidated operating partnership increases because it acquires a redeemable noncontrolling interest that was being accounted for pursuant to the guidance in ASC Section 480-10-S99, we believe that, consistent with the aforementioned guidance in ASC Subtopic 810-10, any difference between the purchase price and the carrying amount of the redeemable noncontrolling interest on the date of acquisition (i.e., the greater of its ASC Subtopic 810-10 measurement amount or its ASC Section 480-10-S99 measurement amount) should be recognized in equity with no gain or loss recognized in income or comprehensive income.

15.157 If a REIT’s ownership interest in a consolidated operating partnership decreases while retaining control, the ASC Subtopic 810-10 measurement amount for the additional noncontrolling interests may differ from the carrying amount that would result from applying the measurement guidance in ASC Section 480-10-S99. In that circumstance, the carrying amount of the noncontrolling interest should be adjusted to the appropriate measurement amount under ASC Section 480-10-S99, provided that the ASC Section 480-10-S99 measurement amount exceeds the ASC Subtopic 810-10 measurement amount. That adjustment should be recorded against the REIT’s permanent equity (retained earnings or additional paid-in capital).
Paragraphs 15.158 through 15.161 have been deleted and intentionally left blank.

PRESENTATION OF REDEEMABLE UNITS IN THE SEPARATE FINANCIAL STATEMENTS OF THE OPERATING PARTNERSHIP IN AN UPREIT STRUCTURE

15.162 In the separate financial statements of an operating partnership in a typical UPREIT structure that is an SEC registrant, the provisions of ASC Section 480-10-S99 are applicable if the operating partnership units are within the scope of ASC Section 480-10-S99 based on the terms of their redemption/exchange rights.

15.163 Although ASC Section 480-10-S99 and ASR 268 are not required for non-SEC registrants, many non-SEC registrants have adopted accounting policies consistent with that guidance. We believe that it would generally be considered preferable for non-SEC registrants to follow an accounting policy of presenting redeemable equity instruments, including redeemable noncontrolling interests, outside of permanent equity when those instruments would be subject to the guidance in ASC Section 480-10-S99 if the entity were an SEC registrant. However, a non-SEC registrant operating partnership’s presentation of redeemable units within permanent equity or within temporary equity (i.e., in the mezzanine between liabilities and equity) is an accounting policy election. Additionally, we believe that it generally would be appropriate for non-SEC registrants to apply the measurement guidance contained in ASC Section 480-10-S99 and ASC paragraph 480-10-S99-2 to redeemable equity instruments, including redeemable noncontrolling interests, even if those instruments are classified within permanent equity on the entity’s balance sheet.

DISCLOSURES OF NONCONTROLLING INTERESTS

ASC Paragraph 810-10-50-1A

A parent with one or more less-than-wholly-owned subsidiaries shall disclose all of the following for each reporting period:

a. Separately, on the face of the consolidated financial statements, both of the following:
   1. The amounts of consolidated net income and consolidated comprehensive income
   2. The related amounts of each attributable to the parent and the noncontrolling interest.

b. Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:
   1. Income from continuing operations
   2. Discontinued operations
c. Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:

1. Net income
2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
3. Each component of other comprehensive income.

d. In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent’s ownership interest in a subsidiary on the equity attributable to the parent.

Example 2 (see [ASC] paragraph 810-10-55-4G) illustrates the application of the guidance in this paragraph.

**ASC Paragraph 810-10-50-1B**

In the period that either a subsidiary is deconsolidated or a group of assets is derecognized in accordance with [ASC] paragraph 810-10-40-3A, the parent shall disclose all of the following:

a. The amount of any gain or loss recognized in accordance with [ASC] paragraph 810-10-40-5

b. The portion of any gain or loss related to the remeasurement of any retained investment in the former subsidiary or group of assets to its fair value

c. The caption in the income statement in which the gain or loss is recognized unless separately presented on the face of the income statement

d. A description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in the former subsidiary or group of assets

e. Information that enables users of the parent’s financial statements to assess the inputs used to develop the fair value in item (d)

f. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized

g. Whether the transaction that resulted in the deconsolidation or derecognition was with a related party

h. Whether the former subsidiary or entity acquiring a group of assets will be a related party after deconsolidation.
Not-for-Profit Entities

ASC Paragraph 958-810-50-4

An NFP (parent) that has one or more consolidated subsidiaries with a noncontrolling interest shall provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in notes to the consolidated financial statements or on the face of financial statements, if practicable. That schedule should reconcile beginning and ending balances of the parent’s controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period.

ASC Paragraph 958-810-50-5

The schedule required by the preceding paragraph shall, at a minimum, include:

a. A performance indicator, if the entity is a not-for-profit, business-oriented health care entity (see [ASC] Section 954-10-15)

b. Amounts of discontinued operations

c. Subparagraph superseded by Accounting Standards Update No. 2015-01.

d. Changes in ownership interests in a subsidiary, including investments by and distributions to noncontrolling interests acting in their capacity as owners, which shall be reported separate from any revenues, expenses, gains, or losses and outside any measure of operations, if reported

e. [Before the adoption of ASU 2016-142] An aggregate amount of all other changes in unrestricted net assets (or other net asset classes, if restricted) for the period.

e. [After the adoption of ASU 2016-142] An aggregate amount of all other changes in net assets without donor restrictions and net assets with donor restrictions for the period.

15.164 The new disclosure requirements are consistent with the FASB’s view that both the parent and the noncontrolling interest have an ownership interest in the consolidated group. The required disclosures are intended to enable users of consolidated financial statements to identify and distinguish between amounts attributable to the parent and the noncontrolling interest.

15.165 The references in the above quoted paragraphs to various paragraphs preceded by “A” are to the paragraphs in Appendix A to ARB 51 (ASC paragraphs 810-10-55-4H through 55-4M), as revised by ASC Subtopic 810-10, which includes examples to illustrate the application of the ARB, as amended (ASC Subtopic 810-10), including the disclosure requirements referenced above. ASC paragraphs 810-10-55-4H through 55-4M are reproduced in this Section in its entirety as Example 15.26.

Paragraphs 15.166 through 15.170 have been deleted and intentionally left blank.
IMPLEMENTATION GUIDANCE

15.171 ASC paragraphs 810-10-55-4H through 55-4M and ASC Subtopic 958-805 provide implementation guidance to illustrate the presentation and disclosure requirements for noncontrolling interests in consolidated financial statements.

Example 15.26: Implementation Guidance (based on ASC paragraphs 810-10-55-4H through 55-4M)

Illustrations of the Presentation and Disclosure Requirements for a Parent with One or More Less-Than-Wholly-Owned Subsidiaries

The examples are based on the following assumptions:

Assumptions for all years

a. ABC Co. has one subsidiary, Subsidiary A.

b. The tax rate for all years is 40%.

c. ABC Co. has 200,000 shares of common stock outstanding and pays dividends of $10,000 each year on those common shares. ABC Co. has no potentially dilutive shares.

d. Subsidiary A has 10,000 shares of common stock outstanding and does not pay dividends.

Assumptions for 20X1

e. ABC Co. owns all 10,000 shares in Subsidiary A for the entire year.

f. On June 30, 20X1, Subsidiary A purchases a portfolio of securities for $100,000 and classifies those securities as available for sale.

g. On December 31, 20X1, the carrying amount of the available-for-sale securities is $105,000.

h. For the year ended December 31, 20X1, the amount of Subsidiary A’s net income included in the consolidated financial statements is $24,000.

Assumptions for 20X2

i. On January 1, 20X2, ABC Co. sells 2,000 of its shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100% to 80%.

j. Immediately before the sale, Subsidiary A’s equity was as follows:

<table>
<thead>
<tr>
<th>Subsidiary A</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$25,000</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>125,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>5,000</td>
</tr>
<tr>
<td>Total equity</td>
<td>205,000</td>
</tr>
</tbody>
</table>
k. The sale of Subsidiary A’s shares by ABC Co. is accounted for as an equity transaction in the consolidated financial statements, as follows:

1. A noncontrolling interest is recognized in the amount of $41,000 ($205,000 × 20%).

2. Additional paid-in capital attributable to ABC Co. is increased by $9,000, calculated as the difference between the cash received ($50,000) and the carrying amount of the noncontrolling interest ($41,000).

3. Additional paid-in capital attributable to ABC Co. is also increased by $1,000, which represents the carrying amount of Subsidiary A’s accumulated other comprehensive income related to the ownership interest sold to the noncontrolling interest ($5,000 × 20% = $1,000). Accumulated other comprehensive income attributable to ABC Co. is decreased by a corresponding amount.

4. The journal entry to record the sale of Subsidiary A’s shares to the noncontrolling shareholders is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>50,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income (ABC Co.)</td>
<td>1,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>41,000</td>
</tr>
<tr>
<td>Additional paid-in capital (ABC Co.)</td>
<td>10,000</td>
</tr>
</tbody>
</table>

l. For the year ended December 31, 20X2, the amount of Subsidiary A’s net income included in the consolidated financial statements is $20,000.

Assumptions for 20X3

m. On January 1, 20X3, ABC Co. purchases 1,000 shares in Subsidiary A from the noncontrolling shareholders (50% of the noncontrolling interest) for $30,000 for cash, increasing its ownership interest from 80% to 90%.

n. Immediately before that purchase, the carrying amount of the noncontrolling interest in Subsidiary A was $48,000, which included $4,000 in accumulated other comprehensive income.

o. The purchase of shares from the noncontrolling shareholders is accounted for as an equity transaction in the consolidated financial statements, as follows:

1. The noncontrolling interest balance is reduced by $24,000 ($48,000 × 50% interest acquired by ABC Co.).

2. Additional paid-in capital of ABC Co. is decreased by $6,000, calculated as the difference between the cash paid ($30,000) and the adjustment to the carrying amount of the noncontrolling interest ($24,000).

3. Additional paid-in capital of ABC Co. is also decreased by $2,000, which represents the carrying amount of Subsidiary A’s accumulated other
comprehensive income related to the ownership interest purchased from the noncontrolling shareholders ($4,000 \times 50\% = $2,000). Accumulated comprehensive income attributable to ABC Co. is increased by a corresponding amount.

4. The journal entry to record that purchase of Subsidiary A’s shares from the noncontrolling shareholders is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>24,000</td>
</tr>
<tr>
<td>Additional paid-in capital (ABC Co.)</td>
<td>8,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>2,000</td>
</tr>
<tr>
<td>(ABC Co.)</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>30,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 20X3, the amount of Subsidiary A’s net income included in the consolidated financial statements is $15,000.

(ASC paragraph 810-10-55-4H)

Consolidated Statement of Financial Position

This consolidated statement of financial position illustrates the requirement in ASC paragraph 810-10-45-16 that ABC Co. present the noncontrolling interest in the consolidated statement of financial position within equity, but separately from the parent’s equity.

ABC Co.

Consolidated Statement of Financial Position

As of December 31

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$570,000</td>
<td>$475,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>125,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Available-for-sale securities</td>
<td>125,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>220,000</td>
<td>235,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,040,000</td>
<td>$940,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total liabilities</td>
<td>$555,000</td>
<td>$459,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity: ABC Co. shareholders’ equity:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $1 par</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>42,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>194,500</td>
<td>167,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>22,500</td>
<td>16,000</td>
</tr>
<tr>
<td>Total ABC Co. shareholders’ equity</td>
<td>459,000</td>
<td>433,000</td>
</tr>
</tbody>
</table>
Consolidated Statement of Income

This consolidated statement of income illustrates the requirements in ASC paragraph 810-10-50-1A(a) that the amounts of consolidated net income and the net income attributable to ABC Co. and the noncontrolling interest be presented separately on the face of the consolidated income statement. It also illustrates the requirement in ASC paragraph 810-10-50-1A(b) that the amounts of income from continuing operations and discontinued operations attributable to ABC Co. should be disclosed.

ABC Co.
Consolidated Statement of Income
Year Ended December 31

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$395,000</td>
<td>$360,000</td>
<td>$320,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>(330,000)</td>
<td>(305,000)</td>
<td>(270,000)</td>
</tr>
<tr>
<td>Income from continuing operations, before tax</td>
<td>65,000</td>
<td>55,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(26,000)</td>
<td>(22,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Income from continuing operations, net of tax</td>
<td>39,000</td>
<td>33,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Discontinued operations, net of tax</td>
<td>—</td>
<td>(7,000)</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>39,000</td>
<td>26,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Less: Net income attributable to the noncontrolling interest</td>
<td>(1,500)</td>
<td>(4,000)</td>
<td>—</td>
</tr>
<tr>
<td>Net income attributable to ABC Co.</td>
<td>$37,500</td>
<td>$22,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Earnings per share—basic and diluted:
Income from continuing operations attributable to ABC Co. common shareholders | $0.19 | $0.14 | $0.15 |
Discontinued operations attributable to ABC Co. common shareholders | — | (0.03) | — |
Net income attributable to ABC Co. common shareholders | $0.19 | $0.11 | $0.15 |

Weighted-average shares outstanding, basic and diluted | 200,000 | 200,000 | 200,000 |
**Amounts attributable to ABC Co. common shareholders:**

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations, net of tax</td>
<td>$37,500</td>
<td>$27,600</td>
<td>$30,000</td>
</tr>
<tr>
<td>Discontinued operations, net of tax</td>
<td>—</td>
<td>(5,600)</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>$37,500</td>
<td>$22,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

(ASC paragraph 810-10-55-4J)

**Consolidated Statement of Comprehensive Income**

This statement of consolidated comprehensive income illustrates the requirements in ASC paragraph 810-10-50-1A(a) that the amounts of consolidated comprehensive income and comprehensive income attributable to ABC Co. and the noncontrolling interest be presented separately on the face of the consolidated statement in which comprehensive income is presented.

**ABC Co. Statement of Consolidated Comprehensive Income**

**Year Ended December 31**

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$39,000</td>
<td>$26,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Other comprehensive income, net of tax:

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized holding gain on available-for-sale securities, net of tax</td>
<td>5,000</td>
<td>15,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total other comprehensive income, net of tax</td>
<td>5,000</td>
<td>15,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>44,000</td>
<td>41,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Comprehensive income attributable to the noncontrolling interest</td>
<td>(2,000)</td>
<td>(7,000)</td>
<td>—</td>
</tr>
<tr>
<td>Comprehensive income attributable to ABC Co.</td>
<td>$42,000</td>
<td>$34,000</td>
<td>$35,000</td>
</tr>
</tbody>
</table>

(ASC paragraph 810-10-55-4K)

**Consolidated Statement of Changes in Equity**

This consolidated statement of changes in equity illustrates the requirements in ASC paragraph 810-10-50-1A(c) that ABC Co. present a reconciliation at the beginning and the end of the period of the carrying amount of total equity, equity attributable to ABC Co., and equity attributable to the noncontrolling interest. It also illustrates that because the noncontrolling interest is part of the equity of the consolidated group, it is presented in the statement of changes in equity. (ASC paragraph 810-10-55-4L)
ABC Co.
Consolidated Statement of Changes in Equity
Year Ended December 31, 20X2

<table>
<thead>
<tr>
<th>ABC Co. Shareholders</th>
<th>Total</th>
<th>Comprehensive Income</th>
<th>Retained Earnings</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Common Stock</th>
<th>Paid-in Capital</th>
<th>Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$481,000</td>
<td>$ —</td>
<td>$167,000</td>
<td>$16,000</td>
<td>$200,000</td>
<td>$50,000</td>
<td>$48,000</td>
</tr>
<tr>
<td>Purchase of subsidiary shares from noncontrolling interest</td>
<td>(30,000)</td>
<td></td>
<td>2,000</td>
<td>(8,000)</td>
<td>(24,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensive income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>39,000</td>
<td>39,000</td>
<td>37,500</td>
<td></td>
<td></td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income (loss), net of tax:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gains on securities</td>
<td>5,000</td>
<td>5,000</td>
<td></td>
<td>4,500</td>
<td></td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income (loss)</td>
<td>5,000</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>44,000</td>
<td>$ 44,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid on common stock</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$485,000</td>
<td>$194,500</td>
<td>$22,500</td>
<td>$200,000</td>
<td>$42,000</td>
<td>$26,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ABC Co. Shareholders</td>
<td>ABC Co. Shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------</td>
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<td></td>
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</tr>
<tr>
<td></td>
<td>Total</td>
<td>Comprehensive Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance</td>
<td>$400,000</td>
<td>$155,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$5,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td>$40,000</td>
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<td></td>
<td>$ —</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Sale of subsidiary shares to</td>
<td></td>
<td>(1,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>noncontrolling interest</td>
<td></td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>41,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensive income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>26,000</td>
<td>26,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>22,000</td>
<td>4,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>income, net of tax:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gains on</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>securities</td>
<td>15,000</td>
<td>12,000</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,000</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive</td>
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<td></td>
</tr>
<tr>
<td>income</td>
<td>15,000</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>15,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>41,000</td>
<td>41,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid on common</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>stock</td>
<td></td>
<td>—</td>
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<td></td>
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<tr>
<td></td>
<td></td>
<td>—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$481,000</td>
<td>$167,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$16,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$50,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$48,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Additional Disclosure If a Parent’s Ownership Interest in a Subsidiary Changes during the Period**

This schedule illustrates the requirements in ASC paragraph 810-10-50-1A(d) that ABC Co. present in notes to the consolidated financial statements a separate schedule that shows the effects of changes in ABC Co.’s ownership interest in its subsidiary on ABC Co.’s equity. This schedule is only required if the parent’s ownership interest in a subsidiary changes in any periods presented in the consolidated financial statements.

**ABC Co.**

**Notes to Consolidated Financial Statements**

**Net Income Attributable to ABC Co. and Transfers (to) from the Noncontrolling Interest**

**Year Ended December 31**

The purpose of this schedule is to disclose the effects of changes in ABC Co.’s ownership interest in its subsidiary on ABC Co.’s equity.

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income attributable to ABC Co.</td>
<td>$37,500</td>
<td>$22,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Transfers (to) from the noncontrolling interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in ABC Co.’s paid-in capital for sale of 2,000 Subsidiary A common shares</td>
<td>—</td>
<td>10,000</td>
<td>—</td>
</tr>
<tr>
<td>Decrease in ABC Co.’s paid-in capital for purchase of 1,000 Subsidiary A common shares</td>
<td>(8,000)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Net transfers (to) from noncontrolling interest</td>
<td>(8,000)</td>
<td>10,000</td>
<td>—</td>
</tr>
<tr>
<td>Change from net income attributable to ABC Co. and transfers (to) from noncontrolling interest</td>
<td>$29,500</td>
<td>$32,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

ASC paragraph 810-10-55-4M

**Example 15.27: Illustrations of the Presentation and Disclosure Requirements for a Not-for-Profit Parent with One or More Less-Than-Wholly-Owned Subsidiaries**

The example uses simplified assumptions and highly aggregated amounts to illustrate how to apply the provisions of ASC Subtopic 810-10. It does not illustrate all possible situations or applications of ASC Subtopic 810-10 or of other generally accepted accounting principles. For example, the consolidated statement of financial position and consolidated statement of operations and other changes in unrestricted net assets show relatively few highly aggregated amounts of assets, liabilities, revenues, and expenses rather than details such as expenses by function or nature. The consolidated statement of financial position also does not classify assets and liabilities, which is required for a not-for-profit hospital under ASC paragraph 954-210-45-
which states that “health care organizations should classify assets and liabilities as current and noncurrent.” The example also omits a statement of cash flows, which does not bear on the presentation and disclosure requirements for noncontrolling interests.

Formats or levels of detail other than those presented in this example may be appropriate for other situations. For example, the related net assets and noncontrolling interest would be presented in temporarily or permanently restricted net assets if donor-imposed restrictions on the use of the subsidiary’s net assets existed in this example.

The example is based on the following assumptions:

**Assumptions for all years**

a. Hospital A, a not-for-profit tax-exempt entity has one subsidiary, Subsidiary A. That ownership interest in Subsidiary A was purchased; there are no donor-imposed restrictions on the use of Subsidiary A’s net assets.

b. Subsidiary A is an investor-owned entity that is subject to income taxes. The tax rate for all years is 40%.

c. Subsidiary A has 10,000 shares of common stock outstanding and does not pay dividends.

**Assumptions for 20X2**

d. On January 1, 20X2, Hospital A sells 2,000 of its 10,000 shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100% to 80%.

Immediately before the sale, Subsidiary A’s equity was as follows:

<table>
<thead>
<tr>
<th>Subsidiary A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Paid-in capital</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
</tr>
</tbody>
</table>

The accumulated other comprehensive income balance of $5,000 represents an unrealized gain on a portfolio of securities purchased by Subsidiary A for $100,000, which it classifies as available-for-sale securities at the carrying amount of $105,000 and are the only investment securities of the consolidated group.

The sale of Subsidiary A’s shares is accounted for as an equity transaction (within unrestricted net assets) in the consolidated financial statements of Hospital A, as follows:

1. A noncontrolling interest is recognized in unrestricted net assets in the amount of $41,000 ($205,000 × 20%).

2. Unrestricted net assets attributable to Hospital A are increased by $9,000, calculated as the difference between the cash received ($50,000) and the carrying amount of the noncontrolling interest ($41,000).
(3) The top-level (consolidated) journal entry to record the sale of Subsidiary A’s shares to the noncontrolling shareholder is as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted net assets (noncontrolling interest)</td>
<td>$ 41,000</td>
</tr>
<tr>
<td>Unrestricted net assets (Hospital A)</td>
<td>$ 9,000</td>
</tr>
</tbody>
</table>

e. For the year ended December 31, 20X2, the amount of Subsidiary A’s net income included in the consolidated financial statements is $20,000, which included a net loss for discontinued operations of $7,000.

Assumptions for 20X3

f. On January 1, 20X3, Hospital A purchases 1,000 shares in Subsidiary A from the noncontrolling shareholders (50% of the noncontrolling interest) for $30,000 cash, increasing its ownership interest from 80% to 90%. Immediately before that purchase, the carrying amount of the noncontrolling interest in Subsidiary A was $48,000. The purchase of shares from the noncontrolling shareholders is accounted for as an equity transaction in the consolidated financial statements, as follows:

(1) The noncontrolling interest balance within unrestricted net assets is reduced by $24,000 ($48,000 × 50% interest acquired by Hospital A).

(2) Unrestricted net assets attributable to Hospital A are decreased by $6,000, calculated as the difference between the cash paid ($30,000) and the adjustment to the carrying amount of the noncontrolling interest ($24,000).

(3) The top-level (consolidated) journal entry to record that purchase of Subsidiary A’s shares from the noncontrolling shareholders is as follows:

| Unrestricted net assets (noncontrolling interest) | $ 24,000 |
| Unrestricted net assets (Hospital A)              |          |
| Cash                                             |          |
|                                                 | $ 30,000 |

g. For the year ended December 31, 20X3, the amount of Subsidiary A’s net income included in the consolidated financial statements is $15,000.

Consolidated Statement of Financial Position

This consolidated statement of financial position illustrates the requirement that Hospital A present the noncontrolling interest in the consolidated statement of financial position within net assets, but separately from the parent’s net assets.
Consolidated Statement of Operations and Other Changes in Unrestricted Net Assets

This consolidated statement of operations and other changes in unrestricted net assets illustrates how the requirements for disclosure of the amounts of a performance indicator of a health care entity for an excess of revenues over expenses from continuing operations might be presented on the face of a consolidated statement of operations and other changes in unrestricted net assets.

Notes to Consolidated Financial Statements: Changes in Consolidated Unrestricted Net Assets Attributable to the Parent’s Controlling Financial Interest and to Noncontrolling Interests in Subsidiaries

This note depicting the changes in consolidated net assets attributable to the controlling financial interest of Hospital A (parent) and the noncontrolling interests illustrates the requirements that a not-for-profit entity present a schedule that reconciles the beginning- and the end-of-the period carrying amounts of the parent’s controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists. This note also illustrates the
disclosure requirements for the amounts of a performance indicator of a health care entity (which is equivalent to income from continuing operations), discontinued operations, and other changes in ownership interests in a subsidiary.

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Controlling Interest</th>
<th>Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hospital A</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes to Consolidated Financial Statements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in Consolidated Unrestricted Net Assets Attributable to Hospital A and Transfers (to) from the Noncontrolling Interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balance January 1, 20X2</strong></td>
<td>$ 400,000</td>
<td>$ 400,000</td>
<td>$ -</td>
</tr>
<tr>
<td>Excess of revenues over expenses (from continuing operations)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discontinued operations, net of tax</td>
<td>23,000</td>
<td>17,600</td>
<td>5,400</td>
</tr>
<tr>
<td>Change in net unrealized gains and losses on other than trading securities</td>
<td>(7,000)</td>
<td>(5,600)</td>
<td>(1,400)</td>
</tr>
<tr>
<td>Sale of Subsidiary A shares to noncontrolling shareholders</td>
<td>15,000</td>
<td>12,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Change in net assets</td>
<td>50,000</td>
<td>9,000</td>
<td>41,000</td>
</tr>
<tr>
<td><strong>Balance December 31, 20X2</strong></td>
<td>$ 481,000</td>
<td>$ 433,000</td>
<td>$ 48,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Controlling Interest</th>
<th>Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balance December 31, 20X3</strong></td>
<td>$ 485,000</td>
<td>$ 459,000</td>
<td>$ 26,000</td>
</tr>
</tbody>
</table>


2 ASU 2016-14, *Presentation of Financial Statement of Not-for-Profit Entities*, changes how not-for-profit (NFP) entities, including health care entities, report net asset classes, expenses, and liquidity in their financial statements. This ASU is effective for annual periods in fiscal years beginning after December 15, 2017, and for interim periods in fiscal years beginning after December 15, 2018. The ASU permits early application, and is applied retrospectively in the year of adoption. The ASU should be adopted only for an annual fiscal period or for the first interim period within the fiscal year of adoption.
Section 16 - Overview of ASC Subtopic 820-10

Detailed Contents

Fair Value Measurements
- Objectives of ASC Subtopic 820-10
- Application of ASC Subtopic 820-10 to Business Combination Fair Value Measurements

Measurement
- Definition of Fair Value
- The Asset or Liability
- The Price
- The Transaction
- The Principal Market
  - Example 16.1: Determining the Principal Market
- The Most Advantageous Market
  - Example 16.2: Determining the Exit Market

Market Participants
- Market Participants – Strategic and Financial Buyers
  - Example 16.3: Strategic and Financial Buyers (Highest and Best Use)

Application to Nonfinancial Assets - Highest and Best Use
- Example 16.4: Highest and Best Use Valuation Premise
- Example 16.5: In Combination with Other Assets Valuation Premise
- Example 16.6: Stand-Alone Valuation Premise
- Example 16.6a: Impact of Management's Intention on a Valuation

Application to Liabilities and Instruments Classified in a Reporting Entity’s Shareholders’ Equity
- Example 16.7: Effect of Nonperformance Risk on the Fair Value of a Liability
- Example 16.8: Non-Actively Traded Debt Instrument

Fair Value at Initial Recognition

Valuation Approaches
- Market Approach
- Income Approach
- Cost Approach
  - Example 16.9: Income vs. Cost Approaches – Software Asset

Valuation Analysis Inputs

Fair Value Hierarchy
- Level 1 Inputs
- Level 2 Inputs
- Level 3 Inputs
- Inputs Based on Bid and Ask Prices

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are not Orderly
Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased
  Identifying Transactions That Are Not Orderly
FAIR VALUE MEASUREMENTS

ASC Paragraph 805-20-30-1

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

16.000 ASC Topic 805, Business Combinations, requires that the acquirer in a business combination measure the identifiable assets acquired, the liabilities assumed, and any acquired noncontrolling interest in the acquiree at their acquisition-date fair values (with certain exceptions—see Section 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree). Assets acquired, liabilities assumed, and consideration transferred that are subject to the measurement exceptions are measured in accordance with the guidance specified for those exceptions, rather than at fair value. ASC Topic 805 also requires that the consideration transferred including any contingent consideration be measured at fair value (see Section 6, Recognizing and Measuring the Consideration Transferred). This Section provides a general overview for determining fair value for financial reporting purposes and common valuation approaches used to estimate fair value in accordance with ASC Subtopic 820-10, Fair Value Measurement – Overall. Fair value measurements require significant judgment and, for some items, the use of complex valuation techniques and methods to determine fair value. The use of valuation professionals to assist in the process is fairly common.

OBJECTIVES OF ASC SUBTOPIC 820-10

16.001 ASC Subtopic 820-10 defines fair value for financial reporting purposes, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. ASC Subtopic 820-10 was developed to provide increased consistency and comparability of fair value measurements required under U.S. GAAP, as well as to require more transparent disclosures about fair value measurements including the levels within the fair value hierarchy for those measurements. ASC paragraph 820-10-05-1A

16.002 ASC Subtopic 820-10 emphasizes that fair value is a market participant-based exit price measurement, and not an entity-specific measurement. ASC Subtopic 820-10 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value should maximize the use of observable inputs.

16.003 Generally, the framework for measuring fair value includes determining:

(a) The particular asset or liability that is the subject of the measurement (consistent with its unit of account);
16. Overview of ASC Subtopic 820-10

(b) For a nonfinancial asset, the valuation premise that is appropriate for the measurement (consistent with its highest and best use);

(c) The principal (or most advantageous) market for the asset or liability;

(d) The valuation approaches and underlying technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorized. ASC paragraph 820-10-55-1

16.004 While ASC Subtopic 820-10 does not specifically address the measurement of noncontrolling interests, the same framework applies. While the following discussion refers to assets or liabilities, the guidance also applies to the fair value measurement of any noncontrolling interests.

16.005 Once the appropriate valuation approaches and underlying technique(s) have been determined for the asset or liability, the inputs used in the fair value measurement are categorized into three hierarchical levels - quoted market prices in active markets for identical assets or liabilities (Level 1), other observable market inputs (Level 2), and unobservable inputs (Level 3). These concepts will be discussed in detail in the following subsections.

APPLICATION OF ASC SUBTOPIC 820-10 TO BUSINESS COMBINATION FAIR VALUE MEASUREMENTS

16.006 ASC Subtopic 820-10 applies to all fair value measurements required by ASC Topic 805. As noted above, ASC Topic 805 generally requires that identifiable assets acquired, liabilities assumed, and noncontrolling interest be measured at acquisition-date fair value. ASC Topic 805 does, however, provide for certain exceptions whereby certain items are measured at an amount other than fair value (see Section 7).

16.007 ASC Subtopic 820-10 does not eliminate the practicability exceptions to fair value measurements that are provided by other ASC Topics. ASC Subtopic 820-10 describes the practicability exceptions, as follows:

(a) The use of a transaction price (an entry price) to measure fair value (an exit price) at initial recognition of guarantees in accordance with ASC Topic 460.

(b) An exemption to measure financial instruments at fair value in accordance with ASC subtopic 825-10 if it is not practicable to do so. Note: ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, as amended by ASU 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall, eliminates the practicability exception for equity securities without readily determinable fair values. However, reporting entities may elect to initially measure the securities at cost less impairment and adjust the measurement to fair value as of the date that an orderly transaction with an observable price for an identical or similar security
of the same issuer occurs. Under this election, additional disclosures would be required.

(c) An exemption to the requirement to measure fair value if fair value is not reasonably determinable such as the following:

(1) Nonmonetary assets in accordance with ASC Topic 845 and ASC Sections 605-20-25 and 605-20-50.

(2) Asset retirement obligations in accordance with ASC Subtopic 410-20 and ASC Sections 440-10-50 and 440-10-55.

(3) Restructuring obligations in accordance with ASC Topic 420.

(4) Participation rights in accordance with ASC Subtopics 715-30 and 715-60.

(d) An exemption to the requirement to measure fair value if fair value cannot be measured with sufficient reliability (such as contributions in accordance with ASC Topic 958 and ASC Subtopic 720-25.

(e) The use of particular measurement methods referred to in ASC paragraph 805-20-30-10 that allow measurements other than fair value for specified assets acquired and liabilities assumed in a business combination. ASC paragraph 820-10-15-3.

ASU 2016-01 is effective for public business entities for fiscal years (including interim periods) beginning after December 15, 2017. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. Early adoption (including in interim periods) for entities that are not public business entities is permitted.

16.008 Not used

16.009 In addition to including the various practicability exceptions that existed in other topics, ASC Topic 820 provides practical expedients in applying the fair value framework in certain instances. For example, ASC paragraphs 820-10-35-59 through 35-62 provide a practical expedient for investors that have investments in certain investment vehicles, such as hedge funds, private equity funds, venture capital funds, funds of funds, and in foreign or other vehicles (e.g., real estate funds) that calculate and report net asset value (NAV) or an equivalent amount to use that amount as fair value if certain conditions are met (see KPMG's Fair Value Measurements Q&A I40). Investors may use NAV to estimate the fair value of investments in investment companies that do not have a readily determinable fair value if the investees have the attributes of investment companies and NAV, or its equivalent, is calculated consistent with the guidance in ASC Topic 946, Financial Services—Investment Companies, which generally requires investments to be measured at fair value (see Section Q in KPMG's Fair Value Measurements). The practical expedient should be applied on an investment-by-investment basis and applied consistently to the investor’s entire position in a particular investment unless it is probable as of the reporting date that all or a portion of the investment will be sold at an amount other than NAV (e.g., in a secondary market transaction). In those instances, the investor would instead be required to estimate the fair
value of the investment considering all of the rights and obligations inherent in the investment and other market data applicable to the investment interest (see KPMG's Fair Value Measurements Q&A G70).

MEASUREMENT

DEFINITION OF FAIR VALUE

ASC Paragraph 820-10-35-2

[ASC Subtopic 820-10] defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

16.010 The objective of a fair value measurement under ASC Subtopic 820-10 is to estimate the price that would be received to sell an asset currently or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market for that asset or liability at the measurement date. That is, fair value measurements are based on an exit price notion considered from the perspective of a market participant that is prepared to buy an asset from an entity or willing to accept an entity’s performance obligation. The fair value of an asset or liability is based on a hypothetical transaction at the measurement date considered from the perspective of a market participant that holds the asset or owes the liability. The exit price notion is consistent with the FASB’s objective for fair value measurements and is consistent with FASB Concepts Statement No. 6, Elements of Financial Statements, for the definition of an asset and liability, because an exit price is developed based on current expectations about future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants. Statement 157, par. C26

THE ASSET OR LIABILITY

ASC Paragraph 820-10-35-2B

A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

a. The condition and location of the asset

b. Restrictions, if any, on the sale or use of the asset.

16.011 A fair value measurement is for a particular asset or liability, considering various factors such as its condition and location at the measurement date. The asset or liability may be a stand-alone asset or liability such as a financial instrument or a group of assets or liabilities such as a reporting unit. When measuring the fair value of an asset or liability, an entity first determines the item being measured, giving consideration to its unit of account.
16.012 Often, an asset or liability is easily identifiable as an individual asset or liability. For example, the unit of account for a portfolio of identical financial instruments that is actively traded is the individual security within the portfolio. For a group of operating assets in a manufacturing plant that are acquired in a business combination, the unit of account generally is at the level at which the asset is separable or substitutable with other equivalent assets (e.g., a piece of equipment within the manufacturing plant).

16.013 In some circumstances, applicable U.S. GAAP specifies or permits that the unit of account may be at an aggregated level rather than at the individual asset or liability level. For example, ASC Topic 805 permits the aggregation of an operating license and a nuclear power plant into a single asset if the useful lives of those assets are similar. (ASC paragraph 805-20-55-2(b)) To determine the appropriate unit of account for measuring fair value, an entity first identifies whether specific accounting standards require or permit the unit of account to be at a level of aggregation above the individual asset or liability level, such as an asset group, a reporting unit, or a business.

THE PRICE

ASC Subtopic 820-10-35-9A

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

16.014 A fair value measurement assumes that the asset or liability being exchanged is done so in an orderly transaction between market participants. The concept of an orderly transaction assumes access to the relevant market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving the specific assets or liabilities being measured at fair value. The concept of an orderly transaction distinguishes fair value from forced liquidation value, which reflects the price that would be received or paid in a distressed sale, where a limited marketing period is available for the sale of the assets or liabilities.

16.015 For assets or liabilities that are actively traded in only one market, the exit price is readily available because market participants have engaged in transactions to buy and sell the identical asset or liability. For assets or liabilities that are actively traded in more than one market, it is necessary to identify the appropriate reference market. For assets or liabilities for which there is no active trading of the identical asset or liability, determining the appropriate exit price requires the utilization of valuation techniques or adjustments to the observed prices using assumptions that market participants would consider when transacting for similar assets or liabilities.
THE TRANSACTION

ASC Paragraph 820-10-35-5

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

a. In the principal market for the asset or liability

b. In the absence of a principal market, in the most advantageous market for the asset or liability.

THE PRINCIPAL MARKET

16.016 According to ASC Subtopic 820-10, the principal market is the market with the greatest volume and level of activity for the asset or liability. When more than one market exists for an asset or liability, the source of the exit price used in a fair value measurement depends on whether a principal market exists for the entity with respect to that asset or liability.

16.017 When an entity engages in transactions to buy or sell an asset or transfer a liability in multiple marketplaces, the entity first considers whether there is a specific marketplace where a majority of transactions (i.e., greatest volume of transactions) for the asset or liability occur. The perspective of the reporting entity is not the primary influence in the market determination.

16.018 The principal market determination takes into account where the asset sale or liability transfer takes place with the most volume. In this way the valuation subject drives the identification of the market. However, the reporting entity will need to have access to the principal market. Thus, the fair value of comparable valuation subjects may differ among entities.

Example 16.1: Determining the Principal Market

ABC Corp.’s common shares trade on both the New York and London Stock Exchanges, with the volume on New York Stock Exchange representing 80% of the total volume for ABC’s common shares. DEF Corp., a holder of ABC common shares, principally buys and sells ABC common shares on the London Stock Exchange. What is the principal market for DEF – the New York or London Stock Exchange?

If DEF has access to the New York Stock Exchange, it is the principal market because the majority of ABC’s common shares are traded there. If DEF cannot access the New York Stock Exchange, the principal market for DEF is the London Stock Exchange.

16.019 ASC Subtopic 820-10 does not provide detailed guidance for determining a principal market. Specifically, ASC Subtopic 820-10 does not discuss the assessment period for determining the greatest volume and level of activity for the asset or liability to
identify the principal market. However, the definition of principal market under ASC Subtopic 820-10 suggests that it may be appropriate for an entity to consider both: (1) the historical volume and level of activity in each of the markets in which the securities are sold and (2) the anticipated volume and level of activity in markets in which securities are sold to the extent the future activity is expected to differ from historical levels. The analysis should be performed for each class of securities (e.g., share investments, debt obligations, investments in loans) traded in multiple marketplaces to assess the volume and level of activity in each market. When contrary evidence does not exist, the market in which the reporting entity normally transacts is presumed to be the principal or most advantageous market. Because an entity’s trading activities can change over time, a reassessment of its principal market (or lack thereof) should be performed at regular intervals or based on changes in facts or circumstances when events occur that may change the entity’s assessment of its principal market. The reporting entity is not required to perform an exhaustive search of all possible markets but it would consider reasonably available information.

16.020 There may be circumstances when no single market represents the principal market for a particular asset or liability that is measured at fair value. When there is no principal market for the asset or liability, then fair value is determined based on the price in the most advantageous market for the asset or liability.

16.020a See Section E in KPMG's Fair Value Measurements for more discussion and Q&As on principle market.

THE MOST ADVANTAGEOUS MARKET

16.021 According to ASC Subtopic 820-10, the most advantageous market is defined as the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs. Determining the most advantageous market requires that an entity review multiple markets in which it sells assets or transfers liabilities to identify the most advantageous market. This assessment should be performed in each reporting period when a principal market does not exist for the asset or liability.

16.022 As with a principal market, the most advantageous market should be considered first taking into account where the asset sale or liability transfer takes place. Also, the reporting entity’s access to the most advantageous market is evaluated. This can result in different fair values among comparable valuation subjects from entity to entity.

16.023 There may be differences between exit prices indicated by the principal market and the most advantageous market. If a principal market is identified, the price from the principal market should be used in the fair value measurement even if the price from the most advantageous market is higher.
Example 16.2: Determining the Exit Market

An asset is sold in two different active markets at different prices. A reporting entity enters into transactions in both markets and can access the price in both markets at the measurement date. In Market A, the price that would be received is $26, transaction costs in that market are $3, and the costs to transport the asset to that market are $2 (i.e., the net amount that would be received is $21). In Market B, the price that would be received is $25, transaction costs in that market are $1, and the costs to transport the asset to that market are $2 (i.e., the net amount that would be received in Market B is $22).

(f) If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transportation costs ($24 per share).

(g) If Market B is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transportation costs ($23 per share).

(h) If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximizes the amount that would be received to sell the asset after taking into account transaction costs and transportation costs (i.e., the net amount that would be received in the respective markets). Because the reporting entity would maximize the net amount that would be received for the asset in Market B ($22), the fair value of the asset would be measured using the price in that market ($25), less transportation costs ($2), resulting in a fair value measurement of $23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for transaction costs (although it is adjusted for transportation costs).

ASC paragraphs 820-10-55-43 through 45A

MARKET PARTICIPANTS

ASC Master Glossary: Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price of a related party transaction may be used as an input to a
fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. They are able to enter into a transaction for the asset or liability

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

ASC Paragraph 820-10-35-9

A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally, considering factors specific to all of the following:

a. The asset or liability

b. The principal (or most advantageous) market for the asset or liability

c. Market participants with whom the reporting entity would enter into a transaction in that market.

16.024 Market participants are buyers and sellers in the principal (or most advantageous) market for an asset or liability. ASC Subtopic 820-10 emphasizes that fair value is a market participant-based measurement, not an entity-specific measurement, and that fair value measurements should be determined based on assumptions that market participants would use in pricing the asset or liability. ASC paragraph 820-10-35-9

16.025 When evaluating the assumptions that a market participant uses when pricing an asset or liability, an entity would first use observable market information, if such information exists. If observable market information does not exist, the entity may use its own entity-specific assumptions, but it would modify those assumptions to remove any entity-specific characteristics (i.e., synergies) or expertise not available to other market participants. For example, any asymmetry of information where a reporting entity has information about an asset or liability that is not available to market participants, even through the market participants’ due diligence efforts, would not be reflected in the determination of fair value. ASC Subtopic 820-10 specifies that measurements based only on entity-specific assumptions, if those assumptions are contrary to, or not all-inclusive of, assumptions that market participants are expected to use, are not consistent with the fair value measurement objective.

16.026 ASC Subtopic 820-10 states that it is reasonable to assume that a market participant that is both able and willing to transact for an asset or liability would
undertake efforts necessary to understand all of the rights and obligations inherent in the asset or liability based on all available information and would factor any related risks into the fair value measurement.

16.027 Risks that are considered in fair value measurements include market, nonperformance (including credit), liquidity, and volatility risk. Fair value measurements should consider the assumptions of market participants related to the asset or liability’s utility and related future cash flows, including the risks and uncertainties surrounding those cash flows and the amount that market participants would demand for bearing those risks and uncertainties. For example, an entity applies a liquidity factor when measuring the fair value of a particular financial instrument if it believes market participants would apply such a factor, even in circumstances in which the entity deems such a factor unnecessary for its own purposes. Similarly, an entity should consider a risk-adjusted discount rate that is deemed appropriate by market participants even when the entity believes its inherent risk is lower for that financial instrument as compared to other market participants due to the entity’s specific expertise.

MARKET PARTICIPANTS – STRATEGIC AND FINANCIAL BUYERS

16.028 When identifying the characteristics of market participants for a particular asset or liability, an entity should consider whether the market participants are strategic or financial buyers. Strategic buyers are considered buyers that have related, complementary, or substitute assets to the subject asset, while financial buyers do not. Fair value measurements may differ depending on whether the market participants for a particular asset or liability are strategic or financial buyers, reflecting, for instance, different uses for an asset and different operating strategies among the market participant buyers within those groups. In determining whether the market participants are strategic or financial buyers, it is important to consider the highest and best use of the asset (see Application to Nonfinancial Assets - Highest and Best Use in this Section for additional discussion).

Example 16.3: Strategic and Financial Buyers (Highest and Best Use)

ABC Corp., a strategic buyer, acquires a group of assets (Assets A, B, and C) from DEF Corp. in a business combination. Asset C is billing software developed by DEF for its own use in conjunction with Assets A and B (related assets). ABC measures the fair value of each of the assets individually, consistent with the specified unit of account for the assets. ABC determines that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (highest and best use is in combination with other assets as a group).

In this instance, the market in which ABC sells the assets is the market in which it initially acquired the assets (that is, the entry and exit markets from the perspective of ABC are the same). Market participant buyers with whom ABC transacts in that market have characteristics that are representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets. As discussed below, differences
between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

(a) Strategic buyer asset group. ABC, as a strategic buyer, determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). The assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold standalone at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are $360, $260, and $30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is $650.

(b) Financial buyer asset group. ABC determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the financial buyer asset group are $300, $200, and $100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is $600.

The fair values of Assets A, B, and C are determined based on the use of the assets as a group within the strategic buyer group ($360, $260, and $30). Although the use of the assets within the strategic buyer group does not maximize the fair value of each of the assets individually, it maximizes the fair value of the assets as a group ($650).

ASC paragraphs 820-10-35-10E and 820-10-35-11A

APPLICATION TO NONFINANCIAL ASSETS - HIGHEST AND BEST USE

ASC Paragraph 820-10-35-10A

A fair value measurement of a nonfinancial asset takes into account a market participant’s ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

ASC Paragraph 820-10-35-10B

The highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financially feasible as follows:

a. A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).
b. The use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property).

c. The use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account 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.

**ASC Paragraph 820-10-35-10C**

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity’s current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

**ASC Paragraph 820-10-35-10E**

The highest and best use of the nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

a. The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).

   1. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and associated liabilities) would be available to market participants.

   2. Liabilities associated with the asset and the complementary assets include liabilities that fund working capital, but do not include liabilities that fund assets other than those within the group of assets.

   3. Assumptions about the highest and best use of a nonfinancial asset shall be consistent for all of the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.
16.029 Highest and best use is a valuation concept that refers broadly to the use of an asset in a manner that would maximize the value of the asset or group of assets to market participants, even if the intended use of the asset by the entity is different. A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. As an example, an entity may intend to continue the operations of a recently acquired asset in a business combination as a manufacturing facility; if market participants consider the highest and best use of the asset as residential property because it will produce a greater fair value, then the fair value measurement would be considered from the perspective of market participants as residential property rather than the entity’s intended use as a manufacturing facility. The fair value measurement would reflect the costs and risks associated with the change to this highest and best use. ASC paragraphs 820-10-35-10A, 35-10C, and 35-10D

16.030 The highest and best use is a valuation concept that only applies to nonfinancial assets (e.g., real estate and intangible assets). The valuation concept of highest and best use does not apply to liabilities as the fair value measurement for liabilities assumes the liability is transferred to a market participant in its existing condition (including credit-standing) at the measurement date. Additionally, the concept does not apply to financial assets.

16.031 Under the highest and best use valuation concept, the fair value of an asset is measured in combination with other assets as a group or under a stand-alone valuation premise. When the highest and best use is determined to be in combination with other assets and liabilities as a group, the valuation premise assumes the highest and best use of an asset will provide maximum value to market participants if combined with other assets as a group and that those assets are already owned or are available to market participants. The stand-alone valuation premise assumes the highest and best use of an asset will provide maximum value to market participants if used on a stand-alone basis. Assumptions about the highest and best use of a nonfinancial asset would need to be consistent for all of the assets (for which highest and best use is relevant) of the group of assets and liabilities within which the asset would be used. A reporting entity’s current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

16.031a See Section J in KPMG's Fair Value Measurements for more discussion of highest and best use.

**Example 16.4: Highest and Best Use Valuation Premise**

ABC Corp. acquires land in a business combination. The land is currently developed for industrial use as a site for a manufacturing facility. The current use of land often is presumed to be its highest and best use. However, nearby sites have recently been developed for residential use as sites for high-rise condominiums. Based on that development and recent zoning and other changes to facilitate that development, ABC
determines that the land currently used as a site for a manufacturing facility could be developed as a site for residential use (for high-rise condominiums).

In this instance, the highest and best use of the land is determined by comparing:

(a) The fair value of the land in combination with the manufacturing operation, which presumes that the land would continue to be used as currently developed for industrial use (in combination with other assets as a group); and

(b) The fair value of the land as a vacant site for residential use, considering the demolition and other costs necessary to convert the land to a vacant site (stand-alone).

The highest and best use of the land is determined based on the higher of those values.

ASC paragraph 820-10-35-10E

Example 16.5: In Combination with Other Assets Valuation Premise

ABC Corp. produces camera film for which the production requires a multiple-step process whereby chemicals are applied to a cellulose material to produce the film. Individually, the machinery necessary to produce the celluloid, along with the machinery and other chemicals necessary to bond the materials for film production, have little or no market value to market participants. However, the machinery taken as a group has significant value to market participants due to the high margins resulting from the sale of the film. In this case, the highest and best use to market participants is use of the related assets in combination as a group.

Example 16.6: Stand-Alone Valuation Premise

DEF Corp. provides worldwide oceanic transportation services via the entity’s deep draft cargo ships. DEF is in the process of estimating the fair value of one of its older ships for purposes of impairment due to a new federal regulation requiring cargo ships past a certain age to be decommissioned and removed from service. Due to a current market slump for oceanic transportation services, the stand-alone fair value estimate is $4 million. Based on DEF’s historical experience, this fair value estimate is consistent with how other market participants in the oceanic transportation market would value similar-age draft cargo ships.

Oilfield drilling and production companies also use decommissioned ships as permanent moorings to their offshore drilling and production platforms for storage, tankage, etc. The current market price offered by several oilfield drilling and production companies to purchase similar-age draft cargo ships is $5 million.
DEF would measure the fair value of its deep draft cargo ship using the stand-alone valuation premise resulting in a fair value measurement of $5 million, as it represents the highest-and-best-use for the asset. This valuation premise would be used even if DEF does not have the current intent or ability to sell its draft cargo ship in an in-exchange transaction.

**Example 16.6a: Impact of Management’s Intention on a Valuation**

DEF Corp. owns and operates a chain of convenience stores. DEF often acquires single stores, or a portfolio of stores, to rebrand and remodel them. DEF also acquires competitor stores as a strategy to remove them from the market.

DEF enters into an agreement with ABC Corp. (a competitor) to purchase one of ABC’s convenience stores with the intention of closing it, placing a deed restriction on the property that prohibits it from being used to operate a convenience store, and reselling the property.

When estimating the fair value of the property, DEF should apply the highest and best use concept and not consider management’s intent to place a restriction on the deed and resell it. Therefore, assuming the highest and best use by a market participant is the continued operation of the store, DEF’s estimate of the fair value of the property should reflect that assumption.

**Application to Liabilities and Instruments Classified in a Reporting Entity’s Shareholders’ Equity**

**ASC Paragraph 820-10-35-16**

A fair value measurement assumes that a financial or nonfinancial liability or an instrument classified in a reporting entity’s shareholders’ equity (for example, equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an instrument classified in a reporting entity’s shareholders’ equity assumes the following:


b. A liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

c. An instrument in a reporting entity’s stockholders’ equity would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.
16.032 The fair value of a liability is the price that would be paid to transfer it to a market participant at the measurement date. The fair value measurement of a liability assumes that the liability is not settled with the counterparty and the obligation continues with the market participant. Because the liability is assumed to be transferred to a market participant and the liability continues to exist, the fair value measurement also should consider the effect of nonperformance risk (i.e., the risk the obligation will not be fulfilled). In accordance with ASC Subtopic 820-10, the nonperformance risk associated with the liability is assumed to be the same before and after its transfer. Nonperformance risk affects the price at which a liability would be transferred. Therefore, the fair value of a liability should reflect the nonperformance risk for that liability at the measurement date.

16.033 Nonperformance risk includes, but may not be limited to, the entity’s own credit risk. The effect of nonperformance risk (e.g., credit standing) on the fair value of a liability may differ depending on the liability. For example, a liability that represents an obligation to deliver cash (a financial liability) may have a different nonperformance risk than an obligation to deliver goods or services (a nonfinancial liability). Additionally, the terms of credit enhancements related to the liability, if any, will affect its nonperformance risk.

16.034 When a quoted price for the transfer of an identical or a similar liability or instrument classified in a reporting entity’s shareholders’ equity is not available, and the identical item is held by another party as an asset, a reporting entity would measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date. In these cases, a reporting entity would measure the fair value of the liability or equity instrument as follows:

(1) Using the quoted price in an active market for the identical item held by another party as an asset, if that price is available.

(2) If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.

(3) If the observable prices are not available, using another valuation approach, such as an income or market approach. ASC paragraph 820-10-35-16BB

16.035 The holder of an instrument as an asset incorporates nonperformance risk in the measurement of fair value. Because fair value assumes the transfer, rather than the settlement, of a liability, the issuer of the instrument likewise should include nonperformance risk in its measurement of fair value. Consideration of nonperformance risk in the measurement of a liability results in symmetry in the fair value measurement for a financial liability between the issuer and the holder. That is, to the issuer, the instrument is a liability, but to the holder, the instrument is an asset. If both parties have access to the same market and have similar views about market participants and their related assumptions, then it is reasonable to expect that both parties would arrive at substantially the same fair value measurement for the instrument. A reporting entity
should adjust the quoted price of a liability or an instrument classified in a reporting entity’s shareholders’ equity held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument.

**Example 16.7: Effect of Nonperformance Risk on the Fair Value of a Liability**

ABC Corp. and DEF Corp. each enter into a contractual obligation to pay cash ($500) to GHI Corp. in 5 years. ABC has an AA credit rating and can borrow at 6%, while DEF has a BBB credit rating and can borrow at 12%. ABC receives about $374 in exchange for its promise (the present value of $500 in 5 years at 6%). DEF receives about $284 in exchange for its promise (the present value of $500 in 5 years at 12%).

The fair value of the liability to each entity (the proceeds) incorporates that entity’s credit standing.

ASC paragraphs 820-10-55-56 through 55-58

**16.036** Measuring the fair value of debt that is not actively traded, for example, notes payable to a lender, typically requires the use of valuation approaches. Although different valuation approaches may be appropriate, a common approach used is the income approach. Specifically, cash flows attributable to the obligation, including future payments of principal and interest, are discounted to present value from the payment dates back to the fair value measurement date, using a discount rate reflective of the risk of the cash flows, including nonperformance risk. Nonperformance risk captures the credit risk associated with the obligor, which may have characteristics of the creditworthiness of the acquirer, the acquiree, or a blending of the two. If an identical item is held by another party as an asset, the reporting entity may apply an income approach that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset.

**Example 16.8: Non-Actively Traded Debt Instrument**

DEF Corp., a private retail distribution entity, has one primary debt issue outstanding with a consortium of banks. The debt issue, which had an original maturity of 30 years, currently has 10 years remaining to maturity. Due to a recent credit downgrade by DEF’s primary rating agency, DEF’s cost of borrowing has significantly increased. Specifically, based on discussions with its primary bank, DEF determines the current spread (credit and liquidity) above the risk-free rate for its obligations is approximately 700 basis points.
For most debt issuances, the interest rate on new issuances is determined by adding the pre-determined credit spread required by the debt underwriters to a risk-free market rate (usually the treasury rate that matches the term of the proposed issuance).

Assuming the current interest rate for a 10-year Treasury Bill (10 years is the length of time until maturity of the debt issue being evaluated) is 5%, then the current interest rate for any new DEF obligations is estimated to be 12%. To determine the fair value of its existing debt at the measurement date, DEF discounts all future cash flows attributable to the debt, including contractual interest payments at the stated rate of the debt, and contractual principal payments, adjusted for prepayment considerations, to the measurement date using a 12% discount rate. This discounted amount represents the estimated fair value for the debt instrument at the measurement date.

**FAIR VALUE AT INITIAL RECOGNITION**

ASC Paragraph 820-10-30-2

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

16.037 A transaction price represents the price paid to acquire an asset or received to assume a liability. There are many questions whether a transaction price in an actual transaction represents the fair value of an asset or liability at initial recognition. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, states that “at initial recognition, the cash or equivalent amount paid or received (historical cost or proceeds) is usually assumed to approximate fair value, absent evidence to the contrary.” This concept is an entry price notion.

16.038 Under ASC Subtopic 820-10, fair value is defined as the price received to sell an asset currently or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market for that asset or liability at the measurement date. That is, fair value is based on an exit price notion considered from the perspective of a market participant that is prepared to buy an asset from an entity or willing to accept an entity’s performance obligation for its liability.

16.039 Conceptually, entry and exit prices are different. Entities do not necessarily sell or transfer assets or liabilities at the prices paid to acquire or assume them, respectively. However, in certain cases the transaction price (entry price) may equal the exit price and, therefore, could provide evidence of the fair value of the asset or liability at initial recognition.
16. Overview of ASC Subtopic 820-10

16.040 ASC Subtopic 820-10 includes several examples of factors an entity should consider in determining whether a transaction price provides evidence of the fair value of an asset or liability at initial recognition. For example, a transaction price might not provide evidence of the fair value of an asset or liability at initial recognition if:

(a) The transaction is between related parties. Although the transaction price might be used as an input to the fair value measurement if the reporting entity has evidence to support a conclusion that the transaction was entered into at market terms.

(b) The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, if the seller is experiencing financial difficulty and therefore cannot wait the customary time it would take to market and sell the asset.

(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.

(d) The market in which the transaction takes place is different from the principal or most advantageous market for the asset or liability. For example, those markets might be different if the entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market) while the principal (or most advantageous) market for the exit transaction is with other dealers. ASC paragraphs 820-10-30-3 through 30-3A

VALUATION APPROACHES

ASC Paragraph 820-10-35-24A

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Three widely used valuation approaches are the market approach, cost approach, and income approach. The main aspects of valuation techniques consistent with those approaches are summarized in [ASC] paragraphs 820-10-55-3A through 55-3G. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

Market Approach

ASC Paragraph 820-10-55-3A

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.
ASC Paragraph 820-10-55-3B

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgment, considering qualitative and quantitative factors specific to the measurement.

ASC Paragraph 820-10-55-3C

Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities’ relationship to other benchmark quoted securities.

Cost Approach

ASC Paragraph 820-10-55-3D

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

ASC Paragraph 820-10-55-3E

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases, the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.

Income Approach

ASC Paragraph 820-10-55-3F

The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

ASC Paragraph 820-10-55-3G

Those valuation techniques include, for example, the following:

a. Present value techniques

b. Option-pricing models, such as the Black-Scholes-Merton formula or a binomial model (that is, a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option
c. The multiperiod excess earnings method, which is used to measure the fair value of some intangible assets.

16.041 The next step in measuring fair value for financial reporting purposes is to determine the appropriate valuation technique, or combination of valuation techniques, to use when measuring fair value. ASC Subtopic 820-10 requires all measurements of fair value to use techniques that are consistent with one or more of the three following valuation approaches: market approach, income approach, and cost approach (see also KPMG's Fair Value Measurements Q&A F10 for additional examples of these approaches beyond those discussed below).

MARKET APPROACH

16.042 The *market approach* uses prices and other relevant information generated by reference to market transactions involving identical or comparable assets or liabilities (including a business). Valuation techniques under the market approach often use market multiples (e.g., a Price-to-Earnings (P/E) multiple, a multiple of EBITDA, or a price per square foot) derived from a set of comparable transactions. Market multiples from comparable transactions often will indicate a range of possible valuations and the selection within the range requires judgment, considering factors specific to the measurement (qualitative and quantitative), and assumptions of market participants. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

INCOME APPROACH

16.043 Under the *income approach*, fair value is determined by converting future amounts (e.g., cash flows or earnings) to a single present amount. One of the most common valuation techniques under the income approach is the discounted cash flow method. Under that method, the entity first estimates the net cash flows expected to accrue directly or indirectly resulting from ownership of the asset. Second, the entity discounts those future cash flows to their present value using an appropriate discount rate converting the cash flows or earnings to a single present amount. Variations of the discounted cash flow method are often used to value intangible assets, including: the multi-period excess earnings method, the relief from royalty method, and the incremental cash flow method. A key component in any discounted cash flow technique is the discount rate and, generally, the discount rate should be commensurate with the risk associated with the cash flows reflecting market participant expectations of risk and return for the particular asset or liability. ASC Section 820-10-55 provides additional guidance on the application of present value techniques in a fair value measurement. Other common valuation techniques under the income approach are option-pricing models, such as the Black-Scholes-Merton formula, which is a closed-form model, and binomial models (e.g., a lattice model).
COST APPROACH

16.044 The cost approach establishes a value based on the cost of reproducing or replacing the asset, often referred to as current replacement cost. From the perspective of a market participant, the price received for an asset is estimated based on the cost to a market participant to reproduce or to replace the asset with a substitute asset of comparable utility. For nonfinancial assets, the valuation process under the cost approach typically begins with an estimation of the asset’s replacement cost adjusted, where applicable, for obsolescence to estimate the replacement cost of the asset’s current service potential. Obsolescence includes physical depreciation, functional or technological obsolescence, and economic obsolescence.

16.045 ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value should be appropriate for the circumstances and should be consistent with the market approach, income approach, and/or cost approach. A single valuation approach is appropriate in certain circumstances. For example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities, a market approach is most appropriate. In other cases, multiple valuation approaches may be appropriate. For example, when estimating the fair value of a reporting unit, both a market approach and an income approach may be appropriate. ASC paragraph 820-10-35-24

Example 16.9: Income vs. Cost Approaches – Software Asset

ABC Corp. acquires a group of assets. The asset group includes an income-producing software asset internally developed for licensing to customers and its complementary assets (including a related database with which the software asset is used) and the associated liabilities. For purposes of measuring the fair value of the software asset, ABC determines that the software asset provides maximum value to market participants through its use in combination with other assets or with other assets and liabilities (that is, its complementary assets and associated liabilities). There is no evidence to suggest that the current use of the software asset is not the highest and best use. Therefore, the highest and best use of the software asset is in its current use. (In this case, the licensing of the software asset, in and of itself, does not indicate that the fair value of the asset would be maximized through its use by market participants on a stand-alone basis.)

ABC determines that in addition to the income approach, sufficient data may be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:

(a) **Income approach.** The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (license fees from customers) over its economic life. The fair value indicated is $15 million.
(b) **Cost approach.** The cost approach is applied using a replacement cost method by estimating the amount that currently would be required to construct a substitute software asset of comparable utility (considering functional, technological, and economic obsolescence). The fair value indicated is $10 million.

Through its application of the cost approach, ABC determines that market participants are unable to replicate a substitute software asset of comparable utility. Certain attributes of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. ABC determines that the fair value of the software asset is $15 million, as indicated by the income approach.

ASC paragraphs 820-10-55-39 through 41

16.046 If multiple valuation techniques are used to measure fair value, the results of each should be evaluated and weighted, as appropriate, in determining fair value. In making that evaluation, an entity should consider, among other things, the reliability of the valuation techniques applied and the related inputs that are used in those techniques. If a particular market approach relies on higher level inputs (e.g., Level 1 – observable market prices) compared to a particular income approach that relies heavily on unobservable inputs (e.g., Level 3 – cash flow projections), the entity should apply greater weight to the market approach to maximize the use of observable inputs.

16.047 ASC Subtopic 820-10 does not provide guidance for a particular weighting exercise if multiple approaches or techniques are used. Instead, judgment is required depending on the circumstances and available information. If multiple valuation approaches are used, a fair value measurement is the point within the range that is most representative of fair value under the circumstances.

16.048 ASC Subtopic 820-10 emphasizes that valuation approaches and techniques used to measure fair value should be consistently applied. However, a change in a valuation technique is appropriate if the change results in a measurement that is more representative of fair value in the circumstances. Examples include development of new markets, new information becoming available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique should be accounted for prospectively as a change in accounting estimate under ASC Topic 250, *Accounting Changes and Error Corrections*. ASC paragraphs 820-10-35-25 and 35-26, 50-7, 65-2, and 250-10-50-5

16.049 ASC Subtopic 820-10 does not provide specific requirements for selecting an appropriate valuation technique or techniques for measuring fair value. The appropriate valuation technique or techniques depends on the value drivers, the reliability of inputs, and market participants. While ASC Subtopic 820-10 does not provide specific guidelines for determining the appropriate valuation technique, it establishes a fair value hierarchy that prioritizes fair value measurements based on the significance of observable inputs.
16. Overview of ASC Subtopic 820-10

VALUATION ANALYSIS INPUTS

ASC Paragraph 820-10-35-36

Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

ASC Paragraph 820-10-35-36B

A reporting entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see [ASC] paragraphs 820-10-35-2B through 35-2C). In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the [ASC] Topic [820] that requires or permits the fair value measurement. Premiums or discounts that reflect size as a characteristic of the reporting entity’s holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 820-10-35-44) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. In all cases, if there is a quoted price in an active market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.

ASC Master Glossary: Observable Inputs

Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

ASC Master Glossary: Unobservable Inputs

Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

16.050 Inputs to valuation techniques refer to assumptions that market participants use in pricing an asset or liability when using a valuation technique. Inputs to valuation techniques may be either observable or unobservable when valuing an asset or liability, including assumptions about risk. Observable inputs are inputs that reflect the assumptions market participants use in pricing the asset or liability based on market data that can be obtained from sources independent of the entity. The price of listed equity securities on the New York or London Stock Exchanges are observable inputs. Unobservable inputs are inputs that reflect the entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. For instance, in a business combination using the acquisition method of accounting, observable inputs typically do not exist for...
many assets acquired when there is no active market for such items. Nevertheless, valuation techniques used to measure fair value should maximize the use of observable inputs to the extent possible when measuring those assets and liabilities acquired and assumed in a business combination.

16.051 ASC Subtopic 820-10 provides examples of markets in which inputs might be observable for some assets and liabilities (e.g., financial instruments), including the following:

(a) *Exchange market.* A market in which closing prices are both readily available and generally representative of fair value. An example of such a market is the New York Stock Exchange.

(b) *Dealer market.* A market in which dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of items for which they make a market. Typically, bid and ask prices (representing the price at which the dealer is willing to buy and the price at which the dealer is willing to sell, respectively) are more readily available than closing prices. Over-the-counter markets (for which prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by Pink Sheets LLC) are dealer markets. For example, the market for U.S. Treasury securities is a dealer market. Dealer markets also exist for some other assets and liabilities, including other financial instruments, commodities, and physical assets (e.g., used equipment).

(c) *Brokered market.* A market in which brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. In other words, brokers to not use their own capital to hold an inventory of the items for which they make a market. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party’s price requirements. Brokered markets include electronic communication networks, in which buy and sell orders are matched, and commercial and residential real estate markets.

(d) *Principal-to-principal market.* A market in which transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be made available publicly.

**FAIR VALUE HIERARCHY**

ASC Paragraph 820-10-35-37

To increase consistency and comparability in fair value measurements and related disclosures, [ASC] Topic [820] establishes a fair value hierarchy that categorizes into three levels (see [ASC] paragraphs 820-10-35-40 through 35-41, 820-10-35-41B through 35-41C, 820-10-35-44, 820-10-35-46 through 35-51, and 820-10-35-52 through 35-54A) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in
active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

16.052 ASC Subtopic 820-10 establishes a three-level fair value hierarchy that prioritizes inputs to valuation techniques used when measuring fair value. The fair value hierarchy is classified into Level 1, Level 2, or Level 3 and is based on the inputs used to measure fair value. The highest priority is given to unadjusted quoted market prices (Level 1) and the lowest priority to unobservable inputs based on the reporting entity’s judgments about the assumptions that market participants would use in pricing the asset or liability (Level 3). These three broad levels also provide a framework for related disclosures about fair value measurements. Inputs to the fair value measurements should be consistent with the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.

16.053 In many cases, the inputs used in a particular fair value measurement technique might fall within different levels of the fair value hierarchy. For example, an entity might estimate the fair value of a reporting unit based on a multiple of projected earnings. In that circumstance, the entity might be able to identify observable multiples for similar entities, which could be considered to be Level 2 inputs. However, the earnings projections would likely be based on the reporting entity’s judgments about the assumptions that market participants would use in pricing the asset or liability (Level 3). In that circumstance, the measurement in its entirety falls within Level 3 of the hierarchy based on the lowest level input that is significant to the fair value measurement.

16.054 The availability of market inputs relevant to the asset or liability and the relative reliability of the inputs may affect the selection of the appropriate valuation techniques. However, the fair value hierarchy focuses on the inputs to valuation techniques, not the valuation techniques themselves.

LEVEL 1 INPUTS

ASC Paragraph 820-10-35-41

A quoted price in active markets provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in [ASC] paragraph 820-10-35-41C.

16.055 Level 1 inputs are quoted prices in active markets. Level 1 inputs provide the most reliable and verifiable measure of fair value and should be used whenever available. An active market for an asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. An entity’s determination of whether a market for an asset or liability is active is based on whether there are sufficient transactions to provide ongoing pricing information for the asset or liability. That determination is not affected by the size of the entity’s own position in the asset or liability that is being traded on that market. The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability. To determine whether, on the basis of the
evidence available, there has been a significant decrease in the volume or level of activity, a reporting entity should consider factors such as those listed in ASC paragraph 820-10-35-54C.

16.056 The existence of observable quoted prices in active markets for identical assets or liabilities generally preclude the use of other valuation techniques (e.g., internal valuation models) that may result in a different fair value measurement. ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value maximize the use of observable inputs and the existence of Level 1 inputs for an asset or liability generally precludes the use of lower level inputs in a valuation technique. For example, assume Entity A holds an option to acquire common shares of Entity B, a public company with actively traded shares on the New York Stock Exchange. Entity A’s option to acquire common shares of Entity B is not actively traded; thus, to perform a fair value measurement of the share option, Entity A uses a valuation technique (e.g., Black-Scholes-Merton formula). A required input to the Black-Scholes-Merton formula is the share price (i.e., closing price) of Entity B’s common shares, a Level 1 input, at the measurement date. Entity A would use the closing price rather than using a lower level input for Entity B’s share price, such as Entity A’s discounted cash flow analysis for a contemplated tender offer of Entity B’s common shares.

16.057 ASC Subtopic 820-10 provides an exception to the required use of Level 1 inputs in situations when a reporting entity holds a large number of similar (but not identical) assets or liabilities measured at fair value and a quoted price for an identical asset or liability in an active market is available, but it is not readily accessible for each of those assets or liabilities individually. In that case, as a practical expedient, a reporting entity may measure the fair value of the asset or liability using an alternative pricing method that does not rely exclusively on quoted prices (e.g., matrix pricing). However, the use of an alternative pricing method results in a fair value measurement categorized within a lower level of the fair value hierarchy. ASC subparagraph 820-10-35-41C(a)

16.058 The FASB provided the above exception as a practical measure for holders of a large number of assets or liabilities (e.g., debt securities) that require those holders to subscribe to multiple data services and perform extensive research for actively traded prices for each asset or liability held in its portfolios. Generally, this exception can only be used when all of the following criteria are met:

- The entity holds a large number of similar assets or liabilities (i.e., homogenous assets or liabilities);
- Quoted prices from an active market are not readily accessible for each of the individual assets or liabilities, without undue cost or effort; and
- The use of the alternative pricing method results in a price that the entity believes it would receive to sell an asset or pay to transfer a liability in an orderly transaction with market participants at the measurement date.

16.059 In rare circumstances, a quoted price in an active market might not be representative of the fair value of a particular asset or liability at the measurement date.
Adjustments to Level 1 inputs may be necessary. However, adjustments to Level 1 inputs should only occur in limited circumstances and will result in a fair value measurement categorized within a lower level of the fair value hierarchy. ASC paragraph 820-10-35-41C states three situations in which an adjustment to the quoted price is allowed:

- When a reporting entity holds a large number of similar (but not identical) assets or liabilities that are measured at fair value and a quoted price in an active market is available but not readily accessible (discussed in Paragraph 16.057 above)

- Significant events (such as transactions in a principal-to-principal market, trades in a brokered market, or announcements) that take place after the close of the applicable market but before the measurement date; and

- When measuring the fair value of a liability or an instrument classified in a reporting entity’s shareholders’ equity using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset. If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorized within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorized within a lower level of the fair value hierarchy.

16.060 Adjustments to Level 1 measures for other reasons (e.g., temporary market conditions, other reserves, or blockage factors) are not permitted. For instance, the FASB considered whether the appropriate unit of account for a block position in an instrument that trades in an active market is (1) at the individual trading unit where the fair value measurement would be determined as a product of the quoted price of the individual security (P × Q) or (2) the block where the fair value measurement would be determined using the quoted price, adjusted for the size of the position relative to trading volume (i.e., blockage factor). In that instance, where there is a Level 1 price for an individual unit of a block of securities, the aggregated block of securities would be valued as the product of the Level 1 price (unadjusted) multiplied by the quantity of instruments held by the entity at the measurement date (P × Q), excluding consideration of blockage factors. ASC paragraph 805-10-35-36B

**LEVEL 2 INPUTS**

**ASC Paragraph 820-10-35-47**

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

**ASC Paragraph 820-10-35-48**

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets
b. Quoted prices for identical or similar assets or liabilities in markets that are not active

c. Inputs other than quoted prices that are observable for the asset or liability, for example:
   1. Interest rates and yield curves observable at commonly quoted intervals
   2. Implied volatilities
   3. Subparagraph superseded by Accounting Standards Update No. 2011-04
   4. Subparagraph superseded by Accounting Standards Update No. 2011-04
   5. Credit spreads.
   6. Subparagraph superseded by Accounting Standards Update No. 2011-04

d. Market-corroborated inputs.

16.061 Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly through corroboration with observable market data. If the asset or liability has a specified contractual term, a Level 2 input should be observable for substantially the full term of the asset or liability.

16.062 Determining if a Level 2 input is observable for substantially the full term of the asset or liability requires judgment. For instance, fair value measurements that use multiple future data points, such as debt involving interpolated yield curve data or over-the-counter commodity forward contracts involving forward curves, should match the term of the asset or liability being measured and also be observable for substantially the entire term of the asset or liability to qualify as Level 2 inputs. It is generally inappropriate to use a 10-year Treasury rate as an input for measuring the fair value of a debt instrument with either an 8-year term or a 12-year term, unless that Level 2 input has been adjusted for the difference in the terms between the reference rate and the term of the debt instrument.

16.063 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset, the extent to which inputs relate to items that are comparable to the asset, and the volume or level of activity in the markets within which the inputs are observed. Adjustments to a Level 2 input that are significant to the entire measurement might result in a fair value measurement categorized within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.

16.064 ASC Subtopic 820-10 provides the following examples of Level 2 inputs for particular assets and liabilities:

(a) Receive-fixed, pay-variable interest rate swap based on the London Interbank Offered Rate (LIBOR) swap rate. A Level 2 input would be the LIBOR swap
rate if that rate is observable at commonly quoted intervals for the full term of the swap.

(b) Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency. A Level 2 input would be the swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.

(c) Receive-fixed, pay-variable interest rate swap based on a specific bank’s prime rate. A Level 2 input would be the bank’s prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.

(d) Three-year option on exchange-traded shares. A Level 2 input would be the implied volatility for the shares derived through extrapolation to year 3 if (1) prices for one-year and two-year options on the shares are observable and (2) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities’ shares, provided that correlation with the one- and two-year implied volatilities is established.

(e) Licensing arrangement. For a licensing arrangement that is acquired in a business combination and that was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would be the royalty rate in the contract with the related party at inception of the arrangement.

(f) Finished goods inventory at a retail outlet. For finished goods inventory that is acquired in a business combination, a Level 2 input would be either a price to customers in a retail market or a price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (that is, similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments should be used for the fair value measurement.

(g) Building held and used. A Level 2 input would be the price per square foot for the building (a valuation multiple) derived from observable market data, for
example, multiples derived from prices in observed transactions involving comparable (that is, similar) buildings in similar locations.

(h) Reporting unit. A Level 2 input would be a valuation multiple (e.g., a multiple of earnings or revenue or a similar performance measure) derived from observable market data (e.g., multiples derived from prices in observed transactions involving comparable (that is, similar) businesses, taking into account operational, market, financial, and nonfinancial factors). ASC paragraph 820-10-55-21

LEVEL 3 INPUTS

ASC Paragraph 820-10-35-52

Level 3 inputs are unobservable inputs for the asset or liability.

ASC Paragraph 820-10-35-53

Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

ASC Paragraph 820-10-35-54A

A reporting entity shall develop unobservable inputs using the best information available in the circumstances, which might include the reporting entity’s own data. In developing unobservable inputs, a reporting entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the reporting entity that is not available to other market participants (for example, an entity-specific synergy). A reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, a reporting entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.

16.065 Level 3 inputs are unobservable inputs for an asset or liability. That is, inputs that reflect an entity’s own estimates about the assumptions market participants would use in pricing the asset or liability, including assumptions about risk, which have been developed based on the best information available in the circumstances (including the entity’s own data). Although Level 3 inputs are not obtained from observable market data, the fair value measurement objective remains the same - an exit price notion reflecting the assumptions of market participants.
16.066 Unobservable inputs should be used to measure fair value only when observable inputs are not available. When developing unobservable inputs, an entity is not required to undertake all possible efforts to obtain information about market participant assumptions. However, the entity cannot ignore information about market participant assumptions that is reasonably available without undue cost and effort. The entity’s own data used to develop unobservable inputs is adjusted if information indicates that market participants would use the adjusted assumptions and the information is reasonably available without undue cost and effort.

16.067 ASC Subtopic 820-10 provides the following examples of Level 3 inputs for particular assets and liabilities:

(a) Long-dated currency swap. A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries’ yield curves.

(b) Three-year option on exchange-traded shares. A Level 3 input would be historical volatility, that is, the volatility for the shares derived from the shares’ historical prices. Historical volatility typically does not represent current market participants’ expectations about future volatility, even if it is the only information available to price an option.

(c) Interest rate swap. A Level 3 input would be an adjustment to a mid-market consensus (nonbinding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.

(d) Asset retirement obligation at initial recognition. Level 3 inputs are typically used in applying an expected present value technique. An entity estimates future cash flows based on market participants’ expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the asset retirement obligation. A credit-adjusted risk-free rate is used to discount those future cash flows to estimate fair value.

(e) Reporting unit. A Level 3 input would be a financial forecast (e.g., of cash flows or earnings) developed using the entity’s own data if there is no reasonably available information that indicates that market participants would use different assumptions. ASC paragraph 820-10-55-22

INPUTS BASED ON BID AND ASK PRICES

ASC Paragraph 820-10-35-36C

If an asset or a liability measured at fair value has a bid and an ask price (for example, an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorized within the fair value
hierarchy (that is, Level 1, 2, or 3). The use of bid prices for asset positions and ask prices for liability positions is permitted but is not required.

16.068 Certain markets for assets and liabilities function such that market prices are quoted in terms of bid and ask prices. Bid and ask prices are common in dealer markets that involve sales and purchases of assets or liabilities between dealers in a particular market. In such markets, the bid price represents the last offer to purchase a particular asset or assume a liability, and the ask price represents the last offer to sell an asset or transfer a liability. The difference between the bid and the ask price is referred to as the bid-ask spread. The price paid for the asset or liability is at a value within the boundaries of the bid-ask spread.

16.069 If an input used to measure fair value is based on bid and ask prices, the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value within all levels of the fair value hierarchy provided that the price is consistently determined.

16.070 ASC Subtopic 820-10 allows practical approaches for determining the appropriate price within a bid-ask spread, including the use of a mid-market or other pricing convention for fair value measurements based on bid and ask prices. The two most common approaches are (1) a mid-market pricing convention, which prices all assets and liabilities at the mean price between the bid and ask prices, or (2) the use of bid prices for assets and ask prices for liabilities. However, entities cannot ignore available evidence that suggests that the selected pricing convention produces an amount that is not the most representative of fair value in the circumstances. For example, if an entity selected a mid-market pricing convention and there is available information that suggests market participants currently believe the most representative fair value is closer to the bid price for an asset, then the entity should reconsider if a mid-market pricing convention is appropriate for that specific asset in the circumstances.

DETERMINING FAIR VALUE WHEN THE VOLUME AND LEVEL OF ACTIVITY FOR THE ASSET OR LIABILITY HAVE SIGNIFICANTLY DECREASED AND IDENTIFYING TRANSACTIONS THAT ARE NOT ORDERLY

16.071 ASC Subtopic 820-10 provides guidance on when the volume and level of activity for the asset or liability have significantly decreased, as well as additional guidance on identifying circumstances that indicate a transaction is not orderly.

DETERMINING FAIR VALUE WHEN THE VOLUME AND LEVEL OF ACTIVITY FOR THE ASSET OR LIABILITY HAVE SIGNIFICANTLY DECREASED

16.072 In accordance with ASC paragraph 820-10-35-54C, the fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity
for that asset or liability, a reporting entity shall evaluate the significance and relevance of factors such as the following:

- There are few recent transactions.
- Price quotations are not developed using current information.
- Price quotations vary substantially either over time or among market makers (e.g., some brokered markets).
- Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, taking into account all available market data about credit and other nonperformance risk for the asset or liability.
- There is a wide bid-ask spread or significant increases in the bid-ask spread.
- There is a significant decline in the activity of, or there is an absence of, a market for new issues (that is, a primary market) for the asset or liability or similar assets or liabilities.
- Little information is publicly available (e.g., for transactions that take place in a principal-to-principal market).

16.073 ASC paragraph 820-10-35-54G confirms that the objective of a fair value measurement remains the same even if the volume and level of activity in the market for the asset or liability have significantly decreased, regardless of the valuation technique or techniques used. Fair value is the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions.

16.074 If an entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or for similar assets or liabilities), further analysis of the transactions or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. However, if a reporting entity determines that a transaction or quoted price does not represent fair value (e.g., there may be transactions that are not orderly), an adjustment to the transactions or quoted prices will be necessary if the reporting entity uses those prices as a basis for measuring fair value and that adjustment may be significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (e.g., when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale). ASC paragraph 820-10-35-54D
16. Overview of ASC Subtopic 820-10

16.075 ASC Subtopic 820-10 does not prescribe how to make significant adjustments to transactions or quoted prices. Regardless of the valuation technique used, a reporting entity would include appropriate risk adjustments, including a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows of an asset or a liability. If there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate.

Identifying Transactions That Are Not Orderly

16.076 Entities should consider whether information indicates that an observed transaction was not orderly. Entities may not assume that all transactions are not orderly even if there has been a significant decrease in the volume and level of activity for the asset or liability. A transaction price that is associated with a transaction that is not orderly is not determinative of fair value or market-participant risk premiums. Entities should use judgment to determine whether evidence indicates that a transaction is not orderly. Although not necessarily determinative, entities should consider factors such as:

- Exposure to the market for a period before the measurement date was not adequate to allow usual and customary marketing activities for transactions involving the asset or liability under current market conditions.
- There was a usual-and-customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller is in or near bankruptcy or receivership (a distressed transaction).
- The seller was required to sell to meet regulatory or legal requirements (the seller was forced).
- The transaction price is an outlier when compared to other recent transactions for the same or a similar asset or liability.

16.077 Reporting entities should consider all of the following when measuring fair value or estimating market risk premiums:

- Entities should place little, if any, weight (compared with other indications of fair value) on transactions that are not orderly when estimating fair value or market risk premiums.
- Entities should consider the transaction price of orderly transactions when estimating fair value or market risk premiums. The amount of weight placed on that transaction price (compared to the weight placed on other indications of fair value) depends on specific facts, such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.
- If a reporting entity does not have sufficient information to conclude whether a transaction is orderly, it would take into account the transaction price. However, that transaction price may not represent fair value (that is, the
transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When a reporting entity does not have sufficient information to conclude whether particular transactions are orderly, the reporting entity would place less weight on those transactions when compared with other transactions that are known to be orderly.

16.078 Entities need not undertake exhaustive efforts to determine whether a transaction is orderly, but should not ignore information that is reasonably available. When a reporting entity is a party to a transaction, it is presumed to have sufficient information to conclude whether the transaction is orderly.

16.079 ASC paragraph 820-10-35-54K notes that ASC Subtopic 820-10 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, if a reporting entity has determined that the quoted prices provided by those parties are developed in accordance with ASC Subtopic 820-10. However, entities should carefully evaluate those quoted prices to determine whether they are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risk). Entities should place less weight on quotes that do not reflect the result of transactions. Entities should place more weight on quotes based on binding offers than on quotes based on indicative prices.
Section 17 - Determining the Fair Value of Assets Acquired and Liabilities Assumed in a Business Combination

Detailed Contents

Overview
  FASB Valuation Resource Group
  Use of a Third-Party Valuation Professional
Illustrative Balance Sheet
Assets
  Overview
  Cash and Cash Equivalents
  Trade and Other Receivables
    Example 17.1: Determination of Fair Value of Acquired Trade Receivables
Inventories
  Raw Materials and Supplies
  Finished Goods and Work-in-Process
  Q&A 17.1: Acquisition of a Business That Outsources the Manufacturing Process and Has Patent Protection
  Q&A 17.2: Measurement of the Fair Value of Inventories That Will Be Discontinued
    Example 17.2: LIFO Method
Debt and Equity Securities
  Debt and Equity Securities-Classification (Pre-ASU 2016-01)
  Debt and Equity Securities-Classification (ASU 2016-01)
  Debt and Equity Securities-Measurement
    Example 17.3: Restriction on Sale of Security
Other Securities
Property, Plant, and Equipment
  Example 17.4: Apportionment of Unit of Measurement to the Individual Units of Account
  Example 17.4a Valuation of Assets That Are Subject to a Government Grant
  Sales Comparison Method
  Income Capitalization Method
  (Pre-ASC Topic 842*) Replacement Cost New Method
Property, Plant, and Equipment to Be Used
Property, Plant, and Equipment to Be Sold (Held for Sale)
Mining Assets
Intangible Assets
Valuation Analysis
Market Approach
Income Approaches
Cost Approach
Intangible Assets Commonly Acquired in Business Combinations
Long-Term Construction-Type Contracts (Pre-ASC Topic 606)
  Accounting under the Completed Contract Method#
  Example 17.5: Accounting for LTCC (Completed Contract Method)
  Accounting under the Percentage of Completion Method#
  Example 17.6: Accounting for LTCC (Percentage of Completion Method)
Contracts with Customers (after Adoption of ASC Topic 606##)
  Contract Assets (after Adoption of ASC Topic 606##)
  Contract Liabilities (after Adoption of ASC Topic 606)
  Accounting for Acquired Revenue Contracts (after Adoption of ASC Topic 606)
    ##
  Example 17.6a: Accounting for an Acquiree's Revenue Contract after Adopting
  ASC Topic 606
(Pre-ASC Topic 842*) Operating and Capital Leases
  Operating Leases
  Capital Leases
(ASC Topic 842) Leases (Acquiree Is Lessee)
(ASC Topic 842) Leases (Acquiree Is Lessor)
(Before and after Adopting ASC Topic 842*) Income Producing Real Estate in the
Real Estate Industry
  Q&A 17.3 Purchase of a Real Estate Development Company
Liabilities
Overview
Trade Accounts and Notes Payable
Deferred Revenue (Pre-ASC Topic 606##)
  Market Approach
  Income Approach
  Example 17.7: Deferred Revenue
(Pre-ASC Topic 842*) Deferred Revenue Arising from a Vendor-Financed Leasing Arrangement

Long-Term Debt
  Market Approach
  Income Approach
  Example 17.8: Determining the Fair Value of Debt Assumed in a Business Combination

Asset Retirement Obligation

Derivative Instruments

Redeemable Preferred Stock
  Example 17.9: Redeemable Preferred Stock Held by Noncontrolling Interests
OVERVIEW

17.000 As stated in Section 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree, ASC Topic 805, Business Combinations, requires an acquirer to recognize, separately from goodwill, the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquiree, and to measure such items at their acquisition date fair values in accordance with ASC Subtopic 820-10, Fair Value Measurement - Overall, with certain exceptions. This Section provides general guidance on the measurement of certain assets acquired and liabilities assumed in a business combination. A modified balance sheet has been provided to demonstrate commonly used valuation approaches to measure the acquisition-date fair value of those assets and liabilities.

17.001 The guidance herein is based on general valuation principles, and the specific approach may differ for a specific transaction depending on the facts and circumstances, including the relevant market participant assumptions and available information at the measurement date. Fair value measurements require the application of judgment and for some items the use of complex valuation techniques to determine fair value.

FASB VALUATION RESOURCE GROUP

17.002 In June 2007, the FASB formed a FASB Valuation Resource Group (the VRG) to address issues related to valuation for financial reporting consistent with their mission to improve and enhance the quality, consistency, and comparability of financial reporting. The FASB continues to assess whether and to what extent additional and more specific valuation guidance is needed for financial reporting purposes beyond the guidance provided in ASC Subtopic 820-10. As part of this process, the VRG meets periodically to provide the FASB staff with information on existing implementation issues surrounding fair value measurements used for financial reporting purposes and alternative viewpoints associated with those implementation issues. However, the VRG does not make authoritative decisions and ultimately all authoritative decisions are subject to the FASB’s normal open due process, including public deliberation by the FASB.

USE OF A THIRD-PARTY VALUATION PROFESSIONAL

17.003 The application of ASC Topic 805 requires fair value measurements for assets acquired and liabilities assumed and noncontrolling interests in a business combination. While ASC Topic 805 does not require an entity to use a third-party valuation professional to determine fair value for such items, an entity should consider whether it employs competent and knowledgeable professionals to perform those measurements. In many situations, an entity may have in-house expertise for valuing some, but not all, of the assets acquired and liabilities assumed. Therefore, the need to use a third-party valuation professional is expected to vary by entity and even by transaction.
ILLUSTRATIVE BALANCE SHEET

17.004 The table below provides items commonly found on balance sheets that would be subject to fair value measurement in applying the acquisition method. The table provides the valuation approach (market, income, or cost) commonly used for these items; however, in specific situations, depending on the information available, other approaches may be appropriate.

<table>
<thead>
<tr>
<th>Common Fair Value Measurement Approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Current assets:</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
</tr>
<tr>
<td>Trade and other receivables</td>
</tr>
<tr>
<td>Inventories</td>
</tr>
<tr>
<td>Finished goods</td>
</tr>
<tr>
<td>Work-in-process</td>
</tr>
<tr>
<td>Raw materials</td>
</tr>
<tr>
<td>Long-term assets:</td>
</tr>
<tr>
<td>Debt and equity securities</td>
</tr>
<tr>
<td>Plant and equipment</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>Long-term construction-type contracts</td>
</tr>
<tr>
<td>Operating and capital leases (Pre-ASC</td>
</tr>
<tr>
<td>Topic 842*)</td>
</tr>
<tr>
<td>Income producing real estate (Pre-ASC</td>
</tr>
<tr>
<td>Topic 842*)</td>
</tr>
</tbody>
</table>

| Liabilities                               | Valuation Approaches |
| Current liabilities:                     | Market | Income | Cost |
| Trade accounts payable                   | F      | F      | N/A  |
| Deferred revenue                         | O      | F      | S    |
| Notes payable                            | F      | F      | N/A  |
| Long-term liabilities:                   |        |        |      |
| Long-term debt                           | F      | F      | N/A  |
| Asset retirement obligation              | S      | F      | S    |
| Derivative instruments                   | F      | F      | N/A  |
| Contingent consideration                 | S      | F      | S    |
| Deferred income taxes (a)                | N/A    | N/A    | N/A  |
| Liability for pension benefits (a)       | N/A    | N/A    | N/A  |

| Redeemable preferred stock               | F      | F      | S    |

(a) Exceptions to the recognition and measurement principles. See Section 7 for further discussion.
ASSETS

OVERVIEW

17.005 Concepts Statement 6 defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” With limited exceptions, ASC Topic 805 requires that assets acquired and liabilities assumed in a business combination be measured at fair value determined in accordance with ASC Subtopic 820-10, including the requirement to consider the highest and best use for the unit of measure, regardless of the acquirer’s intended use.

17.006 The following section identifies valuation techniques commonly used to measure the acquisition date fair value of assets acquired and liabilities assumed in a business combination.

CASH AND CASH EQUIVALENTS

17.007 Cash equivalents are highly liquid investments that are readily convertible to known amounts of cash and generally have a maturity of three months or less when purchased. Given the short-term nature and “insignificant risk of changes in value because of changes in interest rates,” according to ASC Section 230-10-20, the carrying amount or nominal amount is often assumed to approximate fair value for cash and cash equivalents. However, the acquiring entity should make its own evaluation of the instruments classified by the acquiree as cash and cash equivalents to determine whether an assumption of insignificant risk of changes in value in response to interest rate changes is supportable, as that conclusion generally is the basis for using carrying amount or nominal amount as the approximation of fair value for such instruments.

TRADE AND OTHER RECEIVABLES

17.007a Measuring trade and other receivables acquired in a business combination is affected by ASU 2016-13, Measurement of Credit Losses on Financial Instruments, which established ASC Topic 326, Financial Instruments--Credit Losses. The table below sets out the mandatory adoption dates for ASC Topic 326.
<table>
<thead>
<tr>
<th>Annual and interim periods beginning after…</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public business entities that are SEC filers</td>
<td>December 15, 2019</td>
</tr>
<tr>
<td>Public business entities that are not SEC filers</td>
<td>December 15, 2020</td>
</tr>
<tr>
<td>All other entities</td>
<td>December 15, 2021</td>
</tr>
</tbody>
</table>

**17.007b** See chapter 25 of KPMG’s Handbook, *Credit impairment*, for detailed information about the effective date, early adoption, and transition requirements of ASC Topic 326. See section 12.3 of that Handbook for guidance on measuring financial assets acquired in a business combination after adopting ASC Topic 326. The remainder of this section addresses measuring acquired trade and other receivables before adopting ASC Topic 326.

**17.008** Receivables acquired in a business combination should be measured at fair value without a related allowance account. The objective of fair value measurement of receivables is to approximate the amount that would be received if the receivables were sold in a transaction with market participants (an exit price) under current market conditions. For some trade receivables, this amount may be approximated by the amount that would be received from factoring the receivables. Alternatively, the fair value of receivables could be measured at the present value of the contractually required payments discounted using an interest rate reflecting market participants’ requirements at the measurement date. Because ASC Topic 805 does not permit the recognition of a separate valuation allowance for receivables acquired in a business combination, the effects of timing and uncertainty about future cash flows (i.e., credit and liquidity risk) are included in the measurement of fair value of those receivables.

**17.009** The interest rate used in the measurement should be commensurate with the risk associated with uncertainty about future cash flows reflecting the expectations of market participants. Paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables* (ASC paragraphs 835-30-25-12 and 25-13), provide guidance in arriving at an appropriate interest rate.

**17.010** In September 2008, the VRG noted that in practice some entities recognize components of working capital, including trade accounts receivable, at the acquiree’s book value, because the differences resulting from current interest rates are often deemed to be insignificant. However, use of this approach is a non-GAAP policy and, accordingly, entities should evaluate the potential significance of the policy and be able to support that applying the non-GAAP policy is immaterial to the entity’s financial statements at the date of acquisition and in subsequent periods.
### Example 17.1: Determination of Fair Value of Acquired Trade Receivables

ABC Corp. acquires DEF Corp. in a business combination. At the acquisition date, ABC determines the fair value of the trade receivable of DEF, as follows:

<table>
<thead>
<tr>
<th>Acquired Trade Receivables</th>
<th>Commercial</th>
<th>Consumer</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractually required payments receivable at acquisition date</td>
<td>$1,200</td>
<td>575</td>
<td>225</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash flows expected to be collected</td>
<td>1,115</td>
<td>495</td>
<td>210</td>
<td>1,820</td>
</tr>
<tr>
<td>Difference</td>
<td>1,103</td>
<td>489</td>
<td>208</td>
<td>1,800</td>
</tr>
<tr>
<td>Estimated fair value</td>
<td>$1,103</td>
<td>489</td>
<td>208</td>
<td>1,800</td>
</tr>
</tbody>
</table>

(a) Disaggregated as commercial, consumer, and other trade receivables based on pool of receivables with common attributes and risk characteristics.
(b) Book value of DEF’s contractually required payments receivable at date of acquisition.
(c) Estimated future cash flows expected to be collected, considering uncertainty about future cash flows (i.e., estimated credit risk).
(d) Difference relates to total estimated credit risk of trade receivables.
(e) Present value of estimated future cash flows using an appropriate interest rate, considering estimated timing associated with the cash flows.
(f) Difference between DEF’s carrying amount and estimated fair value.

17.011 Because the fair value of a tax-exempt note receivable may be affected by conditions other than changes in interest rates, such as changes in tax laws, determining the fair value of a tax-exempt note acquired in a business combination by adjusting the previous carrying amount for the effects of the difference between current interest rates and the stated rate on the note may not be sufficient. It may be necessary to obtain independent appraisals from an investment adviser or broker in determining the fair value of tax-exempt notes.

### INVENTORIES

17.011a The AICPA has convened a task force to develop an Accounting and Valuation Guide — Business Combinations (the AICPA Business Combinations Guide), which will provide guidance and illustrations for preparers, independent auditors, and valuation specialists regarding the accounting and valuation considerations for business combination transactions. The guidance below reflects the latest framework, but may require updating once the guidance contained in the AICPA Business Combinations Guide...
Guide is finalized. At the current time, KPMG recommends consulting a valuation professional for additional guidance on the topic.

**17.012** FASB Statement No. 141 (Statement 141), *Business Combinations*, provided more guidance than ASC Topic 805 regarding measurement methods for specific assets and liabilities assumed in business combinations, including inventory. While the guidance for valuing inventory in paragraph 37 of Statement 141 has been superseded, it was aligned with the tax guidance for estimating fair market value of inventory specified in IRS Revenue Procedure 2003-51. In practice, methods used for valuing inventory remain consistent with the superseded Statement 141 and Revenue Procedure 2003-51 guidance.

**17.013** Conceptually, the analysis of inventory can be thought of as an allocation of value created pre-valuation date by the seller versus post-valuation date by the buyer. The fair value of inventory is estimated as the value created prior to the acquisition date—the process of procuring and manufacturing the inventory. The fair value measurement should provide the seller with fair compensation for the efforts and costs previously incurred and assets used related to the inventory, while allowing the market participant buyer to be fairly compensated for its purchase, risk, future efforts, and assets used to complete and dispose of the inventory after the acquisition date.

**17.014** The valuation method used to measure the fair value of inventory acquired in a business combination depends on its stage in the production cycle (finished goods, work-in-process (WIP), or raw materials) on the acquisition date and availability of reliable inputs. Historically, finished goods and WIP inventory have typically been valued using the Comparative Sales Method (Top-down Method) and raw materials were typically valued using the Replacement Cost Method (Bottom-up Method). Theoretically, applying a Top-down or Bottom-up Method should result in a consistent measure of the inventory value.

**Raw Materials and Supplies**

**17.015** The fair value of raw materials would be the price a market participant could achieve in a current sale. Raw materials inventory is often valued using the Bottom-up Method because typically there are fewer subjective assumptions. If no preparation costs have been incurred, the Bottom-up Method may simply be an analysis of the net book value as of the valuation date. However, adjustments to book value would need to be considered. Supplies purchased to be consumed directly or indirectly in production are measured at fair value, often in the same manner as raw materials.

**17.016** If applicable, the target's book value of raw materials prior to the acquisition may be reduced to account for obsolete, defective, and subnormal goods as well as shrinkage, and adjusted to account for variances between actual and standard costs. Shrinkage refers to differences between accounting and actual inventory quantities (e.g., due to theft, damage, miscounting, incorrect units of measure, evaporation). Variances refers to difference between the actual and standard costs, applicable if standard cost is used (e.g., by manufacturing companies). These reserves and variances should be considered in the
starting point when using a Bottom-up Method. However, LIFO is not an appropriate
starting point for estimating the fair value of raw materials because it does not represent
current replacement cost. If the inventory cost accounting is based on LIFO, the starting
point for the valuation should be the gross amount, before consideration of the LIFO
reserve. Fair value of raw materials may approximate book value as of the valuation date
if the following exists: FIFO accounting is used, inventory is measured at actual cost, any
preparation costs are minimal, and the reserves fully account for obsolete and defective
goods as well as shrinkage.

Finished Goods and Work-in-Process

17.017 In the Top-down Method, the value of finished goods and WIP inventory is based
on the estimated selling price less the sum of (a) costs of disposal, (b) any costs to
complete WIP, and (c) a reasonable profit allowance for the efforts contributed and assets
used by the buyer (acquirer). Amounts not deducted when using the Top-down Method
would have implicitly been added to the book value if valuing inventory using the
Bottom-up Method. Thus, in the Bottom-up Method, the value is based on (a) the book
value, including costs already incurred toward procurement and manufacturing efforts,
and (b) a reasonable profit allowance for the efforts contributed and assets used by the
acquiree.

17.018 Similar to raw materials, the book value of finished goods and WIP, after
consideration of reserves for obsolescence, defective goods, and shrinkage, as well as
variances, may serve as a starting point for the Bottom-up Method. However, the starting
point should exclude the LIFO reserve, because LIFO does not represent current
replacement cost.

17.019 For the valuation of finished goods and WIP inventory, it is relevant to first
identify the appropriate baseline projected financial information (PFI). Conceptually, this
should represent the market participant PFI for the initial projected period when the
inventory is expected to be sold. The acquiree's PFI may be a good starting point, but
adjustments may be needed to reflect a market participant perspective. The baseline PFI
should represent the income statement through EBITA, and provide detail on the
breakdown of expenses (e.g., R&D, marketing, depreciation, etc.). If projected financial
data is not sufficiently detailed, then historical financial statements may be used as a
proxy but adjustments may be appropriate to represent the period in which the inventory
is sold (e.g., adjustments for seasonality, etc.).

17.020 The Top-down Method begins with an assessment of the selling price of the
inventory to the company’s direct customer in the principal or most advantageous market.
The selling price should be consistent with the selected baseline PFI used throughout the
inventory valuation analysis. Selling prices can be derived directly from observed or
listed selling prices on a per unit basis or indirectly through a gross margin analysis, as
appropriate. A gross margin analysis estimates the selling price of the inventory by
dividing the adjusted net book value of finished goods by the appropriate gross profit
margin percentage.
17.020a The analysis of costs of disposal for the Top-down Method and costs already completed for the Bottom-up Method is based on the selected baseline PFI. The first step is to exclude any costs that are intended to benefit future periods, such as R&D costs related to new product development, marketing costs for a new product, training costs to increase the size of the workforce, costs for expansion into a new territory, depreciation of an R&D facility dedicated to future research, or restructuring costs. Removing the future-benefit direct and indirect costs generally results in an adjusted baseline PFI with higher margins. The next step is to identify the proportion of the costs in the adjusted baseline PFI that already have been incurred with respect to the finished goods inventory versus the proportion of costs that will be incurred during the disposal process of finished goods inventory. Costs of disposal would include both direct selling and marketing costs as well as a portion of the indirect overhead costs such as general and administrative expenses and depreciation. Similarly costs incurred would include costs of procuring raw materials and manufacturing as well as a portion of the indirect overhead costs such as general and administrative costs and depreciation.

17.020b The WIP analysis of costs to complete (for the Top-down Method) and manufacturing costs already completed (for the Bottom-up Method) is performed on the subset of the adjusted baseline PFI assumed to have been contributed to finished goods in the functional apportionment above. These costs can be further bifurcated into the completed portion that relates to the effort of procuring raw materials and manufacturing WIP already incurred pre-measurement date versus those costs that relate to the remaining incremental effort to bring the WIP to its finished state. The completion costs should exclude the disposal costs that have already been estimated for the inventory once finished.

17.020c The reasonable profit allowance may also be derived from the adjusted baseline PFI. Based on the assumptions above, the acquirer determines a profit margin earned pre- and post-measurement date on the cost structure. However, the acquirer may need to adjust those amounts based on the relative efforts exerted, risks assumed, value added, and assets used with respect to the inventory. In some cases the value added or intangible assets used during the procurement and manufacturing of the inventory pre-valuation date may not be the same as those contributed post-valuation date. For example, the materials portion of cost of goods sold may not contribute any value added benefit and may not drive the profit earned. Additionally, when internally developed intangible assets contribute to an increase in the level of profitability for the business, the acquirer should evaluate whether each of those intangible assets has been used during the procurement and manufacturing of the finished goods and WIP inventory or remain to be used during the disposition process.

17.020d Holding costs may need to be estimated to account for the opportunity cost associated with the time required to sell the inventory (time to sale). This represents the foregone return on investment during the time to sell the inventory. Holding costs are based on the inventory turnover rate and the cost of borrowing. Time to sale may be estimated by analyzing historical inventory turnover rates. The rate of return (borrowing cost) applicable to the inventory is generally lower than the overall rate of the business and may approximate the return on working capital. Diversity in practice exists with
respect to including holding costs and, even when included, there is diversity in practice with respect to how to calculate them. Holding costs may be immaterial if the inventory turnover is high or the borrowing rate is low.

**Q&A 17.1: Acquisition of a Business That Outsources the Manufacturing Process and Has Patent Protection**

**Q.** Should an entity that acquires a business that outsources the manufacture of its proprietary widgets and enjoys a high gross margin and low selling cost owing to patent protection, record acquired inventory at the historic cost to the acquiree?

**A.** No. ASC Topic 805 requires that an entity measure identifiable acquired assets at their acquisition-date fair values using a market participant perspective. In the Top-down Method, the fair value of finished goods inventories is measured from the perspective of a market participant as the selling price less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiree (selling margin). In this example, the high gross margin realized by the acquiree is inherent in the historical cost of the widget to the acquirer. Because the high gross margin relates to patent protection and the patent is used as part of the manufacturing process, it is contributed to the inventory as part of the manufacturing process and therefore increases the fair value of inventory. The fact that the entity outsources the production to a third party is irrelevant as the third-party contract manufacturer uses the know-how of the patent in the production process.

The acquirer recognizes an intangible asset associated with the patent protection that historically allowed the acquiree to realize the high margins (i.e., the patent was internally generated and not recognized as an asset in the acquiree’s financial statements). The fair value of the intangible asset would be adjusted to reflect the portion that has been contributed to inventory and therefore already included in the fair value of the inventory.

**Q&A 17.2: Measurement of the Fair Value of Inventories That Will Be Discontinued**

ABC Corp. operates retail hardware stores. ABC acquires DEF Corp., also a hardware retailer. In the transaction, ABC acquires inventories of DEF, including certain products that DEF has historically stocked and sold under brand names not sold in ABC stores. Some of the inventories on hand for the DEF products are liquidated as ABC does not intend to continue selling the DEF-branded products. DEF stores will mark down and sell the existing inventory and then will begin to sell ABC’s products and brands.

**Q.** How should inventories of DEF’s products that will be discontinued after the acquisition be valued in the acquisition accounting?
A. The fair value of the inventories acquired should be based on the expected selling price of the units from a market participant perspective. If a market participant is expected to continue to sell the DEF-branded products, then the baseline PFI should reflect this. If, however, a market participant is expected to liquidate the DEF-branded products, the baseline PFI should reflect liquidation prices and cost structure.

In general, if a market participant retailer is expected to continue selling the acquired inventory, the fair value of that inventory for a retailer is often similar to its book value. This is because the profit on the selling effort left to be earned post-acquisition is often a large percentage of the overall profit. For retailers, most of the inventory is purchased for resale (i.e., cost of goods sold is not a value-added expense) and the inventory tends to turn quickly.

Example 17.2: LIFO Method

ABC Corp. acquired DEF Corp. on January 1, 20X0. Before the acquisition, DEF measured its inventory using the LIFO method. ABC’s similar inventory is also measured using the LIFO method. The carrying amount of DEF’s inventory under the LIFO method as of January 1, 20X0, and the fair value of the inventory at the date of acquisition is as follows:

<table>
<thead>
<tr>
<th></th>
<th>LIFO</th>
<th>Fair Value</th>
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<tbody>
<tr>
<td>20X7 – Base year</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>20X8 – Layer</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>20X9 – Layer</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>Total inventory</td>
<td>$225</td>
<td>$305</td>
</tr>
</tbody>
</table>

Under ASC paragraph 330-10-S99-1 (which supports conclusions reached in AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*), ABC should measure the acquisition-date fair value of the acquired inventory at $305. If the acquired inventory is deemed to be a separate LIFO pool, this amount becomes the base year layer for the inventory to apply LIFO in periods subsequent to the acquisition. If it is deemed to be part of the existing LIFO pool (i.e., it is similar to ABC’s existing inventory), then this amount is included in the current period’s purchases to determine the current period LIFO layer.

DEBT AND EQUITY SECURITIES

17.021 Debt and equity securities include investments in U.S. Treasury securities, corporate debt securities, and equity securities publicly traded on an active exchange (e.g., the New York Stock Exchange).
17.021a ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, amends the classification of investments in equity securities that do not meet the criteria for equity method accounting or consolidation. The standard is effective for public business entities in annual and interim periods beginning after December 15, 2017; for all other entities in annual periods in fiscal years beginning after December 15, 2018 and interim periods in fiscal years beginning one year later. Early adoption is permitted for any period for which financial statements have not been made available for issuance (other than public business entities).

DEBT AND EQUITY SECURITIES-CLASSIFICATION (PRE-ASU 2016-01)

17.022 At the date of acquisition, investment securities in the scope of ASC Topic 320, Investments--Debt and Equity Securities should be classified as held-to-maturity, available-for-sale, or trading securities, based on the intent and ability of the acquirer rather than the historical classification of the securities by the acquiree. ASC Topic 805 requires that the acquirer make those classifications or designations based on contractual terms, economic conditions, the acquirer’s operating or accounting policies, and other relevant conditions as they exist at the acquisition date. ASC paragraph 805-20-25-6

DEBT AND EQUITY SECURITIES-CLASSIFICATION (ASU 2016-01)

17.022a After adopting ASU 2016-01, debt securities should be classified as held-to-maturity, available-for-sale or trading securities, under ASC Topic 320, Investments--Debt Securities, based on the intent and ability of the acquirer rather than the historical classification of the securities by the acquiree. ASC Topic 805 requires that the acquirer make those classifications or designations based on contractual terms, economic conditions, the acquirer’s operating or accounting policies, and other relevant conditions existing at the acquisition date. All investments in equity securities (other than those to which consolidation or equity method accounting applies) are accounted for under ASC Topic 321, Investments--Equity Securities. Generally, equity securities are initially and subsequently measured at fair value, with changes in fair value reported currently in earnings. However, an entity can elect an accounting policy to measure equity securities without readily determinable fair value at cost minus impairment, if any, plus or minus changes resulting from observable price changes. See KPMG's publication, Financial instruments--Recognition and measurement of financial assets and financial liabilities, for additional guidance. ASC paragraph 805-20-25-6

DEBT AND EQUITY SECURITIES-MEASUREMENT

17.023 Regardless of classification, securities acquired in a business combination are measured at fair value at the date of acquisition. Quoted market prices (Level 1 inputs), if available, generally provide the most reliable and best evidence of fair value. In certain circumstances, quoted market prices may need to be adjusted downward to recognize the possible effects of security-specific restrictions because other market participants would consider the restrictions when measuring the fair value of the securities. In those circumstances, ASC Subtopic 820-10 requires the fair value of a restricted security be
measured based on a quoted price of an otherwise unrestricted security of the same issuer adjusted for the effect of the restriction.

17.024 Consistent with ASC Subtopic 820-10, quoted market prices should only be adjusted for restrictions that are specific to the security and, therefore, would transfer to market participants. For security-specific restrictions, the price used in the measurement of fair value should include an adjustment for the effect of the restriction. Conversely, for entity-specific restrictions, the price used in the measurement of fair value of the securities would not be adjusted to reflect the restriction. Determining whether a restriction is entity-specific or security-specific may require judgment based on the specific facts and circumstances.

17.025 In the absence of an available quoted market price for securities, fair value is often determined using a market approach or income approach, fair value measurements that use Level 2 or Level 3 inputs. See section H in KPMG's Fair Value Measurements - Questions and Answers for additional discussion.

Example 17.3: Restriction on Sale of Security

The reporting entity holds a security of an issuer for which sale is legally restricted for a specified period. The restriction is determined to be specific to (an attribute of) the security and, therefore, would transfer to market participants.

The fair value of the security is based on the quoted price for an otherwise identical unrestricted security of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment reflects the amount market participants would demand because of the risk relating to the inability to access a public market for the security for the specified period.

The adjustment depends on the nature and duration of the restriction, the extent to which buyers are limited by the restriction (e.g., a large number of qualifying investors), and factors specific to both the security and the issuer (qualitative and quantitative).

ASC paragraph 820-10-55-52

17.026 If the reporting entity manages a group of financial assets or financial liabilities on the basis of its net exposure to either market risk or credit risk, the reporting entity is permitted to measure the fair value of the group of financial assets or financial liabilities on the basis of the price that would be received to sell a net long position or to transfer a net short position. The reporting entity should measure the fair value of the group consistent with how market participants would price the net risk exposure. The exception does not pertain to financial statement presentation. As such, the reporting entity may need to allocate portfolio-level adjustments to the individual assets or liabilities that make up the group of financial assets and financial liabilities managed on the basis of the reporting entity’s net risk exposure.
OTHER SECURITIES

17.027 Determining the fair value of securities that are not quoted in active markets may require the use of valuation techniques. ASC Subtopic 820-10 states that in some instances more than one of the three valuation approaches discussed (market approach, income approach, and cost approach or their underlying techniques) may be required to develop the measurement of fair value.

17.028 In these instances, entities should consider, among other things, the reliability of the valuation approaches and underlying techniques and the inputs used in the techniques. If a particular market-based approach relies on higher level inputs (e.g., observable market prices) compared to a particular income-based approach that relies heavily on projections of income, the reporting entity should apply greater weight to the measurement of fair value generated by the market-based approach, because it relies on higher-level inputs.

17.029 ASC Subtopic 820-10 notes that any, or a combination, of the techniques should be used to measure fair value if the techniques are appropriate in the circumstances. However, when multiple valuation techniques are used to measure fair value, ASC Subtopic 820-10 does not prescribe a mathematical weighting scheme, but requires the use of judgment. Valuation professionals, in many instances, consider multiple valuation approaches and underlying techniques but may conclude that a single valuation technique is appropriate to determine fair value. In instances when multiple valuation techniques are relied on to measure fair value, the techniques should be evaluated for reasonableness and reliability, and the valuation professional should determine if and how the techniques should be weighted. In some cases, a secondary technique is used only to corroborate the reasonableness of the most appropriate technique.

PROPERTY, PLANT, AND EQUIPMENT

17.030 Property, plant, and equipment includes land, buildings, machinery and equipment, leasehold improvements, buildings and leasehold improvement construction-in-progress, and other related tangible assets. ASC Subtopic 820-10 requires that an entity determine the highest and best use of a nonfinancial asset. An entity determines the premise of use whereby market participants would maximize value. The highest and best use of an asset could be on a stand-alone basis or in combination with other assets and liabilities as a group. It should be noted that property, plant, and equipment that qualifies as held-for-sale is measured at fair value less cost to sell at the acquisition date in accordance with ASC Section 360-10-35. Because of the cost to sell element, the measurement of property, plant, and equipment that is classified as held-for-sale is an exception to the fair value measurement principle in ASC Topic 805.

17.031 Some rate regulated entities have asserted that the carrying amount of their property, plant and equipment is always equal to fair value because it is expected that these assets will generate revenue based on the cost incurred to acquire, construct, or develop the assets. Such an approach to determining the fair value of a cost-based rate
regulated asset is not appropriate because it fails to consider the value of the assets to
market participants that are not subject to cost-based rate regulation.

17.032 The fair value can be estimated using a market approach (e.g., sales comparison
method, see Paragraph 17.041), an income approach (e.g., income capitalization method,
see Paragraph 17.042), or a cost approach (e.g., replacement cost new method, see
Paragraph 17.043), or a combination of multiple approaches, depending on facts and
circumstances.

17.033 Factors to consider when evaluating the appropriate valuation technique include:
(a) the type of asset being measured; (b) identifying the principal (or most advantageous)
market and market participants for the assets acquired; and (c) the appropriate valuation
premise (stand-alone or in combination with other assets or assets and liabilities as a
group), consistent with the acquired assets’ highest and best use.

17.034 ASC Subtopic 820-10 includes the concept of highest and best use for a
nonfinancial asset to determine the appropriate valuation premise to measure fair value
for a single nonfinancial asset or group of nonfinancial assets. ASC Subtopic 820-10
identifies two premises of value: in combination with other assets or assets and liabilities
as a group and stand-alone. For nonfinancial assets, either premise may produce the
highest and best use. The premise selected provides maximum value to market
participants.

ASC Paragraph 820-10-35-10A
A fair value measurement of a nonfinancial asset takes into account a market
participant’s ability to generate economic benefits by using the asset in its highest
and best use or by selling it to another market participant that would use the asset
in its highest and best use.

ASC Paragraph 820-10-35-10B
The highest and best use of a nonfinancial asset takes into account the use of the
asset that is physically possible, legally permissible, and financially feasible as
follows:

a. A use that is physically possible takes into account the physical
characteristics of the asset that market participants would take into account
when pricing the asset (for example, the location or size of a property).

b. A use that is legally permissible takes into account any legal restrictions on
the use of the asset that market participants would take into account when
pricing the asset (for example, the zoning regulations applicable to a
property).

c. A use that is financially feasible takes into account whether a use of the
asset that is physically possible and legally permissible generates adequate
income or cash flows (taking into account 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.
ASC Paragraph 820-10-35-10C

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity’s current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

ASC Paragraph 820-10-35-10D

To protect its competitive position, or for other reasons, a reporting entity may intend not to use an acquired nonfinancial asset actively, or it may intend not to use the asset according to its highest and best use. For example, that might be the case for an acquired intangible asset that the reporting entity plans to use defensively by preventing others from using it. Nevertheless, the reporting entity shall measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

ASC Paragraph 820-10-35-10E

The highest and best use of a nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

a. The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).

1. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and the associated liabilities) would be available to market participants.

2. Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.

3. Assumptions about the highest and best use of a nonfinancial asset shall be consistent for all of the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.
In applying the guidance on highest and best use, an entity should determine the fair value for the asset in its current state. ASC Subtopic 820-10 states that the reporting unit’s current use of the asset is considered the highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset. However, in determining the fair value, an entity should consider whether a market participant would acquire the asset with the intent to change its legal use. ASC Topic 805 states that in determining the highest and best use, the reporting entity determines whether the use is legally permissible, financially feasible, and physically possible. The reporting entity also should consider whether maximum value would be provided to market participants by using the asset on a stand-alone basis or in combination with other assets. See further discussion in Section J in KPMG’s Fair Value Measurements - Questions and Answers.

In some situations, an entity may need to consider that a market participant could acquire a property with the intent to change the zoning restrictions. A market participant would do so if this was in its economic best interest. Although current zoning restrictions are an attribute of a property and are a matter of law that could significantly affect fair value, zoning restrictions are generally not permanent, and zoning changes are legally permissible. Zoning restrictions on the use of property can be, and often are, changed, and variances provided at the request of property owners (market participants) consider the possibility of a zoning change when pricing the asset at the measurement date. If the use was considered physically possible and legally permissible, the reporting entity would need to determine if the use was financially feasible. This analysis is consistent with ASC Subtopic 820-10’s market participant view as well as with the guidance on accounting for costs of real estate projects in ASC Topic 970, Real Estate—General, which provides “The fair value of a (land) parcel is affected by its physical characteristics, its highest and best use, and the time and cost required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors.” (Emphasis added.)

When a fair value measurement of a differently zoned asset contemplates a change in the legal usage of the asset (e.g., zoning restrictions), the risks of the change and the cost a market participant would incur to transform the asset should be considered in the measurement.

When use of the asset in combination with other assets as a group is determined to be appropriate and the highest and best use, the fair value measurement of the asset should be based on the fair value that would be received in a sale or transfer of the group of assets.

This aggregation of assets for purposes of establishing the highest and best use premise, which could include multiple units of account, is the unit of measurement that should be used to measure the fair value for the individual units of account within the unit of measurement. ASC paragraph 820-10-35-10 states that assumptions regarding highest and best use should be consistent between the group of assets and the individual assets. Determining the fair value of individual units of account within a unit of measurement...
requires apportionment of the overall fair value measurement for the unit of measurement to the individual units of account. This is illustrated in Example 17.4.

**Example 17.4: Apportionment of Unit of Measurement to the Individual Units of Account**

ABC Corp. has two asset groups: Asset Group 1 and Asset Group 2. Each asset group represents an individual unit of account. If sold separately, ABC would receive $100 for Asset Group 1 and $100 for Asset Group 2. If sold together, ABC would receive $300 for the two asset groups. Given these facts, the highest and best use of Asset Groups 1 and 2 is to be sold in combination. Therefore, the unit of measurement is the aggregation of Asset Groups 1 and 2. Because ABC performed individual fair value measurements for Asset Group 1 and Asset Group 2, and determined the fair values for each asset group, one possible way of apportioning fair value to Asset Group 1 is by using the relative fair values. Based on this methodology, $150 of the overall unit of measurement’s fair value would be apportioned to Asset Group 1 ($100, the individual fair value for Asset Group 1, divided by $200, the aggregated individual fair values for Asset Groups 1 and 2, multiplied by $300, the fair value measurement for the unit of measurement) and $150 would be apportioned to Asset Group 2.

**Example 17.4a Valuation of Assets That Are Subject to a Government Grant**

ABC Corp. acquires DEF Corp. in a business combination. Two years before the acquisition, DEF received a grant from the local government to fund 33% of the cost of certain tangible fixed assets, subject to the condition that it must employ a minimum of 250 full-time employees at all times during the subsequent five years. DEF is required to repay the grant if it fails to meet this condition.

The assets subject to the grant had an original cost of $15 million, and the grant was $5 million. DEF accounted for the grant as a reduction of the cost of the assets, which have a weighted-average 10-year useful life. On the acquisition date, the assets have an aggregate net carrying amount of $8 million and an aggregate fair value of $11 million, based on market participant assumptions about their highest and best use. A contingent obligation to repay the $5 million grant exists if DEF does not continue to employ at least 250 full-time employees for three more years.

ABC should record the assets subject to the grant at their full fair value of $11 million on the acquisition date, i.e., on an unencumbered basis. The amounts recorded in the business combination are not affected by the fact that they were originally acquired subject to a grant or by the possible obligation to repay the grant. Rather, the contingent obligation to repay the grant should be evaluated as an assumed contingent liability (see Section 7).
In addition to determining the highest and best use that will impact the valuation premise, a valuation approach or combination of approaches should be used to determine fair value of property, plant, and equipment. The table below presents certain selected property, plant, and equipment and common valuation approaches to estimate their acquisition-date fair values when the premise of value is assumed to be in combination with other assets as a group.

<table>
<thead>
<tr>
<th>Common Fair Value Measurement Concepts</th>
<th>Market Approach</th>
<th>Income Approach</th>
<th>Cost Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sales Comparison Method</td>
<td>Income Capitalization Method</td>
<td>Replacement Cost New Method</td>
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<td>Plant and equipment</td>
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<td>Real property</td>
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<td>Land</td>
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<tr>
<td>Buildings</td>
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<td>Personal property</td>
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<tr>
<td>Leasehold improvements</td>
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<tr>
<td>Construction-in-progress</td>
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Labeling Key

- **F** = Applied Frequently
- **O** = Applied Occasionally
- **S** = Applied Seldom

### Sales Comparison Method

The sales comparison method is frequently used to measure the fair value of real property (e.g., land and buildings) and often used to measure the fair value of personal property (e.g., machinery and equipment). This method identifies prices of recent transactions between market participants (purchasers/sellers) for comparable properties. The premise of this method is substitution, in which prices, rents, and rates are set by the prevailing prices, rents, and rates of equally desirable substitutes. Once a reasonable substitute for comparable properties is identified, adjustments to the prices of those properties may be necessary for factors, including, but not limited to, the condition of the property, location, size, and occupancy. The adjusted prices represent an estimate of fair value of the acquired property.
**Income Capitalization Method**

17.042 The income capitalization method is used occasionally to measure the acquisition-date fair value of certain types of property (e.g., land) in a business combination. Similar to a discounted cash flow model, the income capitalization method estimates the future net cash flows expected to accrue directly, or indirectly, from ownership of the property, discounted to their present values using an appropriate discount rate from the perspective of a market participant. The estimated net cash flows used in the analysis are based upon potential cash flows after considering vacancy, collection allowances, and operating expenses. The cash flows at the assumed time of reversion are capitalized at an appropriate capitalization rate to derive an estimated terminal value. The fair value of the property is estimated by discounting all future cash flows in the discrete period, as well as the terminal value, at an appropriate discount rate. The key steps as part of the income capitalization method are: (1) estimating the future net cash flows of the property; (2) identifying an appropriate capitalization rate as part of identifying a terminal value; and (3) discounting the estimated net cash flows to a single present value using an appropriate discount rate to estimate fair value.

*(Pre-ASC Topic 842)*

**Replacement Cost New Method**

17.043 The replacement cost new (RCN) method can also be used to measure the fair value of personal property (e.g., machinery and equipment) and other types of property (e.g., leasehold improvements, construction-in-progress) in a business combination when the premise of value is assumed to be in combination with other assets as a group. To determine the fair value of an acquired property, the RCN method identifies the replacement cost of new property with similar capacity, adjusted for depreciable factors such as functional or technological obsolescence, remaining useful life, and physical condition.

**Property, Plant, and Equipment to Be Used**

17.044 Property, plant, and equipment to be used by the acquirer is measured at the acquisition-date fair value, taking into consideration the highest and best use from a market participant perspective, whether or not that use is consistent with the entity’s intended use of the property. If no observable market exists for the acquired assets, an acquirer should use one or a combination of the valuation methods as previously discussed, to measure the fair value of the property, plant, and equipment.

**Property, Plant, and Equipment to Be Sold (Held for Sale)**

17.045 An acquired long-lived asset (disposal group) that will be sold is classified as held for sale at the acquisition date if the sale is probable and expected to qualify for recognition as a completed sale within one year, and the other criteria in ASC paragraph 360-10-45-9 are probable of being met within a short period (usually within three months) following the acquisition (unless already met at acquisition date). The acquirer should measure an acquired long-lived asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with ASC Section 360-10-35 (i.e., at fair value less cost to sell). ASC paragraph 805-20-30-22
Costs to sell, according to ASC Section 360-10-35, are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had it not decided to sell. Those costs include broker commissions, legal and title transfer fees, and closing costs that are incurred before legal title can be transferred. The costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is classified as held for sale. If the sale is expected to occur beyond one year as permitted in limited situations, the costs to sell should be discounted. ASC paragraph 360-10-35-38

**Mining Assets**

Mining assets are comprised of mineral properties and rights. The following guidance applies.

**ASC Paragraph 930-805-30-1**

An entity shall include value beyond proven and probable reserves in the value allocated to mining assets in a purchase price allocation to the extent that a market participant would include value beyond proven and probable reserves in determining the fair value of the asset.

**ASC Paragraph 930-805-30-2**

An entity shall include the effects of anticipated fluctuations in the future market price of minerals in determining the fair value of mining assets in a purchase price allocation in a manner that is consistent with the expectations of marketplace participants. Generally, an entity should consider all available information including current prices, historical averages, and forward pricing curves. Those marketplace assumptions typically should be consistent with the acquiring entity's operating plans with respect to developing and producing minerals. It generally would be inappropriate for an entity to use a single factor, such as the current price or a historical average, as a surrogate for estimating future prices without considering other information that a market participant would consider.

**INTANGIBLE ASSETS**

**Valuation Analysis**

If an intangible asset meets either the separability criterion or legal-contractual criterion under ASC Topic 805, the intangible asset is recognized and measured at its acquisition-date fair value, with limited exceptions (e.g., reacquired rights), typically through the use of a valuation technique, because an observable fair value for individual intangible assets usually is not available. Most intangible assets acquired in a business combination are intended to provide a direct or indirect return to the acquirer through an increase in revenue, lower costs, or other economic benefits. The valuation technique(s) should be those that best capture the value of those benefits.

Determining fair value of intangible assets can be measured using one or a combination of the three valuation approaches identified in ASC Subtopic 820-10,
depending on facts and circumstances and the type of intangible assets being valued. Several techniques have been developed to estimate the fair value of specific intangible assets. This section discusses some of these methods under the three valuation approaches of the market approach, income approach, and cost approach.

**Market Approach**

**17.049** The market approach is used to value intangible assets based on recent sales of similar intangible assets when there are known and observable markets or market data for similar assets. Under the market approach, the value of an asset reflects the price at which comparable assets are sold in recent transactions and under similar circumstances. Use of the market approach requires comparable arm’s length transactions for the individual intangible asset. If comparable transactions of similar assets are available, valuation ratios are calculated and applied to the intangible asset. However, in practice there are few comparable transactions involving comparable intangible assets within a reasonable time frame. As a result, the market approach is not commonly used to value intangible assets acquired in a business combination.

**Income Approaches**

**Relief-From-Royalty Method**

**17.050** The relief-from-royalty method measures the fair value of an asset using a cost-savings concept. This is based on the notion that, if the entity did not own the asset, it would pay a royalty to a third party for the right to use that asset. Therefore, the value of the asset is the fair value of the cost savings of not paying a royalty to a third party. For example, this method would be used for intangible assets expected to be used actively (e.g., brands).

**17.051** The fair value of the asset is estimated based on the present value of the royalty payments that the acquirer saves by owning the asset, based on a market participant royalty rate. In many cases, the royalty rate is estimated based on market data for royalty arrangements involving similar transactions and assets. Because there may be limitations on the availability of observable data, the valuation professional should develop appropriate support for the royalty rate used.

**Multi-Period Excess Earnings Method**

**17.052** The multi-period excess earnings method (MPEEM) is used to estimate the fair value of an intangible asset based on a residual cash flow notion. The principle behind this method is that the fair value of an intangible asset can be determined by estimating the cash flows that can be generated by the entire business or asset group and deducting the cash flows on all of the other assets that contribute to the cash flows (i.e., burdening the cash flows with contributory asset charges). The excess cash flows are ascribable to the intangible asset, and the fair value estimate is equal to the present value of those excess cash flows. For example, this method would be used for customer relationships and technology assets acquired in a business combination.
Contributory asset charges (CACs) used in the MPEEM also are called capital charges or economic rents. Many implementation issues can arise when identifying and calculating CACs and in estimating rates of return associated with each contributory asset. The Appraisal Foundation issued guidance on:

- Considerations when selecting appropriate rates of return on, and in some cases returns of, identified contributory assets when applying the MPEEM;
- Reconciliation of the MPEEM result to the fair value of the asset grouping;
- Treatment of negative working capital and one-time acquisition accounting adjustments to working capital;
- Two potential calculations for determining fixed-asset CACs;
- Charges for elements of goodwill, other than assembled workforce;
- Simultaneous application of the MPEEM to multiple intangible assets that share the same benefit stream; and
- Comparison of the weighted-average cost of capital with the implied rate of return on a transaction and the weighted-average return on assets.

CACs reflect the usage of contributory operating assets, which may include working capital, fixed assets, and intangible assets. CACs compensate for an investment in a contributory operating asset by reflecting the rates of return on those assets that investors require. This represents the return on contributory operating assets, which will be reflected in the CACs.

CACs also may capture the recovery of contributory assets, which is the return of the contributory assets. Judgment is needed to determine whether returns of contributory operating assets should be included in CACs. For example, cash flows may already reflect reductions in the cash-flow stream for costs that are considered synonymous with returns of the contributory operating asset. When specific cash flows representing returns of the contributory operating assets are reflected in the cash-flow stream, they would be excluded from the CACs to avoid double-counting.

Applying CACs under the MPEEM should neither enhance nor diminish the fair value of other identifiable assets and liabilities. Because CACs are viewed as an allocation of earnings to operating contributory assets, the MPEEM should calculate a specific intangible asset fair value in a manner that can be reconciled to the asset grouping fair value when the intangible asset’s value is added to the other discrete operating asset and liability fair values.

Unlike most other asset categories where CACs allocate the cash-flow stream to other assets, which reduces the fair value of the identifiable intangible asset, CACs for negative working capital represent an enhancement to the fair value of the identifiable intangible asset. The Appraisal Foundation’s guidance expresses the view that negative working capital generated in the normal course of business reflects economic reality for some business models (e.g.,
negative operating cycle) and results in an enhancement of the value of the identifiable intangible by creating a business model where customers are willing to pre-pay for goods or services. However, reflecting negative working capital as an increase to the cash-flow stream would not be appropriate in situations where negative working capital represents an anomalous situation. Similarly, one-time business combination adjustments to working capital (e.g., inventory step-ups, deferred revenue write-downs) do not represent long-term working capital operating levels and should be excluded from the initial and ongoing levels of working capital used to calculate CACs.

17.058 Calculating Fixed Asset CACs. The guidance describes two ways that may be appropriate for calculating CACs for fixed assets other than land. Both can take into consideration returns of and returns on the required level of fixed assets.

17.059 The Average Annual Balance calculation includes two separate charges. The return of charge corresponds to the annual economic depreciation for both the fair value of the contributory fixed assets and the estimated levels of future capital expenditures. It is also used as an input in the determination of the average annual balance of the fixed assets. The return on charge is based on the rate of return a market participant investing in such assets would require, which is applied to the average annual balance of the corresponding fixed assets.

17.060 The Level Payment calculation treats CACs as a series of level annual payments. It is conceptually similar to the calculation of an amortizing loan payment. Unlike the Average Annual Balance calculation, the Level Payment calculation presents CACs as one charge comprising both returns on and returns of the required level of fixed assets. Similar to the Average Annual Balance calculation, CACs estimated under the Level Payment calculation are based on the rate of return that reflects the market participant assessment of the investment’s risk and is applied to the fair value of the contributory fixed assets and future capital expenditures. When used properly, the two calculations should yield comparable results.

17.061 CACs for Goodwill. In a business combination, assembled workforce is subsumed into goodwill rather than being recognized as a separate intangible asset. Nevertheless, the assembled workforce is typically an element of goodwill for which CACs are taken. Furthermore, in an acquisition of assets that is not a business combination, assembled workforce is sometimes recognized as an identifiable asset and is measured based on its fair value. Other than assembled workforce, goodwill-related CACs are expected to appear in MPEEM analyses infrequently, and when they are used, an unrecognized asset should be identified as contributing to the cash-flow stream.

Applying the MPEEM to Multiple Assets within the Asset Grouping

17.062 There is diversity in practice in situations where two or more identifiable intangible assets share the same cash-flow stream and where it might be appropriate to measure each using the MPEEM (e.g., technology and customer-relationship intangibles). A question arises about whether it is appropriate to simultaneously apply cross charges between the identifiable intangible assets in the MPEEM computation. The guidance
discourages the use of cross charges and proposes that only one identifiable intangible asset from the asset grouping should be valued using the MPEEM for a specific cash-flow stream. A potential way to resolve the problem is to split the cash-flow stream into more refined subsets of cash-flow streams. Alternatively, other valuation techniques might be used to value other intangible assets in the asset grouping rather than attempting to apply the MPEEM to multiple assets within the asset grouping. Alternative valuation models include the relief from royalty, with and without, quadrant, and separation methods.

Rates of Return on Contributory Assets

17.063 When an identifiable intangible asset is valued concurrent with a business valuation, leading practices include an analysis comparing the weighted-average cost of capital (WACC), implied rate of return (IRR) and weighted-average return on assets (WARA). A WARA analysis displays rates of return associated with each major asset class including the identifiable intangible asset that was valued using the MPEEM. The guidance observes that the selected rates of return on contributory assets should reflect the riskiness of those assets. Typically the risk profile of an entity’s assets increases as one moves down its balance sheet (e.g., working capital generally is less risky than fixed assets, which generally are less risky than intangible assets). There also should be a correlation to how the assets are financed because, as the risk profile increases, the weighting shifts from debt to equity.

17.064 If the analysis shows significant differences among the WACC, IRR, and WARA, it may indicate a need to refine the existing analysis. The process may include altering preliminary rate of return estimates for the identifiable intangible asset or for some of the CACs. Additionally, if the asset grouping fair value assumes a nontaxable transaction structure, the WARA analysis may need to reflect a hypothetical adjustment as if the transaction were taxable, because the portfolio of assets may have been individually valued using a taxable-transaction premise.

Greenfield Method

17.064a The Greenfield Method is frequently used to value licenses (or other operating rights), particularly when the license's benefit significantly exceeds its cost. The underlying theory of the Greenfield Method is that a business is assembled around a pivotal asset (referred to as the subject asset). The subject asset’s existence is the impetus for additional investments in complementary assets to create an operating entity. In other words, there would be no need to assemble the total asset complement without the subject asset. The license or operating rights driving the business are generally scarce, are often granted or regulated by a government, and are common in these industries:

- Television
- Radio
- Wireless telecommunications
- Franchising
• Casino and gaming

17.064b Because the Greenfield Method isolates the cash flow attributable to the subject asset, it is considered a direct valuation method as described in ASC paragraph 805-20-S99-3. The Greenfield Method is often compared to the MPEEM, as both methods are used to value pivotal assets of a company. Unlike the MPEEM, however, the Greenfield Method deducts the costs associated with assembling a complementary asset base through explicit cash outflows to build or purchase the supporting assets. The MPEEM deducts economic rents—contributory asset charges—instead of deducting the costs to assemble the contributory asset base.

17.064c The Greenfield Method is often applied when:

• The license is critical to the business and generally considered indefinite in nature (e.g., where revocation rights are minimal);
• The industry has significant physical or legislative barriers to entry;
• There is a scarcity of licenses accessible to the industry (i.e., not situations where non-exclusive rights are routinely granted to all operators); or,
• The license allows possession of an underlying resource or asset and therefore denies its use to others.

Applying the Greenfield Method

17.064d The assumptions used in applying the Greenfield Method should reflect market participant expectations, industry standards, and trends in the respective markets as of the valuation date. Entities should consider technological advances throughout the forecast period to the extent they may affect the cash flows of market participants. Thus, the assumptions about returns, risks and growth patterns may be materially different from the actual, historical experience of the company that currently owns the asset.

17.064e Typically the Greenfield Method considers at least two distinct stages:

• The ramp-up period, encompassing the initial build-out of the business until mature margins and earnings are reached; and,
• Mature business operations or the terminal value.

17.064f Application of the Greenfield Method differs across industries because determining the fair value should be driven by the economics underlying the value of the subject asset. Generally, the Greenfield method requires a wide range of inputs and assumptions, including the length of the ramp-up period, mature earnings projections, capital expenditures and depreciation, working capital, tax rate, terminal value, discount rate, and tax amortization benefit. It may be challenging to gather all required data and make all relevant assumptions.
**17.064g Ramp-Up Period.** An entity should estimate the time period necessary to achieve a stable, mature business assuming the new business begins only with the subject asset. This ramp-up period should be based on industry norms for the subject asset and therefore may differ from the actual manner in which the business was formed and is currently operated. During this period, the projected earnings typically ramp up from zero or a negative figure to a mature level which in most cases is positive. The length of the ramp-up period may be influenced by various factors, such as the time to build out the required infrastructure (e.g., a wireless network in the case of a wireless spectrum license) or the time to acquire customers and reach a mature level of market share. Often a company would experience significant start-up expenses and inefficiencies resulting in substantial early period losses. Combined with the initial capital expenditures, the general expectation is that cash flows are negative in the initial years. The specifics associated with the ramp-up period may differ depending on the asset, industry, region, and other factors.

**17.064h Mature business operations.** The long-term estimate of cash flows for the subject asset should be based on market participant assumptions for market share, revenue and operating costs. The long-term outlook of the business owning the subject asset, however, is often used as a proxy. In that case, mature Greenfield Method cash flows converge with the projections of the existing business. Alternatively, there might be circumstances in which the existing business is not representative of a market participant long-term expected mature state. Examples can be existing businesses that have significant company-specific synergies with other assets or business units that are independent of the subject asset, or an existing business that does not fully utilize the potential of the subject asset (e.g., using an FCC license for strictly educational or religious broadcasting when it is available for full commercial use). As with the ramp-up period, the projection of the mature level of the business is subjective and thus requires consideration of industry benchmarks, market conditions, etc. to derive a market participant view. Depending on the industry, reliable market data may be difficult to obtain. Assumptions necessary to apply the Greenfield Method may be easier to support for industries where market studies of financial projections are available.

**17.064i Terminal Value.** Assets typically valued using the Greenfield Method generally have indefinite useful lives under ASC paragraph 350-30-35-4 and thus require a terminal value. Some of those assets may need to be renewed regularly. However, the example in paragraphs 350-30-55-11 through 55-13 indicates that if renewal is expected indefinitely with minimal legal, regulatory, economic or technological hurdles and there is a history of renewal for the asset, it would be deemed to have an indefinite useful life.

**17.064j Tax Effects.** To value the subject asset, an entity also must consider the relevant tax rate, tax losses created during the ramp-up period, and the depreciation of assets for tax purposes. During the initial ramp-up period, a business may generate significant losses. As the Greenfield Method theoretically analyzes the subject asset in isolation, an entity should assume that net operating losses generated by the subject asset are carried forward to offset earnings generated by that asset in future periods, rather than assuming that the net operating losses are used immediately to offset earnings from other unrelated assets in the business. Furthermore, only net operating losses generated by the subject
asset should be considered in its valuation. Acquired or future net operating losses of the existing business are generally excluded from a Greenfield Method valuation.

17.064k To the extent that the subject asset qualifies as an amortizing intangible asset for tax purposes in the applicable jurisdiction, a tax amortization benefit is included in the valuation.

17.064l Discount Rate. Because the cash flows portray an entity using the subject asset, a WACC calculation for the hypothetical new business is typically used and is based on the long-term capital structure of a market participant and its associated cost of debt and equity. In practice, the WACC of the assembled business is often used as a starting point. Depending on the relative risk profile of the cash flows used, the discount rate in the analysis may differ from the WACC associated with the combined business operations of the company owning the subject asset, particularly if the market participant’s view of the asset differs from its current use by the existing business; for example, because of company-specific factors or synergies. An entity should consider the start-up nature of the cash flows, the size of the operations, and the resulting riskiness of the cash flows when selecting the appropriate discount rate.

Incremental Cash Flow Method

17.065 Similar to the multi-period excess earnings method, the incremental cash flow method is used to estimate the fair value of an intangible asset based on a residual cash flow notion. This method measures the benefits (e.g., cash flows) derived from ownership of an acquired intangible asset as if it were in place, as compared to the acquirer’s expected cash flows as if the intangible asset were not in place (i.e., with-and-without). The residual or net cash flows of the two models is ascribable to the intangible asset and, when discounted to its present value, provide an estimate of its fair value. The present value estimate should be determined using a discount rate that market participants would demand in light of the risks involved.

Cost Savings Method

17.066 The cost savings method values the asset by calculating the present value of the cost savings that an acquirer estimates would be obtained through owning an existing and functioning asset, provided that the cost savings would be available to market participants if they owned the intangible asset. These cost savings represent a measure of the benefits of ownership of the asset.

Cost Approach

17.067 The cost approach values the intangible asset based on the costs that would be incurred to re-create the intangible asset. Costs include directly attributable costs such as research and development. It is highly unusual for a cost approach to be used to value intangible assets. Intangible assets, especially those valued in combination with other assets or assets and liabilities as a group, possess value that transcends the estimated sum of the costs to re-create the asset.
Intangible Assets Commonly Acquired in Business Combinations

17.068 The table and discussion below identify several intangible assets that are commonly acquired in business combinations, and some of the commonly used techniques for estimating the acquisition-date fair value of those assets. The list is not all-inclusive, and is presented for illustration purposes only.

<table>
<thead>
<tr>
<th>Common Fair Value Measurement Concepts</th>
<th>Market</th>
<th>Valuation Approaches</th>
<th>Income</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing related</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trademarks and trade names</td>
<td>O</td>
<td>S</td>
<td>F</td>
<td>S</td>
</tr>
<tr>
<td>Non-compete agreements</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>O</td>
</tr>
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<td>Customer related</td>
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<tr>
<td>Customer relationships</td>
<td>S</td>
<td>S</td>
<td>F</td>
<td>O</td>
</tr>
<tr>
<td>Order/production backlog</td>
<td>S</td>
<td>S</td>
<td>F</td>
<td>O</td>
</tr>
<tr>
<td>Customer lists</td>
<td>O</td>
<td>S</td>
<td>O</td>
<td>S</td>
</tr>
<tr>
<td>Artistic-related</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Musical works</td>
<td>O</td>
<td>O</td>
<td>F</td>
<td>S</td>
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<tr>
<td>Technology based</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Patented and unpatented technology</td>
<td>S</td>
<td>F</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>In-process research and development</td>
<td>S</td>
<td>O</td>
<td>F</td>
<td>S</td>
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<tr>
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<td>F</td>
<td>Applied Frequently</td>
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Trademarks and Trade Names

17.069 Trademarks and trade names (branding or brand) are used by entities to differentiate the source of a product and to distinguish it from competitors' similar products. Trademarks and trade names are frequently measured using the relief-from-royalty method. Key considerations when applying this technique when measuring trademarks and trade names include:

- Identifying the benefit stream attributed to the trademarks and trade names;
- Understanding the planned use for the trademarks and trade names by the acquirer and whether it is similar to the expected uses by market participants;
- Selecting a royalty rate from market comparable agreements or previous agreements for the asset;
- Establishing a market participant tax rate;
- Determining whether a tax amortization benefit is appropriate; and
- Determining whether a terminal value is appropriate in the calculation.
Noncompete Agreements

17.070 Noncompete agreements are contracts that place restrictions on an entity or former owners of an entity and their ability to compete with the acquirer. The restrictions relate to specified markets and/or specified products or activities for a defined period of time. Noncompete agreements are often measured using the incremental cash flow method. Key considerations when applying this technique include:

- Identifying the benefit stream attributed to the noncompete agreement;
- Understanding of the period covered by the agreement;
- Estimating the probability of competition absent the agreement;
- Assessing the business impact of competition absent the noncompete agreement;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

Customer Relationships

17.071 Customer relationships acquired in a business combination may arise from contractual rights or through means other than contracts. For example, a customer relationship may exist between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer, and (b) the customer has the ability to make direct contact with the entity. In many circumstances, intangible assets representing customer relationships are a significant element of the acquiree’s fair value. Customer relationships are often measured using the multi-period excess earnings method. Key considerations when applying this technique include:

- Identifying one or multiple types of relationships to be measured at fair value;
- Identifying revenue or cash flow attributable to existing customer relationships (excluding order or production backlog, deferred revenue, and any separately recognized contract assets or contract liabilities after adoption of ASC Topic 606);
- Understanding revenue growth for existing customers;
- Estimating remaining contract lives or an attrition rate for existing customers;
- Removing sales and marketing expenses incurred by the entity to attract new customers;
- Quantifying market participant synergies;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.
**Order/Production Backlog**

17.072 Order or production backlog arises from unfulfilled contracts such as purchase or sales orders at the acquisition date. Order or production backlog is often measured using the multi-period excess earnings method because the benefit stream of the backlog may be distinct from the customer relationship intangible asset. Key considerations when applying this technique include:

- Identifying revenue or cash flow attributed to existing, but unfulfilled orders (excluding any separately recognized contract assets or contract liabilities after adoption of ASC Topic 606);
- Understanding the applicable costs related to the revenue or cash flow stream and adjusting to reflect market participant assumptions, if necessary;
- Determining the period over which the orders will be fulfilled;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

**Customer Lists**

17.073 A customer list consists of information about customers, such as their names and contact information. The list may be in the form of a database with other information, such as customer order histories and demographic information. A customer list is often measured using the cost savings method. Key considerations when applying this technique include:

- Identifying the costs incurred to collect, organize, and input the data into a storage system;
- Understanding the applicable costs related to development and maintenance of the software system used to store the data;
- Determining all other applicable costs related to the recreation of the customer list, including opportunity costs;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

**Musical Works and Rights**

17.074 Musical works and rights such as musical compositions, represent works of art that may be income producing. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. Rights to musical works are seldom transacted on an individual basis. Instead, it is common for musical works, or the rights to market them, to be aggregated as a portfolio of income generating assets.
Because musical works and rights generate income, they may be measured under an income approach using a discounted cash flow method. Typically, this occurs when the portfolio constitutes a majority or all of the assets of the business. When musical works and rights exist among other income generating assets and the related cash flows cannot be separated, the portfolio of musical works and rights is frequently measured using the multi-period excess earnings method. Key considerations when valuing artist-related intangible assets include:

- Identifying revenue or cash flow attributed to the artist-related works and rights;
- Understanding the applicable costs related to the artist-related works and rights;
- Evaluating similarities and differences between the subject asset and the observed peer group;
- Determining the period over which the artist-related works and rights will be monetized;
- Calculating contributory asset charges, if appropriate;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

**Patented and Unpatented Technology (Including Software)**

Technology-related assets comprise a set of technical processes, intellectual property, and the institutional understanding within an organization with respect to various processes and products. Those assets can be classified as patented and unpatented technology. Generally, advanced technology is covered by a patent or similar legal protection.

Patented and unpatented technology is frequently measured using the relief-from-royalty method or cost savings method. Key considerations when applying these techniques include:

- Evaluating if the asset provides a return (e.g., generates revenues or cash flows), reduces expenses, or provides some other economic benefit;
- Understanding the planned use for the asset by the acquirer, and whether that planned use is similar to or different from potential use by market participants;
- Identifying depreciable factors (e.g., erosion of value) and the remaining economic life;
- Quantifying costs incurred to develop the asset and required future costs;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.
In-Process Research and Development

17.078 Research and development projects that are underway but not completed are referred to as in-process research and development (IPR&D). IPR&D acquired in a business combination satisfies the definition of an asset for recognition and measurement, because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from the IPR&D (see considerations in evaluating whether IPR&D qualifies as an asset in a business combination in Section 7).

17.079 The income approach is commonly used to value IPR&D assets. Techniques under the income approach include, but are not limited to, the multi-period excess earnings, relief-from-royalty, decision tree, and split methods. These methods are described in Chapter 1 of the AICPA Accounting and Valuation Guide, Assets Acquired to Be Used in Research and Development Activities (IPR&D Guide). Key considerations when applying the multi-period excess earnings method include:

- Selecting prospective financial information that best reflects the consideration transferred;
- Confirming the existence of assets acquired to be used in research and development activities, including IPR&D;
- Determining the cash flows related to the reliance on core or other technologies;
- Eliminating the effects of non-IPR&D activities from the prospective financial information;
- Capturing all expenses related to the IPR&D activity, including any third party royalty payments or future milestone obligations related to previous licenses of products employed in the IPR&D;
- Quantifying market participant synergies;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

17.080 A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as defensive intangible assets or locked-up assets. Under ASC Topic 805, an acquirer recognizes and measures all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Subtopic 820-10. ASC Subtopic 350-30 provides guidance on how defensive intangible assets should be accounted for subsequent to their acquisition. When an IPR&D asset is acquired and intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. Refer to Section 12 for additional discussion of the accounting for defensive intangible assets.
LONG-TERM CONSTRUCTION-TYPE CONTRACTS (PRE-ASC TOPIC 606)

17.081 Long-term construction-type contracts (LTCCs) consist of services to design, engineer, fabricate, construct, or manufacture tangible assets where service periods extend over long periods of time, and the right to receive payment depends on performance and completion of those services.

17.082 As outlined in ASC Topic 820 and discussed starting at Paragraph 17.049, there are three valuation approaches that may be considered to value an intangible asset: the (a) income approach, (b) market approach, and (c) cost approach. An intangible asset that is unique and cannot be readily replaced is normally valued using an income approach. An income approach is generally used because the intangible asset is expected to generate measurable future cash flows. The market approach is usually not used to value intangible assets because of the lack of market transactions for similar individual assets. If an intangible asset is easily re-created and the principle of substitution (a prudent investor would pay no more for an asset than the amount necessary to replace the asset) is valid for that asset, then the cost approach is typically used. The valuation approach(es) should be determined based on whether the LTCC is unique, easily re-created, or there is available market data.

17.082a An acquired LTCC may consist of the following units of account:

- Contract backlog
- Off-market component (asset or liability)
- Long-term Construction Contract
- Customer relationship
- Asset (liability) if costs exceed billings (or vice versa)

The four units of account are commonly measured as follows:

- **Contract backlog.** If the contract is unique or not easily replaceable, then backlog is typically valued using an income approach (e.g., the multi-period
excess earnings method). If the contract is easily replaceable, then backlog is
typically valued using a cost approach via the avoided costs to acquire the
contract. See Paragraphs 17.052 and 17.067 for additional discussion of the
multi-period excess earnings method and the cost approach, respectively.

- **Off-market component.** This is an asset or liability to the extent that the
terms of the contract are above or below what a market participant could
achieve at the time of the acquisition. This unit of account is often valued
using an income approach via the off-market differential as of the acquisition
date. See Paragraphs 7.095 through 7.096 for additional discussion of
accounting for contracts with favorable or unfavorable terms.

- **Asset (liability) to the extent that costs exceed billings (vice versa).** There
are times when the carrying amount on the acquiree's balance sheet
approximates fair value. If this is not the case, then using a market or cost
approach may be appropriate, taking into account costs to complete and a
profit unit of account. See Paragraphs 17.049 and 17.067 for additional
discussion of the market and cost approaches, respectively.

- **Customer relationship.** The customer relationship intangible asset may be
recognized separately from the LTCC and is often measured using an income
approach (e.g., the multi-period excess earnings method or the distributor
method). See Paragraphs 17.071 and 17.052 for additional discussion of
valuing customer relationships and the multi-period excess earnings method,
respectively.

These units of account can be incorporated into one valuation approach or they may be
estimated separately using various valuation approaches. It is important to understand the
units of account so as not to double count value. Regardless of the valuation approach
applied, all cash flow components of an LTCC should be accounted for in the fair value
measurement.

**Accounting under the Completed Contract Method**

17.083 While the fair value of the units of account are not affected by the method of
accounting for LTCCs, the accounting entries for the acquirer differ based on whether the
acquirer uses the completed contract or the percentage of completion method. If the
acquiring entity uses the completed contract method to account for the acquired contract,
the costs incurred and customer billings after the acquisition date should be recognized as
costs incurred (an asset) and billings (a liability), respectively, similar to a new contract
where the completed contract method would be applied. On completion of the contract,
the costs incurred subsequent to the acquisition should be charged to costs of sales and
the billings should be offset against the asset or liability established in purchase
accounting with the difference recognized as revenue.
Example 17.5: Accounting for LTCC (Completed Contract Method)

ABC Corp. acquires DEF Corp. in a business combination on December 31, 20X4. At December 31, 20X4, DEF is party to a LTCC to build a custom engineered widget for Customer. The relevant terms of the contract as of December 31, 20X4:

Amount remaining to be billed under the contract = $200

Estimated costs to complete the widget = $50

For ease of illustration, assume that ABC determined that the LTCC was at market. ABC records a LTCC asset (representing the fair values of the contract backlog of $10 and the costs in excess of billings of $95) of $105 on the acquisition date.

ABC separately determines the fair value of the customer relationship intangible asset and concludes the life of that asset is longer than the life of the LTCC asset. Therefore, ABC separates the customer relationship intangible asset and amortizes it over the remaining useful life of the customer relationship. The amortization of the customer relationship intangible asset is omitted from the example journal entries below for simplicity.

Completed Contract Accounting – Post-Acquisition:

ABC appropriately uses the completed contract method of accounting for the acquired contract. ABC incurs $55 in costs to complete the contract and receives $200 from Customer according to the remaining terms of the contract. The journal entries to record these transactions are:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Costs incurred (Project Widget)</td>
<td>55</td>
</tr>
<tr>
<td>Account payable</td>
<td>55</td>
</tr>
<tr>
<td>(To recognize costs incurred to complete the contract.)</td>
<td></td>
</tr>
<tr>
<td>(2) Cash</td>
<td>200</td>
</tr>
<tr>
<td>Billings (Project Widget)</td>
<td>200</td>
</tr>
<tr>
<td>(To recognize receipt of cash in accordance with terms of acquired contract.)</td>
<td></td>
</tr>
</tbody>
</table>

ABC would report the fair value of the contract at acquisition ($105), the costs incurred subsequent to acquisition ($55), and the billings received ($200) as a net liability (billings in excess of costs incurred), assuming the contract was not complete at its next interim reporting date.

On completion of the contract, the journal entries ABC records are:
### Accounting under the Percentage of Completion Method

17.084 While the fair value of the units of account is not affected by the method of accounting for LTCCs, the accounting entries for the acquirer differ based on whether the acquirer uses the completed contract or the percentage of completion method. If the acquiring entity uses the percentage of completion method to account for the acquired contract subsequent to the acquisition, the accounting at acquisition is the same as used for the completed contract method. However, subsequent to the acquisition, in accordance with the percentage of completion method, the acquiring entity would determine the amount of costs and revenue to recognize in each reporting period until completion of the contract. The calculation should be based on the measure of progress toward completion of the performance obligation that was assumed by the acquiring entity on acquisition of the contract and not through reference to the progress toward completion of the project as a whole.

### Example 17.6: Accounting for LTCC (Percentage of Completion Method)

Assume the same facts as Example 17.5 except ABC Corp. appropriately uses the percentage of completion method to account for the acquired contract subsequent to the date of acquisition. At acquisition, ABC assigns the same amount ($105) to the contract. In addition, ABC estimates that the contract will be completed at June 30, 20X5.

**Percentage of Completion**

During the three-month period ending March 31, 20X5, ABC incurs $40 in costs toward completion of the contract and bills and receives $150 from Customer according to the terms of the contract. As of March 31, 20X5, ABC estimates that the remaining costs to complete the widget are $15. ABC uses the cost-to-cost method to estimate its progress toward completion of the obligation assumed. As a result, ABC estimates that its progress
toward completion percentage is 73% ($40/$55). Based on the current estimate of costs to complete the contract, the contract margin is estimated at $40 (billings of $200 less fair value of contract at acquisition date of $105 and costs to be incurred subsequent to acquisition of $55). The journal entries to record these activities are:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Costs incurred (Project Widget)</td>
<td>40</td>
</tr>
<tr>
<td>Account payable</td>
<td>40</td>
</tr>
<tr>
<td>(To recognize costs incurred toward completion of the contract.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2) Cash</td>
<td>150</td>
</tr>
<tr>
<td>Billings (Project Widget)</td>
<td>150</td>
</tr>
<tr>
<td>(To record cash received in accordance with terms of acquired contract.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(3) Cost of goods sold</td>
<td>40</td>
</tr>
<tr>
<td>Costs incurred (Project Widget)</td>
<td>40</td>
</tr>
<tr>
<td>(To recognize 73% of the total costs expected to be incurred to complete the widget.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(4) Costs incurred (Project Widget)</td>
<td>69</td>
</tr>
<tr>
<td>Revenue</td>
<td>69</td>
</tr>
<tr>
<td>(To recognize revenue earned related to the progress toward completion.)</td>
<td></td>
</tr>
</tbody>
</table>

The amount of revenue recognized is calculated as the sum of the cost of sales and projected profit earned to date using the percent of progress toward completion (($55 + $40) * 73%).

During the three months ended June 30, 20X5, ABC incurs $15 to complete the widget and receives $50 in accordance with the terms of the contract. ABC should record the journal entries as:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(5) Costs incurred (Project Widget)</td>
<td>15</td>
</tr>
<tr>
<td>Account payable</td>
<td>15</td>
</tr>
<tr>
<td>(To recognize costs incurred toward completion of the contract.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(6) Cash</td>
<td>50</td>
</tr>
<tr>
<td>Billings (Project Widget)</td>
<td>50</td>
</tr>
<tr>
<td>(To record cash received in accordance with terms of acquired contract.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(7) Cost of goods sold</td>
<td>15</td>
</tr>
<tr>
<td>Costs incurred (Project Widget)</td>
<td>15</td>
</tr>
<tr>
<td>(To recognize the cost of goods sold related to activities of the current period.)</td>
<td></td>
</tr>
</tbody>
</table>
(8) Costs incurred (Project Widget)  26
    Revenue  26
(To recognize revenue associated with work performed subsequent to the acquisition date. ($55 cost + $40 margin) - 69 of revenue previously recognized)

(9) Billings  200
    Costs incurred (Project Widget)  95
    Fair value of contract acquired  105
(To close the contract.)

In both examples the total revenue recognized subsequent to the acquisition date is $95. This is appropriate because the underlying facts and circumstances are presumed to be the same. The method of recognizing revenue under contract accounting does not affect the total revenue to recognize subsequent to the acquisition; it affects the timing of recognition only. Also note the method of accounting for the contracts prior to the acquisition date has no bearing on the accounting by the acquiring entity.

CONTRACTS WITH CUSTOMERS (AFTER ADOPTION OF ASC TOPIC 606##)

17.084a ASC Topic 606 was effective for public entities for annual periods beginning after December 15, 2017 and for all other entities for annual periods beginning after December 15, 2018. After adoption, an acquirer must account for an acquiree's contracts with customers (revenue contracts) under ASC Topic 606. The accounting for revenue contracts acquired in a business combination is similar to the accounting for acquired long-term construction-type contracts before adoption of ASC Topic 606.

17.084b As outlined in ASC Topic 820, there are three valuation approaches that may be considered to value an intangible asset: the (a) income approach, (b) market approach, and (c) cost approach. An intangible asset that is unique, generates cash flows and cannot be readily replaced is normally valued using an income approach. An income approach is generally used if the intangible asset is expected to generate measurable future cash flows. The market approach is usually not used to value intangible assets because of the lack of market transactions for similar individual assets. If an intangible asset is easily re-created and the principle of substitution (a prudent investor would pay no more for an asset than the amount necessary to replace the asset) is valid for that asset, then the cost approach is typically used. The valuation approach(es) should be determined based on whether the contract with the customer is unique, easily re-created, or there is available market data.
An acquired contract with a customer may affect the following units of account:

- **Contract backlog.** If the contract is unique or not easily replaceable, then backlog is typically valued using an income approach (e.g., the multi-period excess earnings method). If the contract is easily replaceable, then backlog is typically valued using a cost approach via the avoided costs to acquire the contract. See Paragraphs 17.052 and 17.067 for additional discussion of the multi-period excess earnings method and the cost approach, respectively.

- **Off-market component.** This is an asset or liability to the extent that the terms of the contract are above or below what a market participant could achieve at the time of the acquisition. This unit of account is often valued using an income approach via the off-market differential as of the acquisition date. See Paragraphs 7.095 through 7.096 for additional discussion of accounting for contracts with favorable or unfavorable terms.

- **Contract asset or liability.** See Paragraphs 17.084d through 17.084e for a discussion of contract assets and 17.084f through 17.084k for a discussion of contract liabilities.

- **Customer relationship.** The customer relationship intangible asset may be recognized separately from the contract and is often measured using an income approach (e.g., the multi-period excess earnings method or the distributor method). See Paragraphs 17.071 and 17.052 for additional...
discussion of valuing customer relationships and the multi-period excess earnings method, respectively.

These units of account can be incorporated into one valuation analysis or they may be estimated separately using various valuation techniques. It is important to understand the units of account to avoid double counting value. Regardless of the valuation approach applied, all cash flow components of a contract with a customer should be accounted for in the fair value measurements.

**Contract Assets (after Adoption of ASC Topic 606##)**

17.084d Contract assets acquired in a business combination should be measured at their acquisition date fair values.

17.084e Contract assets are rights to receive consideration from a customer that are conditional on something other than the passage of time, such as completing all performance obligations under the related contract. In many cases, the acquiree's carrying amount may approximate fair value. Some factors that could affect the fair value of the contract asset include market rates of interest, the customer's creditworthiness, and the acquiree's ability to satisfy the remaining performance obligations. If the carrying amount on the acquiree's balance sheet does not approximate fair value, using a market or income approach to determine fair value may be appropriate. See Paragraphs 17.049 and 17.067 for additional discussion of the market and cost approaches, respectively. Care should be taken not to double count the cash flows used to measure the contract asset with those used to value contract-related intangible assets, such as order backlog and customer relationships.

**Contract Liabilities (after Adoption of ASC Topic 606)**

17.084f Contract liabilities are obligations to transfer goods or services to a customer, for which an entity either has received consideration or has an unconditional right to receive consideration.

17.084g As of the date of this publication, there was an Issue for consideration on the agenda of the EITF (Issue 18-A) about how to account for contract liabilities assumed in a business combination after the adoption of ASC Topic 606. Entities, valuation professionals, and auditors are encouraged to consult with subject matter experts to obtain the latest information about this issue.

17.084h Existing practice is based on the notion of a legal obligation (based on EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree," which was nullified by Statement 141R). For example, consider a 10-year license of character images in exchange for a fixed up-front payment. One year into the license term, the licensor is acquired by another entity. The acquirer would recognize a liability related to its remaining legal obligations from this contract, which are likely to be minimal, because the acquiree has already provided the images to the customer.
At its September 2018 meeting, the EITF reached a consensus-for-exposure to replace the notion of a legal obligation with the notion of a performance obligation under ASC Topic 606. Under this view, an entity would look to the definition of a performance obligation to determine the nature of the acquiree's outstanding obligation at the date of acquisition. Continuing the licensing example, a license for character images would be a license of symbolic intellectual property, which ASC Topic 606 indicates is a performance obligation satisfied over time (the license term). The FASB issued a proposed ASU on the consensus-for-exposure on February 14, 2019, and the comment period ended on April 30, 2019.

The FASB also concurrently issued an Invitation to Comment to obtain constituent feedback on (1) the valuation of contract liabilities assumed in a business combination and (2) whether the amount of revenue recognized in the post-acquisition period should be affected by the contractual payment terms (absent a significant financing component). The comment period for the Invitation to Comment also ended on April 30, 2019.

We understand that the SEC staff expects entities to continue to apply the legal obligation notion from EITF 01-3 until the EITF reaches a final consensus on Issue 18-A that is ratified by the FASB.

Accounting for Acquired Revenue Contracts (after Adoption of ASC Topic 606)

Generally, the acquirer must determine the accounting for each revenue contract acquired in a business combination individually. However, under ASC paragraph 606-10-10-4, as a practical expedient, an entity may apply the guidance in ASC Topic 606 to a portfolio of contracts (or performance obligations) if the entity reasonably expects that the effect of applying the guidance to the portfolio would not differ materially from applying it on a contract-by-contract basis. We believe this practical expedient also applies to an acquirer's accounting for an acquiree's revenue contracts after the acquisition date.

When determining post-acquisition revenue recognition under Topic 606, an acquirer should reconsider all of the steps in the revenue model, based on the facts and circumstances at the acquisition date. Those steps are:

- **Step 1: identify the contract with the customer.** Generally, we expect that an acquirer's evaluation of this step would not differ from the acquiree's evaluation.

- **Step 2: identify the performance obligations.** The performance obligations identified by the acquirer should be based on the remaining goods or services to be transferred to the customer after the acquisition date. Goods and services transferred to the customer by the acquiree before the acquisition date should be excluded from this evaluation.
Step 3: determine the transaction price. We believe the new transaction price consists of the remaining consideration under the contract less (plus) the amount of a contract asset (liability) recognized in the acquisition accounting.

Step 4: allocate the transaction price to the performance obligations. The newly calculated transaction price is allocated to the remaining performance obligations.

Step 5: recognize revenue when (or as) performance obligations are satisfied. For a performance obligation satisfied over time, an acquirer should consider only post-acquisition activities in both the numerator and denominator to measure progress toward complete satisfaction, regardless of whether it uses an input or output method.

Example 17.6a: Accounting for an Acquiree's Revenue Contract after Adopting ASC Topic 606

Acquirer acquires Acquiree in a business combination on April 30, 20X9. Acquiree has a contract with a customer to perform a daily cleaning service at a customer's properties. The contract term runs from January 1, 20X9 to December 31, 20X9. The fee for the cleaning services is $1,000 per month, billable quarterly in arrears. The cleaning service is a performance obligation satisfied over time, because the customer receives and consumes the benefits of Acquiree's performance as Acquiree performs. At the acquisition date, Acquiree had recognized revenue of $4,000 under the contract (using a time-based measure of progress) and had a contract asset on its books for $1,000.

Assume that the acquirer determines the following fair values for the individual units of account at the acquisition date:

<table>
<thead>
<tr>
<th>Estimated Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract asset</td>
</tr>
<tr>
<td>Backlog intangible asset</td>
</tr>
<tr>
<td>Favorable contract intangible asset</td>
</tr>
</tbody>
</table>

After the acquisition date, the transaction price is $8,040, calculated as the remaining billings under the contract ($9,000) less the contract asset ($960). Acquirer uses a time-based measure of progress, resulting in $1,005 of revenue per month as the performance obligation is satisfied ($8,040/8). Acquirer also amortizes the favorable contract intangible asset against revenue, resulting in a $20 per month reduction of revenue, to $985 per month. Finally, Acquirer recognizes $30 expense per month as the backlog intangible asset is amortized ($240/8). Alternatively, Acquirer could recognize the amortization of the backlog intangible asset as a reduction of revenue, resulting in $955 of revenue and no expense each month.
Acquirer records the following journal entries on May 31, 20X9 if the backlog intangible asset is amortized to expense:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract asset</td>
<td>1,005</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,005</td>
</tr>
</tbody>
</table>

To recognize revenue on Acquiree's revenue contract for May 20X9

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>20</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>20</td>
</tr>
<tr>
<td>on favorable contract</td>
<td></td>
</tr>
<tr>
<td>intangible asset</td>
<td></td>
</tr>
</tbody>
</table>

To amortize the favorable contract intangible asset to revenue for May 20X9

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization expense</td>
<td>30</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>30</td>
</tr>
<tr>
<td>on backlog intangible</td>
<td></td>
</tr>
<tr>
<td>asset</td>
<td></td>
</tr>
</tbody>
</table>

To recognize amortization of backlog intangible asset related to Acquiree's revenue contract for May 20X9

Acquirer records the following journal entries on June 30, 20X9:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>3,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,005</td>
</tr>
<tr>
<td>Contract asset</td>
<td>1,965</td>
</tr>
<tr>
<td>Contract liability</td>
<td>30</td>
</tr>
</tbody>
</table>

To recognize revenue on Acquiree's revenue contract for June 20X9

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>20</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>20</td>
</tr>
<tr>
<td>on favorable contract</td>
<td></td>
</tr>
<tr>
<td>intangible asset</td>
<td></td>
</tr>
</tbody>
</table>

To amortize the favorable contract intangible asset to revenue for June 20X9

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization expense</td>
<td>30</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>30</td>
</tr>
<tr>
<td>on backlog intangible</td>
<td></td>
</tr>
<tr>
<td>asset</td>
<td></td>
</tr>
</tbody>
</table>

To recognize amortization of backlog intangible asset related to Acquiree's revenue contract for June 20X9
The entries for July through December 20X9 would follow in a similar fashion, with the contract asset or liability balances being adjusted to account for the difference between the amounts of revenue and billings, and with amortization of the favorable contract and backlog intangible assets recognized each period.

ABC separately determines the fair value of the customer relationship intangible asset and amortizes it to expense over its remaining useful life.

(PRE-ASC TOPIC 842) OPERATING AND CAPITAL LEASES

17.085 ASC Topic 805 establishes as a general principle that the acquirer classifies or designates identifiable assets acquired and liabilities assumed on the basis of factors that exist at the acquisition date. However, ASC paragraph 805-20-25-8 specifies that the classification of lease contracts as capital or operating is an exception to this general principle and therefore, the classification of lease contracts by the acquiree at the inception of the lease is retained in the acquisition accounting. However, lease contracts are evaluated to determine their fair value at the date of the acquisition.

Operating Leases

17.086 In a business combination, the acquirer would determine whether the terms of operating lease contracts acquired are favorable or unfavorable relative to market terms of comparable leases at the acquisition date. The fair value of an operating lease is the amount another entity of comparable credit standing would pay to assume the lease under its current terms, or the amount a market participant would pay to exit the lease.

17.087 Quoted market prices, if available, provide the most reliable and best evidence of fair value. In the absence of active markets with quoted market prices or other reliable information that indicate the value of the operating lease, the fair value of an operating lease is estimated using an income approach by identifying the present value of a rent differential (i.e., the difference between future cash flows under the contractual lease terms and current market rental rates). In addition, the original value of an acquired lease (e.g., the value associated with the avoidance of costs that would normally be incurred to execute a similar lease) should be considered in determining the fair value of the lease when the acquiree was the lessor under the operating lease.

17.088 If available, currently obtainable rental rates for similar assets, subject to similar terms, provide the best estimate of the market rental rate. If information about currently obtainable rental rates for similar assets is not available, circumstances to consider in estimating the market rental rate of the asset underlying an acquired operating lease include, but are not limited to:

- The general availability of the leased asset;
- Characteristics of the counterparty (such as creditworthiness of the lessee);
• The remaining lease term; and
• Renewal provisions and expectations.

17.089 When using the present value of a rent differential to estimate the fair value of an acquired lease, the acquirer should consider whether the rental rate that could be currently obtained in a market transaction for the underlying asset is a fair representation of the fair value rental rate. Some at the money leases, such as operating leases for airport gates, are sometimes bought or sold in exchange transactions. In those cases, there may be value to lease even if there is no rent differential.

17.090 The acquirer should consider whether an acquired operating lease may produce other identifiable intangible assets. For example, in certain real estate leases there may be an ongoing customer relationship with an anchor tenant associated with an acquired lease. A customer relationship that meets the recognition requirements of ASC Topic 805 should be recognized separately from the value of the lease and accounted for in a manner consistent with other separately identifiable intangible assets.

17.091 The present value of a rent differential of an acquired operating lease should be determined using a discount rate that is commensurate with the risks involved. Notwithstanding the fact that acquired operating leases may be valued using present value techniques, it is not appropriate to accrue interest on the value assigned to those leases subsequent to the acquisition date. Rather, the amount reflected in the acquisition accounting is amortized as an adjustment to lease expense if the acquiree is a lessee, or lease income if the acquiree is a lessor in periods subsequent to the acquisition date.

17.092 When lease agreements contain variable terms, such as adjustments based on revenues or price changes, the acquirer should consider the terms of the lease relative to current market terms of comparable leases that were consummated near the date of acquisition to determine the fair value of the lease. If the annual lease payments of an operating lease are adjusted by the increase in an existing index or rate (such as the Consumer Price Index) plus 100 basis points, and the current market terms of comparable leases are based on the increase in the stipulated index plus 250 basis points, the 150 basis points difference in the application of the inflation index would be considered in determining the fair value of the lease.

**Capital Leases**

17.093 An asset under a capital lease acquired in a business combination should be measured at fair value at the acquisition using the approach in ASC Topic 840, Leases, that triggered capital lease treatment by the acquiree. If the acquired lease asset was capitalized by the acquiree because the lease transfers title to the acquiree or contains a bargain purchase option at the end of the lease term (i.e., under ASC paragraph 840-10-25-1(a) or (b)), the acquired leased asset often is measured under the cost approach (e.g., under the replacement cost new method), similar to the measurement guidance for Property, Plant, and Equipment in this Section. If the acquired leased asset was capitalized based on either of the other criteria for classification of leases as capital (i.e., under ASC paragraph 840-10-25-1(c) or (d)), the value assigned to the asset underlying
the lease should be the fair value of the right to use the property for the remaining lease term, which may be estimated by determining the current market rental rates.

17.094 Capital lease obligations assumed in a business combination should be recorded at the present value of amounts to be paid under the lease agreement using appropriate current interest rates from the perspective of a market participant.

17.095 The acquirer would not separately recognize an additional asset or liability related to a favorable or unfavorable contract in a capital lease because the fair value measurement of the capital lease asset and capital lease obligation would consider all the terms of the lease contract.

(ASC TOPIC 842) LEASES (ACQUIREE IS LESSEE)

17.095a An acquiree's right of use asset is not measured at fair value. Rather, it is measured at an amount equal to the lease liability, adjusted for favorable or unfavorable terms. The favorable or unfavorable component is measured in the same manner described in Paragraphs 17.086-17.092. For additional guidance on recognizing and measuring assets and liabilities associated with acquired leases after adopting ASC Topic 842, see chapter 11 of KPMG's Handbook, Leases.

(ASC TOPIC 842) LEASES (ACQUIREE IS LESSOR)

17.095b An acquirer recognizes an asset (liability) for favorable (unfavorable) terms in an acquiree lessor's operating lease. The favorable (unfavorable) asset (liability) is measured in the same manner described in Paragraphs 17.086-17.092.

17.095c For an acquiree lessor's sales-type and direct financing leases, the lease receivable is measured at the present value of the remaining lease payments and guaranteed residual value, and the unguaranteed residual asset is measured as the difference between the fair value of the underlying asset and the lease receivable. For additional guidance on recognizing and measuring assets and liabilities associated with acquired leases after adopting ASC Topic 842, see chapter 11 of KPMG's Handbook, Leases.

(BEFORE AND AFTER ADOPTING ASC TOPIC 842*) INCOME PRODUCING REAL ESTATE IN THE REAL ESTATE INDUSTRY

17.096 Acquired income producing real estate should be valued as if the acquired property were vacant and include the value of used tenant improvements. The following discussion is intended to provide general guidance on applying this approach for real estate acquisitions. The identification, valuation, and amortization of tangible and intangible assets are determined based on the facts and circumstances of each acquisition and the process may vary from the approach described herein.

Step 1: Determine the as-if vacant fair value of the physical property acquired. Factors to consider in arriving at the value of a vacant building include current
market lease terms, absorption rates, availability of comparable competing space, lease commissions and tenant improvements that would be incurred, historical occupancy and leasing history, quality of the building and its replacement value, and the future cash flows and valuation assumptions (including the capitalization rate and risk adjusted discount rate). Consideration should be given to existing tenant improvements in place in assessing how much, if any, tenant improvement allowance is needed to execute current market leases. In some cases the client and/or lender may obtain a dark value appraisal, which should be considered as a means to determine as-if vacant fair value.

Step 1a: Assign the as-if vacant fair value to land, building and improvements, and equipment based on each component of the asset’s fair value utilizing a cost segregation study, appraisal, or comparable analysis.

Step 2: Determine the portion of the consideration transferred related to the value of above and below market in-place leases. Such amounts are determined on a lease-by-lease basis by computing the net present value of the difference between (i) the contractual amounts to be paid pursuant to the in-place lease and (ii) management’s estimate of the fair market lease rate for the corresponding in-place lease measured over a period equal to the remaining non-cancellable term of the lease. However, for below market leases with fixed rate renewals, renewal periods should be included in the calculation of below market in-place lease values. Once the acquirer has calculated the value of the above and below market in-place leases, if that value is favorable (asset position) for some leases but unfavorable (liability position) for others, the acquirer should present the respective asset and liability amounts gross on its balance sheet as discussed above. Above market lease values would be amortized to rental income over the remaining non-cancelable term of those leases. The below market lease values would be amortized to rental income over the remaining initial lease term plus any fixed-rate renewal periods, if applicable.

Step 3: Determine the portion of the consideration transferred related to the value of leases in-place at acquisition. In-place lease value should consider: (i) the value associated with avoiding the cost of originating the acquired in-place leases (i.e., the market cost to execute a similar lease, including leasing commission, legal, and other related costs); (ii) the value associated with the avoidance of tenant reimbursable operating costs estimated to be incurred during the assumed re-leasing period (i.e., real estate taxes, insurance, and other operating expenses); (iii) the value associated with lost rental revenue during the assumed re-leasing period; and (iv) the value associated with avoided tenant improvement costs or other inducements to secure a tenant lease. The value of in-place leases is amortized over the remaining initial term of the respective leases.

Step 4: Determine the unassigned amount by comparing the purchase price of the property to the sum of the amounts determined in steps 1-3. The unassigned amount represents a preliminary estimate of the value to be assigned to acquired customer relationships.
Step 5: After considering alternative valuation techniques, evaluate the reasonableness of the amount assigned to the value of customer relationships in Step 4 to ensure that the value is representative of the customer relationships acquired. When evaluating the reasonableness of the value assigned to customer relationships, consider the nature and extent of the acquiree’s existing business relationships with the tenants, growth prospects for developing new business with the tenants, and expectations of lease renewals. If the amount appears to be unreasonable, reassess whether all acquired assets assumed have been identified, recognized, and properly valued.

17.097 The value of the customer relationship intangible asset is amortized over the remaining initial term plus any renewal periods in the respective leases, but in no event should the amortization period be longer than the remaining depreciable life of the building.

Q&A 17.3 Purchase of a Real Estate Development Company

ABC Corp., a real estate development company, was acquired for $1 million. Assets consist primarily of cash and real estate (land to be developed, projects under development, and completed projects). In accordance with Topic 805, the acquirer has measured the identifiable assets acquired and liabilities assumed, except real estate, at their acquisition-date fair values. For the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed to equal the consideration transferred (assume no goodwill is involved), real estate is assigned a value of $1.8 million, which is assumed to be less than fair value.

Q. Is a value of $1.8 million assigned to real estate appropriate (again, assuming no goodwill is involved)?

A. No. Under ASC Topic 805, ABC should determine the acquisition-date fair value of the identifiable assets acquired and liabilities assumed. It would not be appropriate to value the real estate using a residual or difference method as described in this example. Fair value of land to be developed should be based on appraised values. Because ABC is a real estate developer, it may be appropriate for ABC to analogize to valuation of work-in-process and finished goods inventories in the valuation of projects under development and completed projects, respectively.

LIABILITIES

OVERVIEW

17.098 ASC Topic 805 requires that liabilities be measured at fair value determined in accordance with ASC Subtopic 820-10, reflecting the price that would be paid to transfer the liability in an orderly transaction between market participants at the date of acquisition. A fair value measurement of the liability should not include an adjustment
related to a restriction that prevents transfer because the restriction is implicitly or explicitly captured in the other inputs to the fair value measurement (ASC subparagraph 820-10-35-18B). ASC paragraph 820-10-35-16 states that the transfer of a liability assumes that the liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. It is further assumed that the liability would not be settled with the counterparty or otherwise extinguished on the measurement date. Because the liability to the counterparty is presumed to be transferred rather than settled, the fair value measurement reflects the credit risk of the reporting entity and nonperformance risk is assumed to be the same before and after transfer.

17.099 Because liabilities are not typically transferred in active markets, estimating the fair value at the acquisition date involves the use of judgment. In ASC paragraph 820-10-35-16, the FASB noted that in the absence of a quoted price in an active market for an identical or similar liability at the measurement date, which would be unavailable because liabilities are not exchange-traded as liabilities, an entity should measure the fair value of the liability as follows:

- Using a valuation technique based on the quoted price of an investment in the identical liability traded as an asset;
- If the price of an identical liability traded as an asset is not available, use of a valuation technique that uses other observable inputs such as the quoted prices for investments in similar liabilities traded as assets; or
- If observable inputs are not available, use of another valuation technique under an income or market approach.

17.100 The following section identifies commonly used ways to measure the acquisition date fair value of certain liabilities acquired in business combinations.

**TRADE ACCOUNTS AND NOTES PAYABLE**

17.101 Trade accounts and notes payable assumed in a business combination are measured at fair value. Given the lack of observable markets or observable inputs for the transfer of trade accounts and notes payable, such liabilities are often measured using an income approach and discounted at the present value of the amounts to be paid, using an appropriate discount rate reflecting nonperformance risk inherent in the payable, using a market participant perspective.

17.102 Similar to trade accounts receivable, discounting for trade account payables may not be necessary when they are to be settled in a short period of time, provided that the difference between the present values and the gross amounts of the payables is not significant.

17.103 In September 2008, the VRG noted that some entities recognize components of working capital, including trade accounts receivable, at the acquiree’s book value because the differences resulting from current interest rates are deemed to be insignificant. However, this is a non-GAAP policy and accordingly, entities should
evaluate the potential significance of the policy and be able to support that applying the non-GAAP policy is immaterial to the entity’s financial statements at the date of acquisition and in subsequent periods.

DEFERRED REVENUE (PRE-ASC TOPIC 606##)

17.104 The balance sheet of an acquiree immediately prior to the date of acquisition may include deferred revenue. Deferred revenue is only recognized in a business combination when a legal obligation is assumed by the acquirer, such as a legal obligation to provide goods or services to customers. Revenue that was appropriately deferred by the acquiree may not represent an assumed liability, or the fair value of the assumed liability may be different from the amount of the deferred revenue on the acquiree’s balance sheet. A liability related to deferred revenue on the acquiree’s balance sheet may be greater than its acquisition-date fair value, and the fair value may be zero when no legal obligation exists at the acquisition date. For example, an acquiree may have delivered all goods or services under an arrangement with a customer in exchange for a promissory note, but may have deferred revenue recognized on its balance sheet because collectibility of the note was not reasonably assured or the arrangement included extended payment terms resulting in the deferral of revenue. In this circumstance, the deferred revenue does not represent a legal obligation, and the acquirer would not record an assumed liability in its acquisition accounting.

17.105 In situations where the deferred revenue does represent a legal obligation at the acquisition date, as noted above, this amount may be less than the deferred revenue on the acquiree’s balance sheet because the acquiree’s deferred revenue usually includes both a fulfillment margin and a selling margin. Because the acquirer’s legal obligation at the acquisition date is only the fulfillment effort (i.e., the selling effort occurred before the acquisition date), the fair value of the deferred revenue may be less than the acquiree’s recognized amount. The acquisition-date fair value of the liability is often estimated using the income approach, and occasionally using the market approach.

Market Approach

17.106 It may be possible in some circumstances to obtain evidence from third-party contractors to determine the amount that would be paid to transfer the liability to a third-party market participant at the measurement date. When third-party contractor or market information is used to determine the fair value of deferred revenue, discounting may not be necessary. It is generally assumed that the effects of discounting are incorporated into observed market prices. However, the manner in which the acquirer elects to settle the liability should not change the fair value estimate. That is, the fair value estimate should be the same whether the acquirer’s intent is to outsource or fulfill the performance effort internally. While market information, when available, generally provides the most reliable and best evidence of fair value, it may be difficult to obtain for most legal obligations.
**Income Approach**

17.107 The fair value of an assumed liability related to deferred revenue includes the cost of fulfilling the obligation plus a normal profit margin, all from the perspective of a market participant.

17.108 The estimated cost of fulfilling the obligation (i.e., fulfillment effort) forms the foundation of the fair value calculation for deferred revenue. The fulfillment costs represent those costs that are directly related to fulfilling the legal obligation under the contract. Direct costs may include an allocable amount of fixed costs associated with the fulfillment effort if a market participant incurs such costs to fulfill the obligation. However, total fulfillment costs should not exceed a reasonable cost structure of a third-party contractor or market participant. Furthermore, costs associated with the selling activities before the acquisition date would be excluded from the fulfillment effort.

17.109 The fair value determination for deferred revenue also permits a normal profit to be realized on the fulfillment effort. A normal profit margin should be the amount that a market participant expects to receive related to the remaining fulfillment effort and excludes any profit associated with the selling effort or fulfillment effort prior to the acquisition date.

17.110 When the fair value is estimated using the income approach, the acquirer evaluates the terms of the obligation and if discounting would be significant, the cost plus normal profit margin would be discounted to its present value. In addition, the fair value of deferred revenue is determined on a pretax basis. If the liability is discounted, use of an appropriate pretax discount rate from the perspective of a market participant is appropriate.

**Example 17.7: Deferred Revenue**

DEF Corp., a technology-based company, entered into a contract to provide maintenance support for the computer hardware systems of a customer. At the date of the contract, DEF collected $100 from the customer to provide services for the following annual period. Approximately three months later, DEF was acquired by ABC Corp. in a business combination. At the date of acquisition, DEF had $75 of deferred revenue ($100 × 9/12) recorded in its financial statements related to the maintenance support contract. ABC expects to incur costs of $50 to perform the maintenance support services required under the terms of the contract (legal obligation) and determines that this is representative of the costs that a market participant would incur as well.

DEF’s normal total profit margin for transactions of this nature (including both margin on the selling activity and margin on fulfillment effort) historically was 20% of its actual costs. If ABC outsources the remaining obligation, a third-party contractor (market participant) would expect a normal profit margin on the actual costs of the fulfillment effort of 6%.
In its acquisition accounting, ABC should measure the fair value of the legal obligation related to the fulfillment of the maintenance support services. The obligation would be measured at $53 ($50 of additional maintenance support services costs plus $3 of normal profit margin [$50 × 6%]). The margin associated with the selling activities and fulfillment effort prior to the acquisition date are excluded from the revenue on the remaining fulfillment effort.

ABC should evaluate whether its measurement of the liability should be on a discounted or undiscounted basis based on its determination of whether the effect of discounting is significant.

In determining the cost of the maintenance support, research and development costs that ABC conducts in relation to the computer hardware system typically would not be considered direct costs to servicing the contract if ABC is expected to incur these costs in the ordinary course of business regardless of whether it had the contract with the customer.

17.111 There may be instances where the acquired revenue arrangement results in a liability to provide goods or services and the acquisition of a customer-related intangible asset. The liability recognized for the assumed legal obligation and any related asset acquired should be recognized separately (i.e., gross) on the balance sheet. For instance, an acquiree who is the lessor in an operating lease may have established a customer relationship that meets the recognition requirements for a customer relationship intangible asset in ASC Topic 805. Likewise, an acquiree who is the lessee of assets may have established customer relationships through the use of such assets (e.g., through the sublease of such assets) that might also meet the recognition requirements for customer relationship intangible assets of ASC Topic 805.

(Pre-ASC Topic 842*) Deferred Revenue Arising from a Vendor-Financed Leasing Arrangement

17.112 The balance sheet of an acquiree immediately before acquisition may include deferred revenue arising from the application of ASC paragraphs 840-20-40-1 through 40-5, 35-4 through 35-5, and 360-10-40-1 through 40-2 related to vendor-leasing arrangements. ASC Topic 840 requires that the sale of property subject to an operating lease or sale of property that is leased by or intended to be leased by a third-party purchaser, be accounted for as a borrowing if the seller or party related to the seller retains substantial risks of ownership in the leased property (i.e., the sale proceeds are recorded as an obligation and the related asset is not derecognized). This liability does not constitute a legal obligation assumed by the acquirer and, therefore, it is not recognized as a liability of the combined entity. The acquirer may, however, retain some of the risks of ownership related to the leased asset. Accordingly, the acquirer should recognize the estimated fair value of the recourse obligation (e.g., the estimated loss exposure) on the date of acquisition as a liability. In these situations, the leased asset is not recognized by the acquirer as an asset as part of the business combination.
Deferred Revenue Arising from Postcontract Customer Support (PCS) Arrangement (Pre-ASC Topic 606##)

17.113 When measuring the fair value of deferred PCS revenue of a software vendor that exists at the acquisition date, one of the key questions is whether a customer’s right to receive unspecified upgrades/enhancements on a when-and-if-available basis should be included in the measurement of the fair value of the legal obligation. This was discussed by the EITF in Issue 04-11, “Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor;” however, the Task Force was unable to reach consensus and the Issue was removed from its agenda.

17.114 There are two analyses that are widely used in practice. In the first view, each component of a PCS arrangement is evaluated separately to assess whether it is a legal obligation that should be included in the measurement of the fair value of the vendor’s obligation as of the acquisition date. Under this view, the fair value of the deferred PCS revenue would be the fair value of the obligation to provide support services and error corrections (i.e., bug fixes). Because the vendor has no legal obligation to develop and deliver upgrades/enhancements, the fair value would not include any value attributable to the when-and-if available enhancements. Although the acquiring entity has an obligation to deliver upgrades/enhancements if they are subsequently developed, whether or not development occurs is within the entity’s control. The acquiring entity can, at its discretion, avoid the use of assets by ceasing development efforts for upgrades/enhancements.

17.115 Under the second view, a PCS arrangement is one unit of account for purposes of assessing whether a legal obligation has been assumed. The concept of PCS as a single arrangement is consistent with the Codification’s definition of PCS. Under this analysis, the fair value of the deferred PCS revenue would include the value attributable to the when-and-if available upgrades/enhancements.

17.116 Under both views, the fair value of the obligation should consider the likelihood that a market participant would not perform under the terms of the arrangement. We believe both views are acceptable and the method should be consistently applied as an accounting policy election.

17.117 In our experience, the obligation under either view is often measured using an income approach (i.e., cost plus a normal profit margin) as described beginning in Paragraph 17.107. We believe that the use of a bottom-up analysis (i.e., a cost build-up analysis) would be appropriate under either view. A top-down analysis (i.e., estimated selling price less estimated selling costs and related margin) also may be an appropriate analysis for estimating the fair value of deferred revenue. Either is likely to result in substantially less deferred revenue than recorded by the seller pre-acquisition.

LONG-TERM DEBT

17.118 Long-term debt, such as bonds and interest-bearing notes, are financial obligations that are not payable within 12 months. In a business combination, debt
assumed is required to be measured at fair value at the date of acquisition. Quoted market prices, if available, generally provide the most reliable and best evidence of fair value. The use of quoted market prices for the debt traded as an identical asset can be used to measure fair value.

17.119 In the absence of quoted market prices for debt assumed (e.g., privately issued debt, quoted price of the instrument when traded as an asset), fair value is frequently determined using a market approach or income approach or, if appropriate, an entry price as a proxy for of the exit price of the liability (see Paragraph 16.040).

**Market Approach**

17.120 If quoted market prices are not available, an acquirer’s best estimate of fair value may be based on the quoted market price of debt instruments traded as assets with similar characteristics, for example, quoted market prices of a similar debt instrument that is traded as an asset on a public exchange or dealer market, taking into consideration legal restrictions on the debt obligation. Similar market approaches are available when determining the fair value of debt assumed in a business combination, including a matrix pricing technique. Matrix pricing is a mathematical technique used to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

**Income Approach**

17.121 An acquirer’s best estimate of the fair value of the debt obligation may be based on the present value of current market expectations of future cash flows using an appropriate discount rate. An appropriate discount rate is developed using observable inputs, if available, and should reflect current interest rates, credit assumptions, market liquidity, and other factors that market participants would incorporate in determining the price they expect to receive for the liability to be transferred to them.

17.122 The discount rate should be based on the credit standing of the combined entity if the acquirer becomes directly obligated or guarantees the assumed debt. The credit standing of the combined entity may have characteristics of the creditworthiness of the acquirer prior to the business combination, or a blended credit standing of the acquirer and acquiree (e.g., for publicly traded debt, the market may react negatively to the increased leverage and combined credit profile of the acquirer as a result of the business combination). If the debt remains the obligation of the acquiree only, the appropriate discount rate may be the rate applicable to the acquiree’s stand-alone creditworthiness at the date of acquisition. However, if market participants anticipate that the acquiree will benefit from synergies of the combined entity, then a more favorable discount rate may be appropriate. We believe using the acquirer's discount rate indicates that the acquirer has implicitly guaranteed the debt, whereas using the acquiree's discount rate could imply that the acquirer would tolerate a default scenario. For a strategic acquirer, we believe that using the acquiree's discount rate would be rare, because usually the acquirer would not permit debt default, which could lead to deconsolidating the subsidiary if it goes into bankruptcy and effectively negate the purpose of an acquisition. However, for a financial
acquirer (e.g., a private equity firm), using the acquiree's discount rate might be more appropriate.

**17.123** Factors to consider in determining the fair value of the debt assumed include:

a. The remaining term to maturity of the debt assumed. If the debt assumed has a remaining term to maturity of five years, the market interest rate of the new debt with a five-year term to maturity should be considered in determining the appropriate interest rate to use in determining fair value.

b. Conversion features of the debt, if any. If the debt is convertible into preferred or common stock, the market price of the preferred or common stock into which the debt is convertible should be considered in determining fair value.

c. All other terms of the debt instrument, such as prepayment penalties, change-in-control provisions, call provisions, guarantees, and debt covenants.

d. If the interest rate on the debt assumed in a business combination is dependent on the prime rate or another benchmark rate, but subject to a stated minimum and maximum rate condition at the date of acquisition.

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**Example 17.8: Determining the Fair Value of Debt Assumed in a Business Combination**

ABC Corp. acquires DEF Corp. in a business combination. DEF operates in a newly deregulated industry, experienced operating losses, and expects negative cash flows beginning two years from now. ABC has an AA-credit rating and can borrow at 5%, while DEF has a BBB-credit rating and can borrow at 12%. Before the business combination, DEF’s property, plant, and equipment were financed with senior unsecured debt. ABC intends to assume or guarantee the debt as part of the business combination. There are no prepayment rights as part of the debt obligation.

**Q.** In determining the fair value of the debt assumed, how should ABC evaluate the senior unsecured debt?

**A.** Because ABC intends to assume or guarantee the senior unsecured debt, the debt should be evaluated based on the creditworthiness of the combined entity (e.g., if the debt is publicly traded, market participants may anticipate the enhanced credit standing of the debt at the date of acquisition based on the creditworthiness of the combined entity when pricing the debt).

However, if the debt remains the obligation of the acquiree, the effective interest rate would be based on the prior credit characteristics of the debt obligation based on DEF’s BBB-credit standing if market participants expect that ABC will not guarantee the debt.

The fair value of the debt may be higher or lower than its face value resulting in the recognition of a debt premium or discount, and an effective interest rate that is lower or greater than the contractual rate.
17.124 In periods after the acquisition, the acquirer should amortize the difference between the fair value recorded on the acquisition date and the ultimate settlement amount using the interest method. If the interest rate used in the valuation of the debt assumed in a business combination is higher than the stated rate of the debt, a discount on debt should be recognized and amortized of the remaining period to maturity using the interest method. Similarly, if the interest rate used in the valuation of debt assumed in a business combination is lower than the stated rate on the debt, a premium on the debt should be recognized and amortized over the remaining period to maturity using the interest method. The recognition of a discount or premium on debt for financing reporting purposes may result in a deductible or taxable temporary difference under ASC Topic 740, unless the discount or premium on debt also is recognized for income tax reporting purposes.

**ASSET RETIREMENT OBLIGATION**

17.125 If a long-lived asset with an existing asset retirement obligation is acquired in a business combination, the acquirer should recognize the acquisition-date fair value of the obligation in accordance with ASC Subtopic 410-20, *Asset Retirement and Environmental Obligations - Asset Retirement Obligations*. The long-lived asset is valued on an unencumbered basis (i.e., without regard to the asset retirement obligation), and the related asset retirement obligation is recognized and measured separately. ASC Subtopic 410-20 applies to legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, or development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. ASC paragraphs 410-20-15-1 through 15-3

17.126 In determining the fair value of an asset retirement obligation, quoted market prices, if available, provide the most reliable and best evidence of fair value. In the absence of quoted market prices for the obligation, fair value is often determined using an income approach. ASC Subtopic 410-20 states that an expected present value technique will usually be the appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation.

**DERIVATIVE INSTRUMENTS**

17.127 In a business combination, the values assigned to derivative instruments, such as options and interest rate swaps, under ASC Topic 815, *Derivatives and Hedging*, should be based on the fair value of the instruments at the date of acquisition. The fair value of derivative assets should consider the effect of potential nonperformance of the derivative counterparty. In addition, ASC Subtopic 820-10 requires that the fair value of liabilities, including derivatives, also consider the impact of the entity’s own nonperformance risk. Many derivative instruments (e.g., swaps and forwards) are affected by the risk of nonperformance of both the counterparty and the entity because the derivatives can be liabilities at some time during their lives and assets at other times (depending on market movements). For these derivatives, both the risk of counterparty credit risk and an entity’s own nonperformance risk would be considered by a market participant in
determining the fair value of these instruments regardless of whether they are currently in an asset or liability position.

**REDEEMABLE PREFERRED STOCK**

17.128 Although redeemable preferred stock may not meet the definition of a liability, it does represent a potential commitment to make future payments, and the acquirer should record the commitment at its fair value at the acquisition date.

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**Example 17.9: Redeemable Preferred Stock Held by Noncontrolling Interests**

Q. How should an acquirer determine the fair value of redeemable preferred stock (RPS) that is held by noncontrolling interests?

A. A market approach or income approach is used most often to determine fair value of RPS. Under a market approach, quoted market prices, if available, are the best evidence of fair value. Where quoted market prices for the RPS are not available, the acquirer can use the income approach and estimate fair value as the present value of amounts to be paid using an appropriate discount rate. Where the acquirer does not collateralize or guarantee the RPS, the appropriate discount rate would be the rate that applies to the acquiree on a stand-alone basis if that is consistent with market participant assumptions. Qualified independent investment bankers may be needed to estimate the discount rate.

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* ASU 2016-02, *Leases*, changes certain aspects of accounting for leases acquired in a business combination. The ASU is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual and interim periods in fiscal years beginning after December 15, 2018. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted.

# The completed contract and percentage of completion methods are eliminated by ASC Topic 606, *Revenue from Contracts with Customers*, which is effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2017. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and for interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted.

## FASB ASC Topic 606, Revenue from Contracts with Customers, changes the accounting for revenue from contracts with customers and establishes the definition of contract assets and contract liabilities. ASC Topic 606 is effective for public business entities and not-for-profit entities that are conduit bond obligors for annual periods commencing on or after December 16, 2017. For all other entities, it is effective for annual periods beginning on or after December 16, 2018. Early adoption is permitted.

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1 The gross amount (before reserve) represents the FIFO value.

2 Deducting holding costs is explicitly mentioned in the guidance for tax purposes but was omitted in the historical (now superseded) guidance that was present in Statement 141. However, holding costs may have been considered as a component of costs of disposal. In any case, if inventory turnover rates are high, the opportunity cost of holding inventory is likely to be de minimis.
Section 18 - Determining the Fair Value of the Consideration Transferred in a Business Combination

Detailed Contents

Fair Value of the Consideration Transferred
   Overview
   Consideration in the Form of Equity Interests
      Valuation Analysis
         Summary reports are acceptable if issued as updates to a comprehensive report issued within the last year, when there has been no significant event or major financing that has occurred or is expected to occur. Shares of a Subsidiary Issued in a Business Combination
   Issuing Shares of a Nonpublic or Closely Held Entity
   Preferred Shares Issued in a Business Combination
   Share-Based Payment Awards Included in the Consideration Transferred (Replacement Awards)
   Debt Issued to Former Owners of Acquiree
   Contingent Consideration
   Example 18.1: Determining the Fair Value of Liability-Classified Contingent Consideration—Scenario 1
   Example 18.2: Determining the Fair Value of Liability-Classified Contingent Consideration—Scenario 2
FAIR VALUE OF THE CONSIDERATION TRANSFERRED

OVERVIEW

18.000 As discussed in Section 6, Recognizing and Measuring the Consideration Transferred, consideration transferred in a business combination may be in many forms including, for example, cash, noncash assets (e.g., a business or a subsidiary), debt issued to the former owners of the acquiree, equity interests issued (e.g., common or preferred equity instruments, options, warrants, member interests of mutual entities), replacement share-based payment awards, and contingent consideration. All consideration transferred, with the exception of replacement share-based payment awards, is measured at fair value at the acquisition date. Replacement share-based payment awards are measured in accordance with the fair value-based measurement principles of ASC Topic 718, Compensation—Stock Compensation.

18.001 Cash payments by an acquirer do not present measurement difficulties. However, the measurement of other forms of consideration can present varying degrees of difficulty and require judgment, so that it may be helpful to have an independent valuation performed in some situations. This Section includes discussion of certain elements of the consideration transferred in a business combination and the related measurement approaches for determining the fair value of those specific items. See Section 6 for additional accounting guidance related to the recognition and measurement of consideration transferred in a business combination.

CONSIDERATION IN THE FORM OF EQUITY INTERESTS

18.002 Equity interests issued as consideration in a business combination (other than replacement share-based payment awards) are measured at fair value at the acquisition date. Whenever available, the quoted price in an active market should be used to measure the fair value of equity securities issued to effect a business combination. If a quoted price in an active market is not available, other approaches will be needed.

Valuation Analysis

18.003 An AICPA Task Force developed a Practice Aid, Accounting and Valuation Guidance: Valuation of Privately-Held-Company Equity Securities Issued as Compensation, about valuing private entities. The Practice Aid was issued in 2013 to provide measurement guidance to be considered when valuing equity instruments of privately held entities. Although the Practice Aid is not authoritative, its guidance has been used as a resource by preparers, valuation professionals, and auditors in all industries.

18.004 While business combinations are outside its scope, the Practice Aid may contain some useful information (e.g., valuation techniques and best practices relevant to such
valuations). Furthermore, Table 5-1 of the Practice Aid details some key differences between the valuations of a controlling interest versus a noncontrolling interest in an entity.

18.005 Paragraph not used.

18.006 The Practice Aid provides specific guidance and reporting requirements on valuations for financial reporting purposes. Key issues to consider when valuing equity securities of privately held entities include:

- **Fair Value Hierarchy.** The Practice Aid states that a valuation performed for the purpose of valuing privately held common stock issued as compensation should be based on the definition of fair value used in the employee share-based payment Topic (ASC Topic 718) and nonemployee share-based payment Subtopic (ASC Subtopic 505-50). This definition is different from the definition of fair value in ASC Subtopic 820-10 and is described in ASC Topic 805 as a fair value-based measure. Consistent with ASC Subtopic 820-10, the Practice Aid indicates that quoted prices in active markets are the best evidence of fair value. While quoted prices are not available for private entities, an entity may have had recent cash transactions for the issuance of shares that can be used to value a security. Use of such transactions would be contingent on (1) the transaction being for the same or similar shares as those being valued, and (2) the transaction being a current transaction between willing parties, that is, other than on a forced or liquidation basis, and not arising from the terms of a prior transaction (e.g., tranched equity offerings, the strike price of exercised share options would not be regarded as indicative of the fair value of the underlying shares or an investment by a strategic investor may not be representative of fair value for other shares).

- **Hierarchy of Valuation Alternatives.** The Practice Aid states that the reliability of a valuation report depends on the timing of the valuation (contemporaneous or retrospective) and the objectivity of the valuation professional (unrelated or related). It recommends that an entity engage an unrelated valuation professional to assist management in determining fair value if neither quoted prices in active markets nor arm’s-length cash transactions are available. The Practice Aid further states that for purposes of valuing privately issued securities for which observable market prices of identical or similar securities are not available, the most reliable fair value estimate would be produced by a contemporaneous valuation.

- **Rules of Thumb Are Inappropriate.** An entity should not apply rules of thumb to value equity shares. For example, rules of thumb that value common shares at a specified discount to a recent round of financing with preferred shares or at a discount to an expected IPO price would be inappropriate.

- **Valuation of the Enterprise.** In valuing equity shares of privately held entities, the Practice Aid suggests a top-down analysis, whereby the value of
the enterprise is determined and is allocated to debt and the different classes of equity.

When valuing shares of privately held entities, generally the value of the entity as a whole should be established, and then used to value each class of the entity’s outstanding shares. This top-down analysis should be based on an evaluation of the different rights of each class of shares, including their liquidation, redemption, or conversion rights. The Practice Aid includes extensive discussion on the nature of these rights.

- **Valuation Analyses to Establish Enterprise Value.** Absent quoted prices or comparable cash transactions, other valuation approaches must be applied to value shares issued by privately held entities. These include the income, market, or cost approaches. The selection of approach(es) depends, in part, on the nature of the entity and its stage of development.

  - In applying an income approach, the Practice Aid indicates that either a discount rate adjustment technique or an expected cash flow technique may be applied. Interest rates used under the traditional present value technique are usually significantly higher than those of similar public entities, calculated using the traditional Capital Asset Pricing Model.

  - When applying a market approach, consideration should be given to the comparability of the entities used in the market analysis and an understanding that the comparable transactions were on a fair value premise (e.g., not a forced sale) for like shares. Comparable pricing information may not be available for early stage entities. The Practice Aid discusses the use of the *backsolve* method, whereby transactions involving the entity’s own securities are used to solve for the implied aggregate equity value of the entity.

  - A cost (asset-based) approach is generally less conceptually sound for valuing shares of privately held entities. However, an asset-based approach may be acceptable at an early stage of an entity’s development when it is difficult to apply a market or income approach.

- **Valuation Analyses to Assign Enterprise Value to Different Classes of Equity.** The Practice Aid discusses several possible methods of assigning enterprise value to an entity’s underlying shares. It refers to these methods as the Current-Value Method, the Option-Pricing Method, the Probability-Weighted Expected Return Method, and the Hybrid Method, and discusses circumstances when each method would be more or less appropriate and provides examples.

  - **The Current-Value Method** assigns value to preferred shares based on its current liquidation or immediate conversion values, whichever is greater. The Practice Aid states that a disadvantage of this method is that while it may be easier to understand, it is highly sensitive to the underlying assumptions. It also looks at the current best value for the preferred shares, without regard to possible future price movements. An
entity should take care in using the current-value method because this method may undervalue the common shares when there is no plan to liquidate or sell the entity in the near future, because the common shares frequently derive much of their value from their disproportionate share of the future market value. This occurs frequently for entities emerging from bankruptcy, early-stage entities, and entities financed by private equity investors.

- **The Option-Pricing Method** treats the common and preferred shares as options on the entity’s enterprise value. The Practice Aid states that a disadvantage of this method is that it may be complex to implement and that some of the assumptions to which it is highly sensitive, for example, the volatility or term, are difficult to objectively estimate. However, this method does capture the option-like characteristics of common shares for entities whose common shares are a small portion of the total capital structure.

- **The Probability-Weighted Expected Return Method** estimates the value of the common and preferred shares by considering possible scenarios for future enterprise value and realization of return by shareholders (e.g., IPO, sale to a strategic buyer, leveraged recapitalization, and continued operation). The return to the preferred and common shareholders is estimated under each scenario, as are associated probabilities. The Practice Aid acknowledges that this technique is difficult to implement and requires a number of assumptions about possible future outcomes, which are difficult to objectively estimate. This method is most appropriate when the time to a liquidity event is short.

- **Hybrid Methods** are discussed in the Practice Aid. In some situations, it may be appropriate to include a combination of the OPM and PWERM methods. The advantage of using both methods is that option-like payoffs associated with the various share classes are captured, while also considering future payoff scenarios.

- **Marketability Discounts.** Marketability discounts are often appropriate when valuing shares of privately held entities. The level of such discounts should be based on an evaluation of the shares’ specific facts and circumstances (e.g., prospects for liquidity, restrictions on transferability, size, and timing of distributions). The use of rules of thumb or of average or median discounts reported in restricted shares studies is not appropriate.

- **Pre-IPO and IPO Value.** The Practice Aid acknowledges that differences would exist between pre-IPO and post-IPO values. The Practice Aid states that an IPO value eliminates many of the factors that give rise to a lack-of-marketability discount, by providing liquidity, reducing valuation uncertainties, and reducing ownership concentration.

The Practice Aid indicates that significant differences between pre- and post-IPO values can exist. A valuation professional often accounts for the lack of marketability before an IPO by applying a marketability discount against the
results of the valuation techniques (i.e., under the income, market, or asset-based approaches). Some of the difference in value between private and public entities may also be reflected in the discount rate used in the income approach. The Practice Aid indicates that the cost of capital for public entities may be lower, which would cause them to have a higher value than an otherwise comparable privately held entity. The quantification of such differences must be evaluated on a case-by-case basis, based on an entity’s specific facts and circumstances.

- **Contents of a Valuation Report.** The Practice Aid includes detailed suggestions for the contents of a valuation report. It indicates that a valuation report prepared by a related valuation professional, including an internal report prepared by management, should contain the same level of information as that prepared by an external valuation professional.

Summary reports are acceptable if issued as updates to a comprehensive report issued within the last year, when there has been no significant event or major financing that has occurred or is expected to occur. Shares of a Subsidiary Issued in a Business Combination

18.007 Shares of a subsidiary issued in a business combination in exchange for shares of the acquiree should be valued as of the acquisition date based on the principles discussed in the previous paragraph. If the acquirer continues to maintain a controlling financial interest in the subsidiary after issuance, any difference between the fair value of the subsidiary shares issued and the carrying amount of the acquirer’s respective interest in the subsidiary’s net assets will be recognized as a capital transaction in equity in accordance with the noncontrolling interests guidance of ASC Subtopic 810-10, Consolidation - Overall. See Section 15, Noncontrolling Interests in Consolidated Financial Statements, for additional guidance related to the accounting for noncontrolling interests.

Issuing Shares of a Nonpublic or Closely Held Entity

18.008 The acquisition of a public entity by a privately held entity provides an example of where the acquisition-date fair value of an acquiree’s equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer’s equity interests issued to effect a business combination. In those situations, consideration should be given to the fair value of the acquiree’s equity interests in determining the fair value of the shares issued to effect the combination.

Preferred Shares Issued in a Business Combination

18.009 When preferred shares are issued in a business combination to the shareholders of the acquiree and there is no quoted market price available to determine the fair value of those shares, the characteristics of the preferred shares (e.g., dividend rate, conversion features, or redemption features) should be incorporated into the fair value of the preferred shares. For example, the fair value of nonvoting, nonconvertible preferred shares that lack characteristics of common shares may be determined by comparing the specified dividend and redemption terms with those of comparable securities and by
assessing market factors. The approach to determining the fair value of such shares may be similar to that used to determine the fair value of debt securities.

18.010 The Practice Aid for privately held entities provides guidance and other considerations for determining the fair value of preferred shares. The guidance may be useful in measuring the fair value of preferred shares as part of the consideration transferred in a business combination.

18.011 See Section 6 for accounting guidance and other fair value consideration related to convertible preferred shares and other convertible instruments issued in a business combination.

Share-Based Payment Awards Included in the Consideration Transferred (Replacement Awards)

18.012 An acquirer may exchange its share-based payment awards (replacement awards) for awards held by grantees of the acquiree. If the acquirer is obligated to replace the awards, either all or a portion of the acquirer’s replacement awards must be included in measuring the consideration transferred in a business combination. The measurement of replacement awards is a fair-value-based measure under ASC Topic 718, and is an exception to a fair value measurement principle under ASC Topic 805, Business Combinations.

18.013 See discussion of Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree in Section 11.

Debt Issued to Former Owners of Acquiree

18.014 An acquirer may issue debt to the former owners of the acquiree as part of the consideration transferred in a business combination. Quoted market prices, if available, generally provide the best evidence of fair value. In the absence of quoted market prices for the debt instrument (e.g., privately issued debt), fair value is frequently determined using a market approach or income approach.

Market Approach

18.015 If quoted market prices for an identical or similar liability are not available, an acquirer’s best estimate of fair value may be based on the quoted market price of identical debt instruments traded as assets in active markets; for example, a quoted market price of an identical debt instrument traded as an asset on a public exchange or dealer market. If that price is not available, other observable inputs may be used, such as the quoted price in a market that is not active for the identical item held by another party as an asset. If prices for an identical liability traded as an asset are not available, there are other similar market approaches available when determining the fair value of the debt instrument, including a matrix pricing technique.
Income Approach

18.016 An income approach measures the fair value of the debt instrument as the present value of the expected future cash flows using an appropriate discount rate. The discount rate should reflect what a market participant would demand to assume the risks of that liability including general interest rates, credit assumptions of the acquirer or combined entity depending on the facts and circumstances, market liquidity, and other risk factors. For examples of valuation techniques used under a market or income approach, see chapter F of KPMG's Fair Value Measurements - Questions and Answers.

Contingent Consideration

18.017 Contingent consideration includes, but is not limited to obligations to transfer additional consideration to the former owners of the acquiree if specified future events occur or conditions are met. Contingent consideration may include the issuance of additional securities or distribution of other consideration (e.g., cash) on resolution of contingencies based on, for example, postcombination earnings, postcombination security prices, or other factors. All contingent consideration is measured at fair value on the acquisition date and included in the consideration transferred.

18.018 Contingent consideration issued in a business combination is classified at the acquisition date as either equity, or as an asset or a liability, based on the applicable GAAP. The accounting for contingent consideration after the transaction depends on whether the obligation for contingent consideration is classified as equity or as a liability (or in some cases, as an asset). See discussion of Contingent Consideration in Sections 6 and 12 for accounting guidance related to the classification and subsequent accounting, respectively, for contingent consideration.

18.019 Regardless of classification, estimating the fair value of contingent consideration can be challenging as the arrangements are often complex. When valuing contingent consideration, one should consider whether:

- The goal is to incentivize the earnout recipients to significantly outperform baseline targets after the acquisition, or it is akin to a deferral of payment with easy-to-achieve target metrics.
- It is based on technical or financial milestones or both.
- The payoff structure is linear or non-linear.
- The payoff in one period is dependent on the payoff in an earlier period.

18.020 To determine whether a payoff is linear or non-linear:

- A linear payoff occurs when the contingent consideration payoff is a fixed percentage of the underlying metric (e.g., the contingent consideration payoff is 50% of cumulative revenue in the first three years after the acquisition).
A non-linear payoff occurs when the contingent consideration payoff is defined as a non-linear function on the underlying metric – frequently involving thresholds, caps, or tiers (e.g., if revenue is less than $2 million, the contingent consideration payoff is zero; however, if revenue is at least $2 million but not greater than $5 million, the contingent consideration payoff is 50% of the revenue in excess of $2 million, and if revenue is greater than $5 million, the contingent consideration payoff is $2.5 million plus 75% of the revenue in excess of $5 million).

18.020a The income approach generally is appropriate for measuring the fair value of contingent consideration, given the forward-looking characteristics of contingent consideration arrangements and the lack of similarly traded assets or liabilities.

18.020b There are two methodologies under the income approach to consider when determining the fair value of contingent consideration:

- **Scenario Based Method:** Linear payoffs and those that require achieving independent technical milestones (e.g., FDA approvals) are often valued using a Scenario Based Method (SBM). Similar to the Expected Present Value Technique (as discussed in ASC paragraphs 820-10-55-13 through 55-20), the SBM considers a range of potential outcomes and their assigned probabilities of occurrence. The expected cash flows attributable to contingent consideration are derived by summing the probability-weighted outcomes for each of the scenarios. The outcomes are discounted to present value at an appropriate risk-adjusted discount rate. The SBM, with multiple scenarios, is well suited for (1) financial-based metrics when the contingent consideration’s payoff is equal to a fixed multiple of the underlying metric with no threshold or cap (i.e., the payoff is linear in nature) and (2) technical or milestone-based metrics.

- **Option Pricing Method:** Non-linear payoffs are well suited to be valued using an option pricing method (OPM), such as a Monte Carlo Simulation, lattice model, or Black-Scholes-Merton option pricing model. Examples of non-linear payoffs include payments that are triggered only if certain financial metric thresholds are met, which is similar to the structure of an option payment.

18.020c Regardless of which method is selected:

- The discount rate should reflect the risk of the cash flow stream to which it is applied.
- The midperiod convention should be used. The midperiod convention assumes that the cash flows are realized at the midpoint of each period.

18.021 ASC Subtopic 820-10 provides guidance for fair value measurements used in financial reporting, including contingent consideration. The guidance specifies that in cases where there is no quoted price for a liability or equity, an entity shall measure the
fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset. An entity should first consider observable market prices to measure the fair value of the identical item held by other parties as an asset. When observable prices are not available, an entity generally will apply an income approach or market approach from the perspective of the market participant holding the identical item as an asset.

**ASC Paragraph 820-10-35-16B**

When a quoted price for the transfer of an identical or a similar liability or instrument classified in a reporting entity’s shareholders’ equity is not available and the identical item is held by another party as an asset, a reporting entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date.

**ASC Paragraph 820-10-35-16BB**

In such cases, a reporting entity shall measure the fair value of the liability or equity instrument as follows:

a. Using the quoted price in an active market for the identical item held by another party as an asset, if that price is available

b. If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset

c. If the observable prices in (a) and (b) are not available, using another valuation approach, such as:

   1. An income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see [ASC] paragraph 820-10-55-3F).

   2. A market approach (for example, using quoted prices for similar liabilities or instruments classified in shareholders’ equity held by other parties as assets; see [ASC] paragraph 820-10-55-3A).

18.022 Not used.

**Example 18.1: Determining the Fair Value of Liability-Classified Contingent Consideration--Scenario 1**

On January 1, 20X9, ABC Corp. acquires DEF Corp. in a business combination for $100 million. As part of the business combination, ABC and DEF’s former owners enter into a contingent consideration arrangement. ABC agrees to pay additional cash consideration equal to 5% of the total revenue generated by DEF between the acquisition date and the first anniversary of the acquisition. According to DEF’s most recent forecast, which reflects market participant expectations, revenue for the first year following the
acquisition is projected as follows: a 60% probability of $125 million, a 20% probability of $100 million, and a 20% probability of $140 million.

In determining the fair value of the contingent consideration, ABC considers the expected revenue amounts and their associated probabilities\(^1\), resulting in an expected payment of $6.15 million \([($125 \times 60\% + $100 \times 20\% + $140 \times 20\%) \times 5\%]\). Because ABC expects the payment one year from the acquisition date, it calculates the present value of the contingent consideration using an appropriate discount rate, which would not be a risk-free rate because the $6.15 million is not a certainty-equivalent amount, and the amount is included in the acquisition-date fair value of the consideration transferred. The contingency is liability-classified because it requires cash settlement and, as such, ABC must remeasure it to fair value each reporting period until the contingency is settled. ABC recognizes adjustments resulting from remeasurement in current earnings.

\(^1\)This technique is known as the Expected Value Method and is described in ASC Section 820-10-55.

**Example 18.2: Determining the Fair Value of Liability-Classified Contingent Consideration—Scenario 2**

As part of a business combination on January 1, 20X7, ABC Corp. agrees to pay the former owners of XYZ Corp. additional consideration of $20 million after the acquisition date if a specific revenue target of XYZ is achieved for the second-year period ending December 31, 20X8. The revenue target is $100 million.

As part of evaluating the probability of achievement of the revenue target at the end of 20X8, ABC estimated the different outcomes, which reflect market participant expectations, using an expected cash flow technique, as follows:

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Probability</th>
<th>Weighted Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low case</td>
<td>90,000</td>
<td>25.0%</td>
</tr>
<tr>
<td>Base case</td>
<td>110,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>Stretch case</td>
<td>130,000</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

ABC has calculated the expected revenue for the second-year ending on December 31, 20X8 as $110,000. ABC determined that the appropriate continuous and annualized risk-adjusted discount rate for revenue is 15%, the revenue annual volatility is 35%, and the continuous and annualized risk-free rate is 1.5%. The counterparty credit risk spread is 2%. Consistent with the midperiod convention, ABC assumes that the period to second-year expected revenue realization is 1.5 years.

ABC first calculates the risk-neutral expected revenue as of January 1, 20X7:

\[
$87,837 = $110,000 \times \exp(-15\% \times 1.5)
\]
ABC applies the Black-Scholes-Merton model to determine the fair value of the additional consideration as of January 1, 20X7 as follows:

Fair Value = Payment × exp(- Counterparty credit risk rate × Time period) × N(d2)

where counterparty credit risk rate is the sum of the risk-free rate and the counterparty credit risk spread and N() is the standard normal distribution function with

d2 = [ ln($87,837/$100,000) + (1.5% - 0.5×35%^2) × 1.5 ] / [35% × 1.5^0.5] = -0.46

The fair value is calculated as:

Fair Value = $20 million × exp(- 3.5% × 1.5) × 32.12% = $6.1 million

The acquisition-date fair value of the contingent consideration is approximately $6.1 million, and is included in the consideration transferred. The contingency is liability-classified and, as such, is remeasured to fair value each reporting period until the contingency is settled. ABC recognizes adjustments resulting from remeasurement in current earnings.
Section 19 - Determining the Fair Value of a Noncontrolling Interest in a Business Combination

Detailed Contents

Fair Value of the Noncontrolling Interest In a Partial Acquisition
  Overview
  Control Premium
  Valuation Analysis
FAIR VALUE OF THE NONCONTROLLING INTEREST IN A PARTIAL ACQUISITION

OVERVIEW

19.000 As discussed in Section 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree, in a partial acquisition, the acquirer measures the noncontrolling interest in the acquiree at its fair value at the date of acquisition.

19.001 Quoted market prices, if available, generally provide the best evidence of fair value of the noncontrolling interest. For example, in a partial acquisition of a public entity, an acquirer should measure the acquisition-date fair value of the noncontrolling interest on the basis of the quoted market price for the equity shares not held by the acquirer that continue to trade in an active market. However, in the absence of quoted market prices (e.g., a privately held entity), it may be necessary to use a valuation approach to determine the fair value of the noncontrolling interest.

19.002 As part of evaluating the best information available, the acquisition-date fair value of the consideration transferred by an acquirer is generally not indicative of the fair value of the noncontrolling interest. For example, the fair value of the acquirer’s controlling interest in the acquiree and the noncontrolling interest on a per-share basis often differ. That is, a control premium is often part of the per-share fair value of the acquirer’s controlling interest in the acquiree, which would not be reflected in the per share amount of any noncontrolling interest. ASC paragraph 805-20-30-8

CONTROL PREMIUM

19.003 A control premium\(^1\) represents the fact that an acquirer is willing to pay more for equity securities that give it a controlling interest to take advantage of synergies and other benefits that flow from control over another entity. For example, the controlling interest may realize additional benefits from (i) improvements in cash flow, (ii) lower cost of capital for the combined entity or (iii) additional features of the controlling interest that are different from features of the noncontrolling interest. Alternatively, another investor may be unwilling to pay as much for a number of equity securities representing less than a controlling interest.

19.003a A control premium on the controlling interest therefore does not apply to the fair value of a noncontrolling interest, except in the rare circumstance it is demonstrated that the noncontrolling interests also will benefit from the market participant synergies and other benefits of the combined entity after the business combination on a pro rata basis. For example, synergies arising from a business combination might be in the form of increased sales or cost efficiencies at the acquired entity. In that scenario, while the acquirer might have paid an acquisition premium, all shareholders - both controlling and noncontrolling - would participate in the value of these synergies on a pro rata basis, thus there would not be a difference in the per share value between the majority or controlling
interest and the noncontrolling interest. Conversely, if the synergies are realized only at the acquirer or another subsidiary of the acquirer, the noncontrolling shareholders of the acquired entity would not participate in the economic benefits realized from the synergies. In this scenario there would be a control premium applicable to the controlling interest and the noncontrolling interest would be valued at a discount from the controlling interest.

**VALUATION ANALYSIS**

19.004 In the absence of quoted market prices for determining the fair value of the noncontrolling interest, an acquirer uses other approaches to determine the fair value of the noncontrolling interest. However, when using appropriate valuation technique(s), it might be necessary to determine the acquisition-date fair value of the acquiree as a whole, and then identify the portion that relates to the noncontrolling interest. We generally would not expect an acquirer to determine the fair value of the noncontrolling interest by grossing up the value of the controlling interest (e.g., simply concluding the fair value of a 10% noncontrolling interest is $10 when the fair value of the controlling interest is $90), unless there is evidence that the noncontrolling interest participates in all benefits associated with control on a pro rata basis.

19.005 An AICPA Task Force developed a Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, on valuing private entities. See Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination*, for additional discussion about the Practice Aid.

19.006 If the acquisition-date fair value of the acquiree as a whole is determined using one or a combination of the valuation approaches described, it may be reasonable to determine the fair value of the noncontrolling interest as the difference between the fair value of the acquiree less the fair value of the consideration transferred by the acquirer. Alternatively, an acquirer can use both market and income valuation approaches to directly measure the fair value of the noncontrolling interest.

1 Control premium may also be referred to as a Market Participant Acquisition Premium (MPAP). The MPAP is expressed through either enhanced cash flows or lower required rates of return.
Section 20 - Determining the Fair Value of a Previously Held Equity Interest in a Business Combination

Detailed Contents

Fair Value of a Previously Held Equity Interest in an Acquiree in a Business Combination Achieved in Stages (Step Acquisitions)

Overview
Valuation Analysis
Control Premium

Example 20.1: Previously Held Equity Interest Valued on a Pro Rata Basis
FAIR VALUE OF A PREVIOUSLY HELD EQUITY INTEREST IN AN ACQUIREE IN A BUSINESS COMBINATION ACHIEVED IN STAGES (STEP ACQUISITIONS)

OVERVIEW

20.000 As discussed in Section 9, Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations, in a business combination achieved in stages, the acquirer measures its previously held interest in the acquiree at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings at the acquisition date. The amount recognized in earnings includes changes in value previously recognized in other comprehensive income (e.g., when the previously held interest was classified as an available-for-sale security).

20.001 Quoted market prices, if available, provide the best evidence of fair value of a previously held interest in the acquiree. However, in the absence of quoted market prices (e.g., a privately held entity), the fair value may need to be determined using valuation approaches.

VALUATION ANALYSIS

20.002 Typically, techniques under the market approach or income approach provide the best evidence of fair value in the absence of quoted market prices. Section 19, Determining the Fair Value of the Noncontrolling Interest in a Business Combination, provides additional guidance in determining the fair value of equity securities in the absence of quoted market prices.

CONTROL PREMIUM

20.003 In September 2008, the FASB Valuation Resource Group (VRG) discussed whether the fair value measurement of a previously held interest should include a control premium. Although the VRG did not reach a conclusion at that meeting, an observer to the joint FASB/IASB business combination project team believes that the intent of the FASB was to exclude any control premium to determine the gain or loss on a previously held equity interest because that interest did not represent a controlling interest before the business combination. The measurement of the previously held equity interest in a business combination achieved in stages should not reflect a control premium, and the entire control premium should be attributed to the additional interest that was newly acquired to obtain control (i.e., any control premium in a step acquisition would be subsumed into goodwill). However, in limited circumstances it may be appropriate to incorporate a control premium when an entity can demonstrate that the previously held equity interest would benefit from the control transaction’s proceeds on a pro rata basis. This might be the case when the previously held interest is subject to tag-along rights or drag-along rights, or other minority shareholders (other than the acquirer) would receive a pro rata share under the transaction structure. This is consistent with the FASB’s
conclusion in paragraph B382 of FASB Statement No. 141(R), *Business Combinations*, in which an acquirer overpays for its interest in an acquiree, and that overpayment is subsumed in goodwill, but does not result in a loss in earnings at the acquisition date.

**Example 20.1: Previously Held Equity Interest Valued on a Pro Rata Basis**

ABC Corp. is a minority investor in Target with 5 percent ownership of the common shares. Aside from ABC, Target has three shareholders that each hold a 5 percent interest with a fifth shareholder owning the remaining 80 percent.

ABC enters into an agreement with the other shareholders to buy the other shareholders' shares (totaling 95%) for $95. The agreement stipulates that each investor receives their proportionate share of the $95. This means the other three minority investors receive $5 each and the majority investor receives $80.

ABC values its previously held interest at $5 because those shares have the same value as the other shareholders.
Section 21 - Determining the Fair Value of a Retained Interest in a Subsidiary When Control Is Lost

Detailed Contents

Fair Value of a Retained Interest in a Subsidiary when Control Is Lost
   Overview
   Control Premium
   Valuation Analysis
   Classification of Retained Interest
FAIR VALUE OF A RETAINED INTEREST IN A SUBSIDIARY WHEN CONTROL IS LOST

OVERVIEW

21.000 As discussed in Section 15, Noncontrolling Interests in Consolidated Financial Statements, on loss of control, a parent deconsolidates a subsidiary as of the date the parent ceases to have a controlling interest in the subsidiary. If a parent deconsolidates a subsidiary that is a business or nonprofit activity, but retains an interest in its former subsidiary, the retained interest generally is measured at fair value and the gain or loss on deconsolidation of the subsidiary includes both the gain or loss on the interest sold and on the interest retained.

21.001 Quoted market prices, if available, provide the best evidence of the fair value of a retained noncontrolling interest in a subsidiary. However, in the absence of quoted market prices (e.g., a privately held entity), the fair value may need to be determined using valuation approaches.

CONTROL PREMIUM

21.002 The fair value of consideration paid by a third party to acquire a controlling interest in the subsidiary does not indicate the fair value of the retained interest that is not a controlling interest. That is, the consideration received by the seller generally includes a control premium paid by the third party for the controlling interest. The fair value of the retained interest generally would not reflect a control premium.

VALUATION ANALYSIS

21.003 Typically, techniques under the market approach or income approach provide the best evidence of fair value in the absence of quoted market prices. Section 19, Determining the Fair Value of a Noncontrolling Interest in a Business Combination, provides additional guidance in determining the fair value of equity securities in the absence of quoted market prices.

CLASSIFICATION OF RETAINED INTEREST

21.004 If the fair value of the retained interest is readily determinable at the measurement date (e.g., quoted market prices), the retained interest should be measured and classified in accordance with ASC Topic 320, Investments—Debt and Equity Securities, based on the intent and ability of the parent company (e.g., available-for-sale or trading securities) unless the retained interest gives the entity the ability to exercise significant influence over the investee (i.e., former subsidiary). If so, it is accounted for under the equity method of accounting in accordance with ASC Topic 323, Investments—Equity Method and Joint Ventures. In applying the equity method, the fair value of the retained interest represents the investor’s basis in the investment and the investor determines if there is any difference between the fair value of the retained interest and its share of the
underlying net assets of its former subsidiary (commonly referred to as *excess of cost over underlying net assets*). The excess of cost over underlying net assets is assigned to identifiable assets and liabilities with the residual constituting *equity-method goodwill.*
Section 22 - Goodwill and Other Intangible Assets*

Detailed Contents

Goodwill and Other Intangible Assets
Scope of ASC Topics 805 and 350 Related to the Accounting for Goodwill and Other Intangible Assets
  ASC Topic 805
  ASC Topic 350
    Accounting Guidance under Other Literature
Initial Recognition of Intangible Assets
  Internally Developed Goodwill and Other Intangible Assets
Variable Interest Entities
Excess Reorganization Value in Bankruptcy
Intangible Assets Arising from a Business Combination (Including Goodwill)
Acquisition of Intangible Assets in Transactions That Do Not Constitute the Acquisition of a Business
Subsequent Accounting for Goodwill and Other Intangible Assets
  Finite versus Indefinite Life
Determining and Evaluating the Useful Life of an Intangible Asset
  Buyer-Specific Intent
  Renewals or Extensions
    Example 22.2: An Acquired Technology License That Renews Annually
    Example 22.3: An Acquired Customer Relationship
    Reacquired Rights
  Other Examples of Determining the Useful Life of an Intangible Asset
    Example 22.4: Intangible Assets--Amortizable and Nonamortizable
    Example 22.5: Potential Indefinite-Lived Intangible Assets
Amortizable Intangible Assets
  Amortization Period and Method
  Amortization Period
  Amortization Method
    Example 22.6: Amortization Methods
  Residual Value
  Reevaluation of Useful Life
  Impairment of Amortizable Intangible Assets
  Order of Impairment Testing
Nonamortizable Intangible Assets Other Than Goodwill
  Indefinite-Lived Intangible Assets Are Not Amortized
Intangible Assets Acquired in a Business Combination That Are Used in Research and Development Activities

Impairment of Identifiable Indefinite-Lived Intangible Assets

Fair Value

Unit of Accounting for Impairment Testing

Example 22.7: Unit of Accounting

Goodwill

Nature of Goodwill

Initial Recognition and Measurement of Goodwill

For Public Business Entities and Entities not Electing PCC Alternative Goodwill
Is Not Amortized, but Is Tested for Impairment at the Reporting Unit Level
(see Section 26, Private Company and Not-For-Profit Accounting Alternatives)

Frequency of Impairment Testing

Example 22.7a: Evaluating Events or Circumstances in between Annual Impairment Tests

Reporting Unit

Business

Discrete Financial Information

Segment Management

Example 22.8: One Operating Segment--Management

Economic Characteristics

Economic Similarity between Components of Different Operating Segments

Example 22.9: Aggregation of Components of Different Operating Segments

Example 22.10: Aggregation of Operating Segments

Identifying the Reporting Unit

Example 22.11: Identifying the Reporting Unit--Case 1

Example 22.12: Identifying the Reporting Unit--Case 2

Subsidiary Reporting Units

Nonpublic Entities

Assigning Acquired Assets and Liabilities to Reporting Units

Assigning Corporate Assets and Liabilities to Reporting Units

Assigning Assets and Liabilities That Relate to Multiple Reporting Units

Unassigned Assets and Liabilities

Assigning Assets and Liabilities to Reporting Units – Other Issues

Single Reporting Unit Entities

Assigning Contingent Consideration Classified as a Liability (or an Asset) to Reporting Units

Example 22.13: Assigning Contingent Consideration to Reporting Units--Case 1

Example 22.14: Assigning Contingent Consideration to Reporting Units--Case 2
Example 22.15: Assigning Contingent Consideration to Reporting Units--Case 3
Example 22.16: Assigning Contingent Consideration to Reporting Units--Case 4
Example 22.17: Assigning Contingent Consideration to Reporting Units--Case 5
Equity-Classified Contingent Consideration Arrangements
Assigning Deferred Tax Assets and Liabilities
Assigning Deferred Taxes When There Is No Corresponding Financial Statement Carrying Amount
Example 22.18: Assigning Deferred Tax Assets Related to Net Operating Loss Carryforwards to a Reporting Unit
Assigning Deferred Tax Asset Valuation Allowance
Assigning Liabilities for Uncertain Tax Positions
Assigning Goodwill to Reporting Units
Reorganizations Affecting the Composition of Reporting Units
Impairment Testing
Pre-Goodwill Impairment Analysis of the Carrying Amount of Other Assets
Example 22.19: Interaction of ASC Sections 360-10-35 and 350-20-35 When Performing an Impairment Test
The Goodwill Impairment Test
Impairment Test - Qualitative Assessment
Impairment Test - First Step
Fair Value of the Reporting Unit Is Determined at the Measurement Date
Example 22.20: Incorporating Assumptions of Change in Conditions in Valuing the Reporting Unit--Case 1
Example 22.21: Incorporating Assumptions of Change in Conditions in Valuing the Reporting Unit--Case 2
Measuring the Fair Value of a Single Reporting Unit
Using Valuation Techniques to Measure the Fair Value of a Reporting Unit
Reconciliation of Market Capitalization
Determining a Reporting Unit’s Fair Value – Assumed Tax Structure
Example 22.22: Determining the Reporting Unit’s Fair Value - Assumed Tax Structure
Negative Carrying Amount of a Reporting Unit
Example 22.22a: Reporting Unit with Negative Carrying Amount
Treatment of Contingent Consideration in the Quantitative Goodwill Impairment Test
Example 22.23: Goodwill Impairment Test--Contingent Consideration in Step 1 of Goodwill Impairment Test
Impairment Test - Second Step (Prior to Adoption of ASU 2017-04)
Example 22.24: Goodwill Impairment Test--Basic Example
Assembled Workforce
Treatment of Contingent Consideration in Step 2 of a Goodwill Impairment Test (Prior to Adoption of ASU 2017-04)

Example 22.25: Goodwill Impairment Test--Contingent Consideration in Step 2 of Goodwill Impairment Test (Prior to the adoption of ASU 2017-04)

Measuring Deferred Tax Assets and Liabilities in Step 2 of the Goodwill Impairment Test (Prior to Adoption of ASU 2017-04)

Cumulative Translation Adjustment (CTA)

Example 22.30: Impairment Test--Cumulative Translation Adjustment Timing of the Annual Goodwill Impairment Test

Change in Annual Impairment Test Date

Subsidiary Financial Statements

Equity Method Investments

Goodwill Impairment Testing and Disposal of All or a Portion of a Reporting Unit When the Reporting Unit Is Less Than Wholly Owned

Example 22.31: Goodwill Attributable to Controlling and Noncontrolling Interests

Dispositions of All or a Portion of a Reporting Unit

Example 22.32: Difference in the Allocation of Goodwill to a Disposed Business in the Consolidated Financial Statements of a Parent and the Financial Statements of Its Subsidiary
GOODWILL AND OTHER INTANGIBLE ASSETS

22.000 Goodwill is defined as follows:

ASC Master Glossary: Goodwill
An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. …

22.001 Intangible assets are defined as:

ASC Master Glossary: Intangible Assets
Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill).

22.002 While goodwill is, by definition, an intangible asset, the term intangible assets, as used in both ASC Topic 805, Business Combinations and ASC Topic 350, Intangibles--Goodwill and Other, generally excludes goodwill, which is discussed in those Topics separately from other intangible assets. These definitions also reflect the fact that intangible assets, as the term is used in ASC Topics 805 and 350, are individually recognized and measured, while goodwill is measured as the residual amount in the acquisition accounting (see Section 8, Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase).

SCOPE OF ASC TOPICS 805 AND 350 RELATED TO THE ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

22.003 The guidance in ASC Topics 805 and 350 for the initial recognition and measurement of, and subsequent accounting for, goodwill and other intangible assets is summarized below:

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<tr>
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<th>Initial Recognition and Measurement</th>
<th>Subsequent Accounting</th>
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<tr>
<td>Internally Developed Intangible Assets</td>
<td>ASC Topic 350 and other applicable GAAP (e.g.,</td>
<td>ASC Topic 350 and ASC Section</td>
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<tr>
<td>Other Intangible Assets</td>
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<td><strong>ASC TOPIC 805</strong></td>
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**22.004** ASC Topic 805 addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. See discussion in Sections 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree, 8, and 26, Private Company and Not-for-Profit Accounting Alternatives.

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<th><strong>ASC TOPIC 350</strong></th>
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**22.005** ASC Topic 350 addresses the initial recognition and measurement of other intangible assets developed internally or acquired in an asset acquisition, and the subsequent accounting for goodwill and other intangible assets, regardless of how they were acquired.

**ASC Paragraph 350-10-05-1**

The Intangibles--Goodwill and Other Topic provides guidance on financial accounting and reporting related to goodwill and other intangible assets, including the subsequent measurement of goodwill and intangible assets. It does not include...
guidance on the accounting at acquisition for goodwill and other intangibles acquired in a business combination or an acquisition by a not-for-profit entity.

**ASC Paragraph 350-20-05-1**

[ASC] Subtopic [350-20] addresses financial accounting and reporting for goodwill subsequent to its acquisition and for the cost of internally developing goodwill.

**ASC Paragraph 350-20-05-2**

[ASC] Subtopic 805-30 provides guidance on recognition and initial measurement of goodwill in a business combination. [ASC] Subtopic 958-805 provides guidance on recognition and initial measurement of goodwill acquired in an acquisition by a not-for-profit entity.

**ASC Paragraph 350-20-15-2**

The guidance in [ASC] Subtopic [350-20] applies to the following transactions and activities:

a. Goodwill that an entity recognizes in accordance with [ASC] Subtopic 805-30 or [ASC] Subtopic 958-805 after it has been initially recognized and measured

b. The costs of internally developing goodwill and other unidentifiable intangible assets with indeterminate lives

c. Subparagraph Not Used

d. Amounts recognized as goodwill in applying the equity method of accounting and to the excess reorganization value recognized by entities that adopt fresh-start reporting in accordance with [ASC] Topic 852.

e. Subparagraph Not Used

**ASC Paragraph 350-30-05-1**

[ASC] Subtopic [350-30] addresses financial accounting and reporting for intangible assets (other than goodwill) acquired individually or with a group of other assets and for the cost of developing, maintaining, or restoring internally generated intangible assets. However, it does not discuss the recognition and initial measurement of intangible assets acquired in a business combination or in an acquisition by a not-for-profit entity. [ASC] Subtopic [350-30] also addresses financial accounting and reporting for intangible assets after their acquisition, including intangible assets acquired in a business combination or an acquisition by a not-for-profit entity.

**Accounting Guidance under Other Literature**

**22.006** ASC Topic 350 does not change the accounting for intangible assets prescribed in other accounting pronouncements identified in ASC paragraph 350-10-15-4. Thus, the accounting for intangible assets in the following pronouncements remains applicable:
(a) ASC Subtopic 730-10, Research and Development - Overall.
(b) ASC Topic 932, Extractive Activities--Oil and Gas.
(c) ASC Topic 928, Entertainment--Music.
(d) ASC Topic 950, Financial Services--Title Plant.
(e) ASC Topic 920, Entertainment--Broadcasters.
(f) ASC paragraphs 980-350-35-1 through 35-2 for rate-regulated activities.
(g) ASC Topic 985, Software.
(h) ASC Topic 740, Income Taxes.
(i) ASC Topic 860, Transfers and Servicing.

22.007 While not specifically cited in ASC Topic 350, it does not change the accounting for specific intangible assets provided by other authoritative GAAP such as ASC Topic 908, Airlines; ASC Subtopic 340-20, Other Assets and Deferred Costs - Capitalized Advertising Costs; ASC Subtopic 720-35, Other Expenses - Advertising Costs; ASC Subtopic 350-40, Intangibles--Goodwill and Other - Internal-Use Software; ASC Subtopic 720-15, Other Expenses - Start-Up Costs; and ASC Topic 926, Entertainment--Films.

INITIAL RECOGNITION OF INTANGIBLE ASSETS

Internally Developed Goodwill and Other Intangible Assets

ASC Paragraph 350-20-25-3

Costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as an expense when incurred.

22.008 ASC Topic 350 requires that the costs of internally developing, maintaining, or restoring intangible assets meeting the criterion in ASC paragraph 350-30-25-3 be recognized as expense as incurred.

22.009 ASC paragraph 350-30-15-3, however, specifies that ASC Topic 350 also applies to costs of internally developing identifiable assets that an entity recognizes as assets. Accounting guidance for internally developed identifiable intangible assets that are recognized as assets by reporting entities generally is included in the pronouncements addressed in the above discussion, Accounting Guidance under Other Literature. However, if ASC Topic 350 includes additional requirements that go beyond, but are not inconsistent with the other pronouncements applied, such as additional disclosure requirements, the additional requirements of ASC Topic 350 are applicable to that intangible asset.
VARIABLE INTEREST ENTITIES

22.010 ASC Subtopic 810-10, Consolidation - Overall, requires an entity that becomes the primary beneficiary of a variable interest entity that does not constitute a business initially measures and recognizes the assets, except goodwill, and liabilities of the variable interest entity in accordance with the recognition and measurement principles of ASC Sections 805-20-25 and 805-20-30. However, the primary beneficiary should recognize a gain or loss for the difference between: (1) the fair value of any consideration transferred, the fair value of any noncontrolling interests, and the reported amount of any previously held interests; and (2) the net amount of the variable interest entity’s identifiable assets and liabilities recognized and measured in accordance with ASC Sections 805-20-25 and 805-20-30. Consistent with ASC Topic 350, no goodwill should be recognized if the variable interest entity is not a business. (Note: ASU 2017-01, Clarifying the Definition of a Business, changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.) ASC paragraphs 810-10-30-4 through 30-6.

22.011 See Section 4, Variable Interest Entities, for additional discussion on accounting for variable interest entities.

EXCESS REORGANIZATION VALUE IN BANKRUPTCY

22.012 ASC Subtopic 852-10, Reorganizations - Overall, indicates that when applying fresh-start accounting upon emergence from bankruptcy, the reorganization value should be assigned to the entity’s assets and liabilities in conformity with the procedures specified by ASC Topic 805, including its provisions for initial recognition and measurement of intangible assets apart from goodwill. The excess reorganization value recognized by emerging entities that adopt fresh-start reporting under ASC Subtopic 852-10 is reported and accounted for in the same manner as goodwill arising in a business combination such that the reorganization value is treated as the consideration transferred in the acquisition accounting under fresh-start reporting. Statement 142, par. B18

INTANGIBLE ASSETS ARISING FROM A BUSINESS COMBINATION (INCLUDING GOODWILL)

22.013 The initial recognition and measurement of goodwill and other intangible assets acquired in a business combination is discussed in the following Sections:

- The initial recognition and measurement of goodwill arising from a business combination is discussed in Section 8, Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase.
- The initial recognition and measurement of other intangible assets acquired in a business combination is discussed in Section 7, Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree.
Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, ASU 2017-01 is effective for annual periods in fiscal years beginning after December 15, 2018 and interim periods in fiscal years beginning after December 15, 2019. This ASU may be early adopted. For additional information, see Paragraph 2.025.

ACQUISITION OF INTANGIBLE ASSETS IN TRANSACTIONS THAT DO NOT CONSTITUTE THE ACQUISITION OF A BUSINESS

22.014 For guidance on accounting for intangible assets in an asset acquisition, see section 4.2 in KPMG's Issues In-Depth, Asset acquisitions.

22.015-22.019 Not used.

Example 22.1 Not used.

SUBSEQUENT ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

22.020 The accounting for other intangible assets subsequent to their acquisition is the same, regardless of whether they are acquired in a business combination or in an acquisition of assets, with the exception of reacquired rights acquired in a business combination (see discussion under Reacquired Rights below).

FINITE VERSUS INDEFINITE LIFE

22.021 The subsequent accounting for an intangible asset depends on whether its useful life is finite or indefinite. An intangible asset with a finite useful life is amortized, while an intangible asset with an indefinite useful life is not. An intangible asset has an indefinite life if there are no legal, regulatory, contractual, competitive, economic, or other factors limiting its life. Useful life is defined as the period over which an asset is expected to contribute directly or indirectly to future cash flows. An indefinite useful life is defined as extending beyond the foreseeable horizon, i.e., there is no foreseeable limit on the period of time over which the asset is expected to contribute to the cash flows of the reporting entity. ASC paragraph 350-30-35-4

22.022 Indefinite does not mean infinite, nor is an intangible asset’s useful life considered to be indefinite because a precise finite life cannot be determined. Where a precise finite life cannot be determined, a best estimate for the useful life is used. ASC paragraphs 350-30-35-4 through 35-5

22.023 We generally expect that mature products and brand names may be considered to have an indefinite life. While an intangible asset may currently be considered to have a finite useful life, the passage of time and more evidence could lead to a reassessment of the useful life and result in a conclusion that the life has changed to indefinite. For
example, an acquired brand name that has only been in the market for a few years would likely not be considered to have an indefinite life, but after a longer history of stable cash flows, the brand name may be determined to have an indefinite life. On such a determination, the unamortized carrying amount of the asset, if any, would cease to be amortized and the impairment provisions of ASC paragraphs 350-30-35-15 through 35-20 applicable to indefinite-lived intangible assets would apply thereafter. Alternatively, an intangible asset that has previously been determined to have an indefinite life may subsequently be determined to have a finite useful life. An entity should continue to evaluate the useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. ASC paragraphs 350-30-35-15 through 35-17A

DETERMINING AND EVALUATING THE USEFUL LIFE OF AN INTANGIBLE ASSET

ASC Paragraph 350-30-35-1

The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life shall be amortized; an intangible asset with an indefinite useful life shall not be amortized.

ASC Paragraph 350-30-35-2

The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The useful life is not the period of time that it would take that entity to internally develop an intangible asset that would provide similar benefits. However, a reacquired right recognized as an intangible asset is amortized over the remaining contractual period of the contract in which the right was granted. If an entity subsequently reissues (sells) a reacquired right to a third party, the entity includes the related unamortized asset, if any, in determining the gain or loss on the reissuance.

ASC Paragraph 350-30-35-3

The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular, the following factors with no one factor being more presumptive than the other:

a. The expected use of the asset by the entity.

b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate.

c. Any legal, regulatory, or contractual provisions that may limit the useful life. The cash flows and useful lives of intangible assets that are based on legal rights are constrained by the duration of those legal rights. Thus, the useful lives of such intangible assets cannot extend beyond the length of their legal rights and may be shorter.

d. The entity’s own historical experience in renewing or extending similar arrangements, consistent with the intended use of the asset by the entity, regardless of whether those arrangements have explicit renewal or extension
provisions. In the absence of that experience, the entity shall consider the assumptions that market participants would use about renewal or extension consistent with the highest and best use of the asset by market participants, adjusted for entity-specific factors in this paragraph.

e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels).

f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

Further, if an income approach is used to measure the fair value of an intangible asset, in determining the useful life of the intangible asset for amortization purposes, an entity shall consider the period of expected cash flows used to measure the fair value of the intangible asset adjusted as appropriate for the entity-specific factors in this paragraph.

**ASC Paragraph 350-30-35-4**

If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term *indefinite* does not mean the same as infinite or indeterminate. The useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon - that is, there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity. Such intangible assets might be airport route authorities, certain trademarks, and taxicab medallions.

**ASC Paragraph 350-30-35-5**

Examples 1 through 9B (see [ASC] paragraphs 350-30-55-2 through 55-28F) illustrate different intangible assets and how they should be accounted for in accordance with this Subtopic, including determining whether the useful life of an intangible asset is indefinite.

**Buyer-Specific Intent**

**22.024** In determining the useful life of an intangible asset (or whether an intangible asset is indefinite lived), an entity should consider its intended use for the intangible asset (ASC paragraph 350-30-35-2). There can be a difference between the useful life of the asset and the period of cash flows used to measure the fair value of the asset based on assumptions market participants would use to price the asset.
Other factors that should be considered in determining the useful life of an intangible asset include:

- Relative stability of the cash flow forecast for the intangible asset;
- Relative stability of the cash flow history for the intangible asset;
- Period of time a product or concept has been in the market;
- Whether revenues are dependent on retaining key employees;
- Churn rate for customers;
- Mobility of customer and employee bases;
- Assumptions used to assess the asset for impairment; and
- Assumptions used to determine the fair value of the asset.

Renewals or Extensions

ASC paragraph 350-30-35-3(d) is intended to provide for greater consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. To achieve this, ASC paragraph 350-30-35-3(d) specifies that in developing assumptions about renewals or extensions used in determining the useful life of a recognized intangible asset, an entity should consider its own historical experience in renewing or extending similar arrangements (consistent with the entity’s intended use of the asset), regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of such experience, an entity considers the assumptions that market participants would use about renewal or extension (consistent with the highest and best use of the asset by market participants), adjusted for the entity-specific factors in ASC paragraphs 350-30-35-1 through 5.

The following examples illustrate the application of ASC Subtopic 350-30.

**Example 22.2: An Acquired Technology License That Renews Annually**

An exclusive, annually renewable technology license with a third party is acquired by an entity that has made significant progress in developing next-generation technology for digital video products. The acquiring entity believes that in two years, after it has completed developing its next-generation products, the acquired technology license will be obsolete because customers will convert to the acquiring entity’s products. Market participants, however, are not as advanced in their development efforts and are not aware of the acquiring entity’s proprietary development efforts. Thus, those market participants would expect the technology license to be obsolete in three years. The acquiring entity determines that the fair value of the technology license utilizing 3 years of cash flows is $10 million, consistent with the highest and best use of the asset by market participants.

In applying ASC paragraph 350-30-35-3(d), the acquiring entity considers its own historical experience in renewing or extending similar arrangements. In this case, the
acquiring entity lacks historical experience in renewing or extending similar arrangements. Therefore, it considers the assumptions that a market participant would use consistent with the highest and best use of the technology license. However, because the acquiring entity expects to use the technology license until it becomes obsolete in two years, it adjusts the market participants’ assumptions for the entity-specific factors in ASC paragraph 350-30-35-3(a), which requires consideration of the entity’s expected use of the asset. As a result, the technology license will be amortized over a two-year period. The technology license will be reviewed for impairment under ASC Section 360-10-35.

**Example 22.3: An Acquired Customer Relationship**

An insurance company acquires 50 customer relationships operating under contracts that are renewable annually. The acquiring entity determines that the fair value of the customer relationship asset is $10 million, considering assumptions (including turnover rate) that a market participant would make consistent with the highest and best use of the asset by market participants. An income approach was used to determine the fair value of the acquired customer relationship asset.

In applying ASC paragraph 350-30-35-3(d), the acquiring entity considers its own historical experience in renewing or extending similar customer relationships. In this case, the acquiring entity concludes that its customer relationships are dissimilar to the acquired customer relationships and, therefore, the acquiring entity lacks historical experience in renewing or extending similar arrangements. Accordingly, the acquiring entity considers turnover assumptions that market participants would make about the renewal or extension of the acquired customer relationships or similar arrangements. Without evidence to the contrary, the acquiring entity expects that the acquired customer relationships will be renewed or extended at the same rate as a market participant would expect, and no other factors indicate a different useful life is appropriate. Thus, absent any other of the entity-specific factors in ASC paragraphs 350-30-35-1 through 35-5, in determining the useful life for amortization purposes, the acquiring entity considers the period of expected cash flows used to measure the fair value of the asset. The customer relationships will be reviewed for impairment under ASC Section 360-10-35.

22.028 In evaluating whether renewal or extension rights should be considered in determining the estimated useful life of an intangible asset, the acquirer should have both the intent and the ability to renew or extend the intangible asset. The acquirer’s past practice of not renewing or extending comparable intangible assets may evidence a lack of the requisite intent or ability to do so. When evaluating an ability to renew or extend an intangible asset, a number of factors should be considered, including the acquiree’s past practices, industry practices, the past practices of the party granting the intangible asset, and the nature of the party granting the right (e.g., governmental entities may be more likely to treat all parties equally which may limit the ability of the existing holder to renew an intangible asset).
Reacquired Rights

22.029 In some business combinations, an acquirer reacquires a right that it previously granted to the acquiree to use one or more of the acquirer’s recognized or unrecognized assets. For example, the acquirer may have previously granted the acquiree a right to use the acquirer’s trade name under a franchise agreement or a right to use the acquirer’s technology under a technology licensing agreement. ASC Topic 805 requires that a right reacquired in a business combination be measured on the basis of the remaining contractual term of the related contract, without regard to whether market participants would consider potential contractual renewals in determining its fair value. ASC Topic 805 also provides guidance on the subsequent accounting for a reacquired right, consistent with its initial measurement, requiring that it be amortized over the remaining contractual period of the contract in which the right was granted without regard to the criteria in ASC paragraphs 350-30-35-1 through 35-5. Refer to additional discussion about reacquired rights at Paragraph 11.015. ASC paragraphs 805-20-30-20 and 35-2

Other Examples of Determining the Useful Life of an Intangible Asset

22.030 The following examples illustrate the application of the criteria of ASC Section 350-30-35 in determining useful lives of intangible assets. Examples 1 through 9B are taken from ASC paragraphs 350-30-55-2 through 55-28F.

Example 22.4: Intangible Assets--Amortizable and Nonamortizable

1. An acquired customer list. A direct-mail marketing company acquired a customer list and expects that it will be able to derive benefit from the information on the acquired customer list for at least one year but for no more than three years.

The customer list will be amortized over 18 months, management’s best estimate of its useful life, following the pattern in which the expected benefits will be consumed or otherwise used up. Although the acquiring company intends to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date of acquisition (a closed-group notion). The customer list will be reviewed for impairment under ASC Section 360-10-35.

2. An acquired patent that expires in 15 years. The product protected by the patented technology is expected to be a source of cash flows for at least 15 years. The reporting entity has a commitment from a third party to purchase the patent in 5 years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in 5 years.

The patent will be amortized over its 5-year useful life to the reporting entity, following the pattern in which the expected benefits will be consumed or otherwise used up. The amount to be amortized is 40% of the patent’s fair value at the acquisition date (residual value is 60%). The patent will be reviewed for impairment under ASC Section 360-10-35.
3. **An acquired copyright that has a remaining legal life of 50 years.** An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate cash flows for approximately 30 more years.

*The copyright will be amortized over its 30-year estimated useful life, following the pattern in which the expected benefits will be consumed or otherwise used up and reviewed for impairment under ASC Section 360-10-35.*

4. **An acquired broadcast license that expires in five years.** The broadcast license is renewable every 10 years if the company provides at least an average level of service to its customers and complies with the applicable Federal Communications Commission (FCC) rules and policies and the FCC Communications Act of 1934. The license may be renewed indefinitely at little cost and was renewed twice prior to its recent acquisition. The acquiring entity intends to renew the license indefinitely, and evidence supports its ability to do so. Historically, there has been no compelling challenge to the license renewal. The technology used in broadcasting is not expected to be replaced by another technology any time in the foreseeable future. Therefore, the cash flows from the license are expected to continue indefinitely.

*The broadcast license is deemed to have an indefinite useful life because cash flows are expected to continue indefinitely. Therefore, the license will not be amortized until its useful life is deemed to be no longer indefinite. The license will be tested for impairment in accordance with ASC paragraph 350-30-35-18 through 35-20.*

5. **For the broadcast license in Example 4.** The FCC subsequently decides that it will no longer renew broadcast licenses, but rather will auction those licenses. At the time the FCC decision is made, the broadcast license has three years until it expires. The cash flows from that license are expected to continue until the license expires.

*Because the broadcast license can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired license is tested for impairment in accordance with ASC paragraph 350-30-35-18 through 20. The license is then amortized over its remaining three-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the license will be subject to amortization, in the future it will be reviewed for impairment under ASC Section 360-10-35.*

6. **An acquired airline route authority from the United States to the United Kingdom that expires in three years.** The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals routinely are granted at a minimal cost and have historically been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service to the United Kingdom from its hub airports indefinitely and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.
Because the facts and circumstances support the acquiring entity’s ability to continue
providing air service to the United Kingdom from its U.S. hub airports indefinitely, the
intangible asset related to the route authority is considered to have an indefinite useful
life. Therefore, the route authority will not be amortized until its useful life is deemed to
be no longer indefinite and will be tested for impairment in accordance with ASC

7. An acquired trademark that is used to identify and distinguish a leading
consumer product that has been a market-share leader for the past eight years. The
trademark has a remaining legal life of five years but is renewable every 10 years at little
cost. The acquiring entity intends to continuously renew the trademark, and evidence
supports its ability to do so. An analysis of product life cycle studies; market,
competitive, and environmental trends; and brand extension opportunities provide
evidence that the trademarked product will generate cash flows for the acquiring
company for an indefinite period of time.

The trademark is deemed to have an indefinite useful life because it is expected to
contribute to cash flows indefinitely. Therefore, the trademark will not be amortized until
its useful life is no longer indefinite. The trademark will be tested for impairment in
accordance with ASC paragraphs 350-30-35-18 through 35-20.

8. A trademark that distinguished a leading consumer product that was acquired 10
years ago. When it was acquired, the trademark was considered to have an indefinite
useful life because the product was expected to generate cash flows indefinitely. During
the annual impairment testing of the intangible asset, the entity determines that
unexpected competition has entered the market that will reduce future sales of the
consumer product. Management estimates that cash flows generated by the product will
be 20% less for the foreseeable future; however, management expects that the product
will continue to generate cash flows indefinitely at those reduced amounts.

As a result of the projected decrease in future cash flows, the entity determines that the
estimated fair value of the trademark is less than its carrying amount, and an impairment
loss is recognized. Because the trademark is still deemed to have an indefinite useful life,
it will continue to not be amortized and will instead be tested for impairment in
accordance with ASC paragraphs 350-30-35-18 through 35-20.

9. A trademark for a line of automobiles that was acquired several years ago in an
acquisition of an automobile company. The line of automobiles had been produced by
the acquired entity for 35 years with numerous new models developed under the
trademark. At the acquisition date, the acquiring entity expected to continue to produce
that line of automobiles, and an analysis of various economic factors indicated there was
no limit to the period of time the trademark would contribute to cash flows. Because cash
flows were expected to continue indefinitely, the trademark was not amortized.
Management recently decided to phase out production of that automobile line over the
next four years.
Because the useful life of the acquired trademark is no longer deemed to be indefinite, the trademark is tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-20. The carrying amount of the trademark after adjustment, if any, will then be amortized over its remaining four-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the trademark will now be subject to amortization, in the future it will be reviewed for impairment under ASC Section 360-10-35.

Example 22.5: Potential Indefinite-Lived Intangible Assets

Example 1. An acquired company has a portfolio of owned or franchised fast food chain restaurants. The restaurants operate under a well-known brand name and the acquired company has historically been profitable. The restaurant brand name is expected to continue to generate positive cash flow for the acquirer beyond the foreseeable future. The fast food chain restaurants are in a mature, steady-growth stage of their life cycle. Therefore, the brand name may have an indefinite useful life. If so, the acquired brand name would not be amortized until its useful life is no longer deemed to be indefinite and would be tested for impairment on an annual basis in accordance with ASC Topic 350.

Example 2. An acquired investment advisory firm has an investment management contract with a registered mutual fund. The contract can be renewed annually by mutual agreement of both parties. The mutual fund and its advisor have had an ongoing relationship for the last five years and the contract has been renewed each year. Although the mutual fund can terminate the contract on short notice, the contract is not expected to be terminated any time in the foreseeable future.

Because the specific facts and circumstances support the company’s ability to renew the contract indefinitely, the intangible asset related to the contractual relationship may have an indefinite useful life and if so would not be amortized but would be tested for impairment on an annual basis in accordance with ASC Topic 350.

AMORTIZABLE INTANGIBLE ASSETS

Amortization Period and Method

ASC Paragraph 350-30-35-6

A recognized intangible asset shall be amortized over its useful life to the reporting entity unless that life is determined to be indefinite. If an intangible asset has a finite useful life, but the precise length of that life is not known, that
intangible asset shall be amortized over the best estimate of its useful life. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used.

**ASC Paragraph 350-30-35-7 (in part)**

An intangible asset shall not be written down or off in the period of acquisition unless it becomes impaired during that period…..

**Amortization Period**

**22.032** An intangible asset is amortized over its useful life to the reporting entity, unless its life is determined to be indefinite. An intangible asset is not written down or off in the period of acquisition unless it becomes impaired during that period. IPR&D assets acquired in a business combination are measured and recognized at fair value regardless of their alternative future use rather than expensed at the acquisition date. 7. ASC paragraphs 350-30-35-6 through 35-7

**22.033** A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as *defensive intangible assets* or *locked-up assets*. Under ASC Topic 805, an acquirer recognizes and measures all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Topic 820. ASC Subtopic 350-30 provides guidance as to how defensive intangible assets should be accounted for subsequent to their acquisition. Refer to Section 12, *Subsequent Measurement and Accounting*, for additional discussion of the accounting for defensive intangible assets.

**Amortization Method**

**22.034** An amortizable intangible asset is amortized over its estimated useful life to its estimated residual value in accordance with the pattern of consumption of the economic benefits inherent in the intangible asset. Because we believe that the focus should be on using up the rights conveyed by the intangible asset, amortization in proportion to estimated revenues (or similar measure) generally would not be appropriate when it results in a back-ended amortization of the intangible asset. If a pattern of consumption cannot be reliably determined, the straight-line method should be used. The pattern in which economic benefits are consumed may be estimated using either a discounted or undiscounted cash flow basis. The difference in amortization between the two methods is illustrated below.
Example 22.6: Amortization Methods

Assume that the intangible asset has estimated undiscounted cash flows of $100. Assuming a 10% discount rate and a five-year life, the present value of the asset would be $75.8. The following table illustrates the pattern of amortization based on the pattern of discounted and undiscounted cash flows.

<table>
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<th>Year</th>
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<th>3</th>
<th>4</th>
<th>5</th>
<th>Total</th>
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</tr>
<tr>
<td>Discounted cash flows</td>
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<td>16.5</td>
<td>15.0</td>
<td>13.7</td>
<td>12.4</td>
<td>75.8</td>
</tr>
<tr>
<td>Amortization – undiscounted</td>
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<td>15.2</td>
<td>15.2</td>
<td>15.2</td>
<td>15.0</td>
<td>75.8</td>
</tr>
<tr>
<td>Amortization – discounted</td>
<td>18.2</td>
<td>16.5</td>
<td>15.0</td>
<td>13.7</td>
<td>12.4</td>
<td>75.8</td>
</tr>
<tr>
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<td>(1.3)</td>
<td>0.2</td>
<td>1.5</td>
<td>2.6</td>
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</tr>
</tbody>
</table>

Residual Value

**ASC Topic 350-30-35-8**

The amount of an intangible asset to be amortized shall be the amount initially assigned to that asset less any residual value. The residual value of an intangible asset shall be assumed to be zero unless at the end of its useful life to the entity the asset is expected to continue to have a useful life to another entity and either of the following conditions is met:

a. The reporting entity has a commitment from a third party to purchase the asset at the end of its useful life.

b. The residual value can be determined by reference to an exchange transaction in an existing market for that asset and that market is expected to exist at the end of the asset’s useful life.

**22.035 Residual value** is the estimated fair value of an intangible asset at the end of its useful life less any disposal costs. ASC Topic 350 presumes that an intangible asset’s residual value is zero, absent an expectation that the intangible asset will have a useful life to another entity after the acquirer finishes using it, and there is evidence to support the nonzero residual value. Evidence would include either a purchase commitment from a third party for the intangible asset or a market that exists currently that supports the estimated residual value and is expected to exist at the end of the intangible asset’s useful life to the current holder. Reliable evidence of a purchase commitment from a third party would include the entity’s right to put the intangible asset to the third party, but would
not include call options held by the third party, rights of first refusal, or rights of first offer.

Reevaluation of Useful Life

ASC Paragraph 350-30-35-9

An entity shall evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset’s remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively over that revised remaining useful life.

ASC Paragraph 350-30-35-10

An intangible asset that initially is deemed to have a finite useful life shall cease being amortized if it is subsequently determined to have an indefinite useful life, for example, due to a change in legal requirements. If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-20.

22.036 Useful lives of amortizable intangible assets are required to be reevaluated each reporting period, with any changes in estimated useful lives accounted for prospectively as a change in accounting estimate in accordance with ASC paragraph 250-10-45-17. The change in accounting estimate should be accounted for in the period of change if the change impacts that period only, or the period of change and future periods if the change affects both. Financial statements of prior periods should not be restated or retrospectively adjusted unless the change in estimate is a correction of an error. See discussion of Adjustments to Provisional Amounts during the Measurement Period in Section 10, Measurement Period.

22.037 An entity would stop amortizing an intangible asset prospectively that the entity subsequently determines has an indefinite useful life. When amortization ceases for an asset determined to have an indefinite life, the impairment test described in Paragraph 22.039 is carried out. Any resulting impairment loss is accounted for as a change in estimate, not as a change in accounting principle, and therefore would be presented in the same manner as other impairment losses. ASC paragraph 350-30-35-11

22.038 For purposes of evaluating the amortization period, ASC Topic 350 is silent as to whether the reference to reporting period is an annual period, an interim period, or both. We believe it is consistent with other requirements in ASC Topic 350 to interpret the reference to reporting period to mean annual reporting periods. Therefore, absent some triggering event (e.g., change in intended use), we believe that an entity should reevaluate the useful lives of intangible assets at least annually.
Impairment of Amortizable Intangible Assets

ASC Paragraph 350-30-35-14

An intangible asset that is subject to amortization shall be reviewed for impairment in accordance with the Impairment or Disposal of Long-Lived Asset Subsections of [ASC] Subtopic 360-10 by applying the recognition and measurement provisions in [ASC] paragraphs 360-10-35-17 through 35-35. In accordance with the Impairment or Disposal of Long-Lived Asset Subsections of [ASC] Subtopic 360-10, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

22.039 ASC Section 360-10-35 requires a long-lived asset (asset group), including amortizable intangible assets, to be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable (triggering events). If a triggering event occurs, the entity must evaluate whether the carrying amount of an amortizable intangible asset is recoverable. If the carrying amount is not recoverable, an entity tests the carrying amount for impairment. Any impairment loss recognized under ASC Section 360-10-35 reduces the asset to its new cost basis. Reversal of a previously recognized impairment loss is prohibited. ASC paragraph 350-30-35-14

Order of Impairment Testing

ASC Paragraph 350-20-35-31

If goodwill and another asset (or asset group) of a reporting unit are tested for impairment at the same time, the other asset (or asset group) shall be tested for impairment before goodwill. For example, if a significant asset group is to be tested for impairment under the Impairment or Disposal of Long-Lived Asset Subsections of [ASC] Subtopic 360-10 (thus potentially requiring a goodwill impairment test), the impairment test for the significant asset group would be performed before the goodwill impairment test. If the asset group was impaired, the impairment loss would be recognized prior to goodwill being tested for impairment.

22.040 When goodwill and another asset (asset group) of a reporting unit are tested for impairment at the same time, the other asset or asset groups (including amortizable and nonamortizable intangible assets) are tested for impairment and any adjustment to carrying amount is made, and any impairment loss is recognized, prior to the performance of the goodwill impairment test. Any impairment loss recognized with respect to the other asset (asset group) reduces the carrying amount of the asset (asset group) and, thus, could impact the amount of impairment, if any, related to goodwill of the associated reporting unit. See the discussion of Pre-Goodwill Impairment Analysis of the Carrying Amount of Other Assets and Reporting Unit in this Section.
NONAMORTIZABLE INTANGIBLE ASSETS OTHER THAN GOODWILL

Indefinite-Lived Intangible Assets Are Not Amortized

ASC Paragraph 350-30-35-15

If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite.

ASC Paragraph 350-30-35-16

An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life.

ASC Paragraph 350-30-35-17

If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-19. That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

ASC Paragraph 350-30-35-17A

Intangible assets acquired in a business combination or in an acquisition by a not-for-profit entity that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered indefinite lived until the completion or abandonment of the associated research and development efforts. During the period those assets are considered indefinite lived they shall not be amortized but shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in this Section. Consistent with the guidance in [ASC] paragraph 360-10-35-49, intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that have been temporarily idled shall not be accounted for as if abandoned.

22.041 Intangible assets with indefinite useful lives are not amortized. However, an entity reevaluates its conclusion that an intangible asset has an indefinite useful life each reporting period. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the intangible asset should be tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-19 and an impairment loss should be recognized to the extent the carrying amount of the asset exceeds its fair value. Thereafter, the intangible asset should be amortized prospectively, based on its remaining useful life.
Intangible Assets Acquired in a Business Combination That Are Used in Research and Development Activities

22.042 ASC Topic 805 specifies that assets acquired in a business combination that are IPR&D are considered indefinite-lived intangible assets until completion or abandonment of the related research and development efforts. Those assets are tested for impairment on an annual basis in accordance with ASC Topic 350 as described below. Once the research and development efforts are completed or abandoned, the entity determines whether the asset continues to be indefinite-lived or has become a finite-lived asset. If finite-lived, the useful lives of those intangible assets, if any, are estimated and the intangible asset is amortized over the useful life, consistent with ASC paragraphs 350-30-35-6 through 35-7.

22.043 When an IPR&D asset is intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. See Paragraph 12.018 for additional guidance.

Impairment of Identifiable Indefinite-Lived Intangible Assets

ASC Paragraph 350-30-35-18

An intangible asset that is not subject to amortization shall be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.

ASC Paragraph 350-30-35-18A

An entity may first perform a qualitative assessment, as described in this paragraph and [ASC] paragraphs 350-30-35-18B through 35-18F, to determine whether it is necessary to perform the quantitative impairment test as described in [ASC] paragraph 350-30-35-19. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test as described in paragraph 350-30-35-19. An entity may resume performing the qualitative assessment in any subsequent period. If an entity elects to perform a qualitative assessment, it first shall assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired.

ASC Paragraph 350-30-35-18B

In assessing whether it is more likely than not that an indefinite-lived intangible asset is impaired, an entity shall assess all relevant events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset. Examples of such events and circumstances include the following:

(a) Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on future expected earnings and cash flows that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
(b) Financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

(c) Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

(d) Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

(e) Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (in both absolute terms and relative to peers), or a change in the market for an entity’s products or services due to the effects of obsolescence, demand, competition, or other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing business environment, and expected changes in distribution channels) that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

(f) Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

ASC Paragraph 350-30-35-18C

The examples included in [ASC paragraph 350-30-35-18B] are not all-inclusive, and an entity shall consider other relevant events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset. An entity shall consider the extent to which each of the adverse events and circumstances identified could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. An entity also shall consider the following to determine whether it is more likely than not that the indefinite-lived intangible asset is impaired:

(a) Positive and mitigating events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset

(b) If an entity has made a recent fair value calculation for an indefinite-lived intangible asset, the difference between that fair value and the then carrying amount
(c) Whether there have been any changes to the carrying amount of the indefinite-lived intangible asset.

ASC Paragraph 350-30-35-18D

An entity shall evaluate, on the basis of the weight of the evidence, the significance of all identified events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset for determining whether it is more likely than not that the indefinite-lived intangible asset is impaired. None of the individual examples of events and circumstances included in [ASC] paragraph 350-30-35-18B(a) through (f) are intended to represent standalone events and circumstances that necessarily require an entity to calculate the fair value of an intangible asset. Also, the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the quantitative impairment test as described in [ASC] paragraph 350-30-35-19.

ASC Paragraph 350-30-35-18E

If after assessing the totality of events and circumstances and their potential effect on significant inputs to the fair value determination an entity determines that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity need not calculate the fair value of the intangible asset and perform the quantitative impairment test in accordance with [ASC] paragraph 350-30-35-19.

ASC Paragraph 350-30-35-18F

If after assessing the totality of events and circumstances and their potential effect on significant inputs to the fair value determination an entity determines that it is more likely than not that the indefinite-lived intangible asset is impaired, then the entity shall calculate the fair value of the intangible asset and perform the quantitative impairment test in accordance with [ASC] paragraph 350-30-35-19.

ASC Paragraph 350-30-35-19

The quantitative impairment test for an indefinite-lived intangible asset shall consist of a comparison of the fair value of the asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an entity shall recognize an impairment loss in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis.

ASC Paragraph 350-30-35-20

Subsequent reversal of a previously recognized impairment loss is prohibited.

22.044 A nonamortizable intangible asset is reviewed annually for impairment and more frequently if events or circumstances indicate that it is more likely than not that the asset is impaired. ASC Topic 350 does not require an entity to establish an annual impairment test date for a nonamortizable intangible asset. Therefore, a change in the impairment test date of a nonamortizable intangible asset is not a change in the method of applying an accounting principle that would require a preferability letter.
An entity may first perform a qualitative assessment to determine whether it is necessary to perform the quantitative impairment test described in ASC paragraph 350-30-35-19. An entity has an unconditional option to bypass the qualitative assessment for an indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test, and can resume performing the qualitative assessment in a subsequent period. If an entity concludes, based on a qualitative assessment, that it is not more likely than not that an intangible asset is impaired, the entity is not required to perform the quantitative impairment test.

ASC paragraph 350-30-35-18D specifies a more likely than not threshold (i.e., more than 50% likely) when performing a qualitative assessment of whether the fair value of the indefinite-lived intangible asset is less than the carrying amount. Similar to the qualitative assessment for goodwill impairment (see discussion beginning at Paragraph 22.117), we do not believe that threshold is intended to require a probability-weighted analysis of all potential outcomes to support the conclusion reached in the qualitative assessment. However, a process will be needed to identify qualitative factors that could significantly affect the fair value of an indefinite-lived intangible asset and to evaluate the potential effect of changes in those factors on the fair value of the intangible asset to support a conclusion that the quantitative impairment test is unnecessary.

ASC paragraph 350-30-35-18B provides similar (but not the same) examples of events and circumstances to consider in the qualitative assessment as those provided for the qualitative assessment of goodwill. The difference is that the list in ASC paragraph 350-30-35-18B focuses on factors that could affect significant inputs used to determine the fair value of the specific indefinite-lived intangible asset, as compared to the examples in ASC paragraph 350-20-35-3C, which focus on changes affecting the fair value of a reporting unit that is a business. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025. See the discussion of Reporting Unit in this Section.) The factors provided in ASC paragraph 350-30-35-18B are:

- **Cost factors** such as increases in raw materials, labor, or other costs that have a negative effect on future expected earnings and cash flows that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset;

- **Financial performance** such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset;

- **Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors** that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset;

- **Other relevant entity-specific events** such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset;

- **Industry and market considerations** such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (in both absolute terms and relative to peers), or a change in the market for an entity’s products or services due to the effects of obsolescence, demand, competition, or other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing business environment, and expected or potential changes in distribution channels) that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset; and

- **Macroeconomic conditions** such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

22.048 The examples of events and circumstances affecting indefinite-lived intangible assets excludes share price trends because those are not likely to directly affect the fair value of the indefinite-lived intangible asset.

22.049 If an entity decides to perform the qualitative assessment for one or more of its indefinite-lived intangible assets, it will be important for management to develop a process and appropriate controls for performing the assessment. The process and conclusions should be documented by the entity with appropriate key controls identified. The process might be similar for indefinite-lived intangible assets and goodwill, which is assessed for impairment at the reporting unit level. (See the discussion of Reporting Unit in this Section.) Although there are no specific requirements in the FASB Codification about the qualitative assessment process, the process could include, as an example, the following steps:

1. Develop a framework to determine when the entity will perform a qualitative assessment for a reporting unit or indefinite-lived intangible asset and when it will proceed directly to Step 1 of the goodwill impairment test or to the quantitative impairment test for an indefinite-lived intangible asset;

2. For those reporting units or indefinite-lived intangible assets for which a qualitative assessment will be performed, consider the most recent fair value measurement and when that measurement was determined;

3. Identify the significant drivers of fair value for the reporting unit or indefinite-lived intangible asset;

4. Determine what events and circumstances have occurred that may have affected those drivers of fair value, including positive and mitigating events and circumstances that could affect the fair value of the reporting unit or indefinite-lived intangible asset;
(5) Assess the likely impact of the factors identified in the previous steps on the fair value of the reporting unit or indefinite-lived intangible asset;

(6) Consider transactions or events that significantly impact the carrying amount of the reporting unit or indefinite-lived intangible asset;

(7) Prepare an analysis based on the events, circumstances, and factors identified and document the assessment as to whether it is more likely than not that the fair value of the reporting unit or indefinite-lived intangible asset is less than its carrying amount.

22.050 Application of these steps is discussed in more detail at Paragraph 22.123. While the steps identified for the qualitative assessment of goodwill also apply to the qualitative assessment of the impairment of indefinite-lived intangible assets, the key drivers in the fair value assessment are those relevant to an indefinite-lived intangible asset rather than to determining fair value of a reporting unit. Consequently, management should have a similar process in place for indefinite-lived intangible assets, but the process should focus on the factors specific to the indefinite-lived intangible asset. For example, an entity that has a reporting unit that contains a specific indefinite-lived intangible asset such as a trademark may find common assumptions that drive the fair value of the trademark and the fair value of the reporting unit, such as market rates of interest or revenue growth rates, if the fair value of both the reporting unit and trademark are affected by these factors. The key drivers of fair value for the indefinite-lived intangible asset, however, will likely also include asset-specific considerations. In the case of an indefinite-lived trademark, for example, asset-specific considerations may include the royalty rate if a relief-from-royalty method is used to determine its fair value, as well as new product developments affecting the duration of cash flows included in the computation of fair value under the relief-from-royalty method.

22.051 Many different valuation models may be used to determine the fair value of an indefinite-lived intangible asset depending on the type of asset, including the relief-from-royalty method, the multi-period excess earnings method, and the incremental cash flow method. The methods used generally determine the fair value by discounting the expected cash flows under the applicable valuation model to determine the fair value of the intangible asset.

22.052 The following are examples of key drivers of value management might consider in the qualitative assessment of an indefinite-lived intangible asset based on the valuation method used. The examples below are not all-inclusive but illustrate how various factors could be considered in completing a qualitative analysis.

Examples of macroeconomic and industry-specific factors

- The market participant weighted-average cost of capital (WACC) is commonly used as a basis to discount expected cash flows used in a valuation model for an intangible asset in determining the fair value. The discount rate selected may be at a premium or discount to the WACC. However, the WACC, which is typically used to discount cash flows when determining the
fair value of a reporting unit, is a valid driver to consider when conducting the qualitative assessment for an indefinite-lived intangible asset.

- Changes in the regulatory environment may affect barriers to entry, the costs to acquire an intangible asset, or the competitive environment as it relates to the intangible asset. These may either positively or negatively impact the value of the intangible asset.

**Examples of asset-specific factors**

- The increased demand for licenses covering FCC spectrum is a potential positive factor for a related indefinite-lived intangible asset. The increased demand may result in an increase in the royalty rate a company would be required to pay if it did not own the asset, increasing the fair value of the intangible asset.

- The value of IPR&D acquired as part of a business combination by a pharmaceutical company is likely to be affected either positively or negatively as the development of the drug progresses, because the key drivers to the fair value of the intangible asset include the probability of commercial success and forecasted sales. When these asset-specific factors involve significant uncertainties, which may exist with IPR&D, an entity should consider the reliability of the factors evaluated in a qualitative assessment and consider if it is possible to make a positive assertion that it is more likely than not the indefinite-lived asset is not impaired. If the entity is unable to make a positive assertion, a quantitative impairment test should be performed.

22.053 ASC paragraphs 350-30-35-18 through 35-19 require that indefinite-lived intangible assets be tested for impairment annually or more frequently if there are events or circumstances that indicate it is more likely than not that the asset is impaired. The examples of events and circumstances that should be considered when performing a qualitative impairment assessment and when considering whether an interim test is necessary are included in ASC paragraph 350-30-35-18B.

22.054 ASC Topic 350 does not include an undiscounted cash flow recoverability test for nonamortizable intangible assets. Rather, the quantitative impairment test is a comparison of the fair value of the intangible asset with its carrying amount each time the asset is tested for impairment. Any excess of carrying amount over fair value is recognized as an impairment loss in continuing operations. Reversal of a previously recognized impairment loss is prohibited.

22.055 See Paragraph 22.068 for examples of events or circumstances that could trigger an impairment test for goodwill, and Paragraph 22.044 for additional timing considerations of the goodwill impairment test that also would apply to nonamortizable intangible assets. ASC paragraphs 350-30-35-18 through 35-20
**Fair Value**

**22.056** Impairment testing uses the fair value definition in ASC Topic 820, which emphasizes the need for consistency in the valuation technique. Changes in technique used to measure the same or similar amount is permitted provided the change results in a measurement that is representative of fair value in the circumstances. Changes in the valuation technique used or how the technique is applied should be accounted for using the guidance in ASC Topic 250 that governs accounting changes, including changes in estimates and error corrections. This guidance and similar guidance in ASC Topic 820 require disclosure of changes and the reason for such changes. ASC paragraphs 820-10-35-25 through 35-26

**22.057** Nonamortizable intangible assets generally are recognized at fair value on initial recognition; therefore, any subsequent decrease in fair value will result in an impairment loss because there is no undiscounted cash flow triggering test as exists for amortizable intangible assets. Therefore, if discounted cash flows are used to measure the fair value of the intangible asset and there is no change to future cash flows, an increase in interest rates could result in an impairment charge.

**Unit of Accounting for Impairment Testing**

**22.058** ASC Sections 350-30-35 and 55 state that that the unit of accounting for testing impairment should consist of a group of indefinite-lived intangible assets (whether acquired or internally developed) if those assets are operated as a single asset and, as such, are essentially inseparable from each other. ASC Sections 350-30-35 and 55 use an indicator-based approach to identify indefinite-lived intangible assets that are operated as a single asset and are inseparable from each other. ASC paragraphs 350-30-55-33 through 55-25 provide an example of grouping at a level above an ASC Section 360-10-35 asset group level if the indicators support this grouping.

**22.059** Determining whether several indefinite-lived intangible assets are essentially inseparable is a matter of judgment that depends on the relevant facts and circumstances, but that the following should be considered: ASC Sections 350-30-35 and 55

Indicators that two or more indefinite-lived intangible assets should be combined as a single unit of accounting for impairment testing purposes:

- The intangible assets were purchased to construct or enhance a single asset (i.e., they will be used together).

- Had the intangible assets been acquired in the same acquisition they would have been recorded as one asset.

- The intangible assets as a group represent the highest and best use of the assets (e.g., they yield the highest price if sold as a group). This may be indicated if (a) it is unlikely that a substantial portion of the assets would be sold separately or (b) the sale of a substantial portion of the intangible assets individually would result in a significant reduction in the fair value of the remaining assets as a group.
• The marketing or branding strategy provides evidence that the intangible assets are complementary, as that term is used in ASC paragraph 805-20-55-18.

Indicators that two or more indefinite-lived intangible assets should not be combined as a single unit of accounting for impairment testing purposes:

• Each intangible asset generates cash flows independent of any other intangible asset (e.g., an intangible asset licensed to another entity for its exclusive use).

• If sold, each intangible asset would likely be sold separately. A past practice of selling similar assets separately is evidence indicating that combining assets as a single unit of accounting may not be appropriate.

• The entity has adopted or is considering a plan to dispose of one or more intangible assets separately.

• The intangible assets are used exclusively by different ASC Section 360-10-35 asset groups.

• The economic or other factors that might limit the useful economic life of one of the intangible assets would not similarly limit the useful economic lives of other intangible assets combined in the unit of accounting.

22.060 ASC paragraph 350-30-35-26 indicates that the following should be used to determine the unit of accounting used to test indefinite-lived intangible assets for impairment:

(1) The unit of accounting should include only indefinite-lived intangible assets - those assets cannot be tested in combination with goodwill or with a finite-lived asset.

(2) The unit of accounting cannot represent a group of indefinite-lived intangible assets that collectively constitute a business or a nonprofit activity. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

(3) A unit of accounting may include indefinite-lived intangible assets recorded in the separate financial statements of consolidated subsidiaries. As a result, an impairment loss recognized in the consolidated financial statements may differ from the sum of the impairment losses (if any) recognized in the separate financial statements of those subsidiaries.

(4) If the unit of accounting used to test impairment of indefinite-lived intangible assets is included in a single reporting unit, the same unit of accounting and associated fair value should be used to measure a goodwill impairment loss under ASC paragraphs 350-20-35-9 through 18. (Note: ASU 2017-04 removes this consideration. For additional information, see Paragraph 22.116a. Also see the discussion of Reporting Unit in this Section.)
If, as a result of a decision to manage or use indefinite-lived assets together, assets that previously were subject to separate impairment tests are now to be grouped for impairment testing purposes, those assets should be tested separately for impairment before being combined as a unit of accounting.

The following examples based on ASC Sections 350-30-55 illustrates the unit of accounting for impairment testing.

**Example 22.7: Unit of Accounting**

**Scenario 1 – Easements**

Company X is a distributor of natural gas. Company X has two self-constructed pipelines, the Northern pipeline and the Southern pipeline. Each pipeline was constructed on land for which Company X owns perpetual easements. On adoption of Topic 842, Company X will first need to determine whether the easements constitute a lease under Topic 842 and determined they do not meet the definition of a lease under that Topic (because those easements are perpetual and therefore, do not convey the right to use the underlying land for a period of time). (See Q&A 3.1.10 in KPMG's Leases Handbook for additional discussion). The Northern Pipeline was constructed on 50 easements acquired in 50 separate transactions. The Southern Pipeline was constructed on 100 separate easements that were acquired in a business combination and were recorded as one asset. Although each pipeline functions independently of the other, they are included in the same reporting unit. Operations of each pipeline are directed by a different manager. There are discrete, identifiable cash flows for each pipeline; thus, each pipeline and its related easements represent a separate ASC Section 360-10-35 asset group. While Company X has no current plans to sell or otherwise dispose of any of its easements, Company X believes that if either pipeline were sold, it most likely would convey all rights under the easements with the related pipeline.

Under ASC Sections 350-30-35 and 55, Company X would have two units of accounting for purposes of testing the easements for impairment - the collection of easements supporting the Northern pipeline and the collection of easements supporting the Southern pipeline. The 50 easements supporting the Northern pipeline represent a single unit of accounting as evidenced by the fact that (a) they are collectively used together in a single ASC Section 360-10-35 asset group; (b) if acquired in a single transaction, they would have been recorded as one asset; and (c) if sold, they would likely be sold as a group with the related pipeline. For the same reasons, the easements supporting the Southern pipeline would represent a single unit of accounting.

**Scenario 2 – Trade Names**

Company Y purchases an international vacuum cleaner manufacturer, Company A, which sells vacuums under a well-known trade name. The operations of Company A are conducted through separate legal entities in each of the three countries and each of those legal entities owns the registered trade name used in that country. When the business combination was recorded, Company Y recorded three separate intangible
trade name assets because separate financial statements are required to be prepared for each separate legal entity. There are separate identifiable cash flows for each country, and each country represents an ASC Section 360-10-35 asset group. A single brand manager is responsible for the Company A trade name, the value of which is expected to be recovered from the worldwide sales of Company A’s products.

Under ASC Sections 350-30-35 and 55, the three separately recorded trade name assets should be combined into a single unit of accounting for purposes of testing the acquired trade name for impairment. The three registered trade names were acquired in the same business combination and, absent the requirement to prepare separate financial statements for subsidiaries, would have been recorded as a single asset. The trade name is managed by a single brand manager. If sold, Company X would most likely sell all three legally registered trade names as a single asset.

Scenario 3 – Brands

Company Z manufactures and distributes cereals under two different brands, Brand A and Brand B. Both brands were acquired in the same business combination. Company Z recorded two separate intangible assets representing Brand A and Brand B. Each brand represents a group of complementary indefinite-lived intangible assets including the trademark, the trade dress, and a recipe. Brand A has two underlying trade names for its Honey and Cinnamon cereals. The trade name and recipe of Cinnamon were internally generated after acquiring Brand A. Sales of Honey cereals have decreased while sales of Cinnamon cereals have increased over the past several years. Despite the decline in sales of Honey cereals, the combined sales of Honey and Cinnamon cereals have increased at the levels expected by management. Sales of Brand B also have increased at expected levels. There are discrete cash flows for Honey, Cinnamon, and Brand B, and each represents a separate ASC Section 360-10-35 asset group. Both Honey and Cinnamon cereals are managed by one brand manager. A separate brand manager is responsible for Brand B; however, there are some shared resources used by these groups, such as procurement. While Company Z has no current plans to sell its brands or exit the cereal business, it believes if it ever did, it would exit the cereal business in its entirety.

Pursuant to the consensus in ASC Sections 350-30-35 and 55, Company Z would have two units of accounting for purposes of testing the acquired brands for impairment. Brand A’s purchased Honey and internally generated Cinnamon trademarks should be combined as a single unit of accounting for purposes of impairment testing. The intangible asset associated with the Cinnamon trademark is simply a variation of the previously acquired Brand A Honey trademark. Although they are associated with different ASC Section 360-10-35 asset groups, they are managed by a single brand manager. Company Z would consider Brand B to be a separate unit of accounting for purposes of testing impairment because that brand is managed separately from Brand A and is used exclusively by a separate ASC Section 360-10-35 asset group.
Scenario 4 – Change in use of trade name

In a business combination several years ago, Company A acquired the rights to a trade name that was used in two distinct lines of business. In the appraisal for the business combination, the trade name was valued based on the cash flows of each distinct business. In the accounting records, a single intangible asset was recorded, which represented the sum of the two amounts. Since the acquisition, Company A has used the trade name in both lines of business. It is now contemplating changing the branding of one of the lines of business to a different brand it owns.

We believe the appropriate measure for determining the carrying amount of the asset to be discontinued is the historical cost of that component. Because the intangible asset comprised two separate assets that were aggregated and the historical records exist to determine their separate carrying amounts, that information should be used. Company A should consider if this shift in branding would cause an impairment or potentially cause the asset to be categorized as a defensive intangible asset after the use of the brand name is discontinued for one of the lines of business.

GOODWILL

Nature of Goodwill

22.063 Goodwill is an asset representing future economic benefits arising from other operations acquired in a business combination that are not individually identified and separately recognized. (ASC Section 805-10-20) Goodwill arises only in an acquisition of a business. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

Under the acquisition method of accounting, goodwill is recognized and measured as a residual, that being the excess of the aggregate of (1) the consideration transferred at its acquisition-date fair value, (2) the fair value of any noncontrolling interest in the acquirer, and (3) the acquirer’s previously held equity interest in the acquiree at its acquisition-date fair value over the amounts assigned to the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed in a business combination, measured in accordance with ASC Topic 805.

Initial Recognition and Measurement of Goodwill

ASC Paragraph 805-30-30-1

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

a. The aggregate of the following:
1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value (see [ASC] paragraph 805-30-30-7)

2. The fair value of any noncontrolling interest in the acquiree

3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree.

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

22.064 The components of the initial measurement of goodwill (or gain from a bargain purchase) are addressed in other Sections, as follows:

Recognizing and Measuring the Consideration Transferred  Section 6
Recognizing and Measuring the Identifiable Assets  Section 7
Acquiring the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree
Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations  Section 9

22.064a ASC paragraph 830-10-40-11 specifies that the foreign currency guidance in ASC Topic 830 applies to assets acquired and liabilities assumed in a business combination, including goodwill. If an acquiree includes foreign entities, goodwill and other acquisition accounting adjustments must be attributed to those foreign entities and measured in their functional currencies, even if the adjustments are not pushed down to the foreign entities’ books. The ASC glossary defines a foreign entity as “an operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both: (a) prepared in a currency other than the reporting currency of the reporting entity [and] (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.”

22.064b There is no specific guidance on how to allocate goodwill to an acquiree's entities. We believe goodwill should be attributed to all the acquiree’s entities (both foreign and domestic) that contain one or more businesses. Conversely, we believe goodwill should not be attributed to an entity that does not contain a business (e.g., a holding company with no operations). See discussion of the definition of a business in Section 2. In the absence of specific guidance, when allocating goodwill to the acquiree's entities that contain businesses, we believe it would be appropriate to analogize to the guidance on allocating goodwill to reporting units in ASC paragraphs 350-20-35-41 through 35-42. See discussion beginning at Paragraph 22.110.

22.064c As a result, goodwill of an acquiree could be denominated in multiple currencies. For example, in an acquisition of a multinational organization with entities in Germany, the United Kingdom, Japan, the United States, Mexico, and South Africa (all of which contain businesses and all of whose functional currencies are the local currency),
Goodwill is assigned to each and denominated in euros, pounds sterling, yen, US dollars, pesos, and rand, respectively.

22.046d If the local currency is the foreign entity's functional currency, goodwill assigned to that entity is translated at current exchange rates in the acquirer’s consolidated financial statements. As a consequence, this translation will affect the cumulative translation adjustment in the acquirer’s financial statements. If the local currency is not the foreign entity's functional currency, goodwill assigned to that entity must first be remeasured into the functional currency at historical exchange rates before it is translated to the reporting currency.

22.064e Only after goodwill has been assigned to an acquiree's entities to determine its functional currencies is it assigned to the acquirer's reporting units for impairment testing (see discussion beginning at Paragraph 22.071).

22.065 The remainder of this Section discusses the accounting for goodwill subsequent to an acquisition.

For Public Business Entities and Entities not Electing PCC Alternative Goodwill Is Not Amortized, but Is Tested for Impairment at the Reporting Unit Level (see Section 26, Private Company and Not-For-Profit Accounting Alternatives)

**ASC Paragraph 350-20-35-1 (Pre-ASU 2017-04)**

Goodwill shall not be amortized. Instead, goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit. ([ASC] paragraphs 350-20-35-33 through 46 provide guidance on determining reporting units.)

**ASC Paragraph 350-20-35-2 (Pre-ASU 2017-04)**

Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The fair value of goodwill can be measured only as a residual and cannot be measured directly. Therefore, this Subtopic includes a methodology to determine an amount that achieves a reasonable estimate of the value of goodwill for purposes of measuring an impairment loss. That estimate is referred to as the implied fair value of goodwill.

**ASC Paragraph 350-20-35-3 (Pre-ASU 2017-04)**

An entity may first assess qualitative factors, as described in [ASC] paragraphs 350-20-35-3A through 35-3G, to determine whether it is necessary to perform the two-step goodwill impairment test discussed in [ASC] paragraphs 350-20-35-4 through 35-19. If determined to be necessary, the two-step impairment test shall be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).

**ASC Paragraph 350-20-35-3A (Pre-ASU 2017-04)**

An entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, including goodwill.
ASC Paragraph 350-20-35-3B (Pre-ASU 2017-04)

An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

ASC Paragraph 350-20-35-3C (Pre-ASU 2017-04)

In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity shall assess relevant events and circumstances. Examples of such events and circumstances include the following:

a. Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

b. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity’s products or services, or a regulatory or political development

c. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

d. Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

e. Other relevant entity-specific events such as changes in management key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

f. Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

22.066 Goodwill is not amortized; rather, it is tested at least annually for impairment at a level referred to as a reporting unit. Goodwill is considered impaired and a loss may be recognized when the carrying amount of a reporting unit with goodwill exceeds its fair value. See the discussion of Reporting Unit in this Section.

22.066a In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment, which replaces the two-step impairment test for goodwill with a
Frequency of Impairment Testing

**ASC Paragraph 350-20-35-28**

Goodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances (see [ASC] paragraph 350-20-35-30). The annual goodwill impairment test may be performed at any time during the fiscal year provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.

**ASC Paragraph 350-20-35-30 (Pre-ASU 2017-04)**

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Additionally, if the carrying amount of a reporting unit is zero or negative, goodwill of that reporting unit shall be tested for impairment on an annual or interim basis if an event occurs or circumstances exist that indicate that it is more likely than not that a goodwill impairment exists. [ASC] paragraph 350-20-35-3C(a) through (g) includes examples of such events and circumstances, and [ASC] paragraph 350-20-35-8A includes additional factors to consider when the carrying amount of a reporting unit is zero or negative. [ASC] Paragraphs 350-20-35-3F through 35-3G describe the process for making these evaluations.

**22.067** Under ASC Section 350-20-35, goodwill is required to be tested for impairment annually at the reporting unit level in lieu of being amortized. Furthermore, goodwill is required to be tested between annual impairment tests if an event or circumstance indicates that it is more likely than not that an impairment loss has been incurred. The factors included in ASC paragraph 350-20-35-3C as well as other relevant information should be used to determine whether an interim test of goodwill for impairment is needed. See the discussion of Reporting Unit in this Section.

**Example 22.7a: Evaluating Events or Circumstances in between Annual Impairment Tests**

ABC Company (ABC) is publicly traded and has a December 31 year-end. In accordance with ASC Topic 350, ABC identified a single reporting unit and elected to perform its annual goodwill impairment test as of the first day of its fourth quarter (i.e., as of October 1).

At October 1, 20X0, ABC Company’s stock price and related market capitalization had declined significantly and the goodwill impairment test resulted in a full impairment of ABC’s goodwill balance.
In the first quarter of 20X1, ABC executed a business combination, which resulted in additional goodwill that ABC allocated to its existing single reporting unit. While ABC’s stock price stabilized from the significant decline experienced in the prior year fourth quarter, it did not rebound and remained at historic lows as of the end of the first quarter of 20X1.

ABC considers whether a goodwill impairment test is necessary in conjunction with its first quarter reporting due to the continued decline in its stock price and market capitalization. ABC notes the business combination was an orderly transaction between market participants (i.e., the transaction was at fair value) and does not believe the goodwill that resulted from the business combination is impaired as of March 31, 20X1. This is due to how recent the transaction was and the absence of significant changes in business or economic conditions since the acquisition.

However, in considering the factors in ASC paragraph 350-20-35-3C, ABC determines that a sustained decrease in share price may indicate that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Consequently, ABC determines that a goodwill impairment test is necessary as of March 31, 20X1, even though its stock price did not decline from its most recent annual test and the business combination was executed only a short time ago.

22.068 The SEC staff discussed how it evaluates management judgments and disclosures related to the interim assessment of goodwill impairment at the 2008 AICPA National Conference on Current SEC and PCAOB Developments. In performing its reviews, the SEC staff may consider publicly available information from both company filings and external sources to assess the likelihood that an interim triggering event has occurred. In addition to the examples of indicators cited in ASC paragraph 350-20-35-3C, the SEC staff believes management should consider the following triggers for an interim impairment test during a recession or periods of extreme volatility:

- **Other impairment charges.** The recognition of impairment charges or a valuation allowance generally indicates that an interim goodwill impairment test should be performed. The SEC staff advised that, at a minimum, the goodwill allocated to a reporting unit should be tested if the reporting unit is holding other assets that were impaired.

- **Cash or operating losses generated at the reporting unit level.** Recent market events and their effects on performance for the company as a whole and for each of the reporting units should be considered. These events or conditions may negatively affect a company’s reporting units in different ways. Management should consider the cause and duration of any losses in determining whether goodwill may have been impaired.

- **Long-term negative outlook, indicators, or events for related industries.** The performance of related industries, as a whole, may affect a company or its reporting units or the assumptions management uses to assess the value of
goodwill. To the extent companies within the same industry evaluate impairment indicators differently, the SEC staff may seek additional insight into how management performed its evaluation and what the key differences are.

- **Performance against expected operating results or forecasts.** The inability to meet quarterly expectations, including analyst estimates or internal forecasts for consecutive periods, or revisions to forecasts for future periods may indicate the need to consider whether the estimated future cash flows used for impairment tests are still reasonable. To the extent future cash flows change significantly, an interim impairment test may be necessary.

- **Significant restructurings.** Restructurings such as store closures, asset dispositions, and layoffs may influence assumptions used in determining the recoverability of goodwill. To the extent restructurings change how management views the company, there may be cause for reallocating goodwill among the reporting units. Such reorganizations may need to reevaluate the impairment indicators in ASC paragraph 350-20-35-3C.

22.069 At the 2008 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stated that it also believes it is important to understand how management evaluates situations where market capitalization is below the company’s or the reporting unit’s carrying amount. In addition to the conditions discussed above, companies should consider how their stock price has been affected by general market conditions and volatility. The SEC staff indicated that a comparison of the company’s decline in market capitalization to relevant indices also may be meaningful. The staff acknowledged that short sellers and unrelated market conditions may cause some volatility, but cautioned companies to distinguish the effects of short-term price spikes from routine trading activity. The degree of the SEC staff’s skepticism about any management decision not to evaluate goodwill for impairment at an interim date will depend on the duration and severity of the indicators discussed.

22.070 When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained should also be tested for impairment (see discussion below under Dispositions of All or a Portion of a Reporting Unit.

**Reporting Unit**

**ASC Paragraph 350-20-35-34**

A component of an operating segment is a reporting unit if the component constitutes a business or a nonprofit activity for which discrete financial information is available and segment management, as that term is defined in [ASC] paragraph 280-10-50-7, regularly reviews the operating results of that component. [ASC] Subtopic 805-10 includes guidance on determining whether an asset group constitutes a business. Throughout the remainder of this Section, the term business also includes a nonprofit activity.
ASC Paragraph 350-20-35-35

However, two or more components of an operating segment shall be aggregated and deemed a single reporting unit if the components have similar economic characteristics. [ASC] paragraph 280-10-50-11 shall be considered in determining if the components of an operating segment have similar economic characteristics.

ASC Paragraph 280-10-50-11

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the objective and basic principles of [ASC] Subtopic [280-10], if the segments have similar economic characteristics, and if the segments are similar in all of the following areas (see paragraphs 280-10-55-7A through 55-7C and Example 2, Cases A and B [paragraphs 280-10-55-33 through 55-36]):

a. The nature of the products and services
b. The nature of the production processes
c. The type or class of customer for their products and services
d. The methods used to distribute their products or provide their services
e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

ASC Paragraph 350-20-35-36

An operating segment shall be deemed to be a reporting unit if all of its components are similar, if none of its components is a reporting unit, or if it comprises only a single component.

ASC Paragraph 350-20-35-38

An entity that is not required to report segment information in accordance with [ASC] Topic 280 is nonetheless required to test goodwill for impairment at the reporting unit level. That entity shall use the guidance in [ASC] paragraphs 280-10-50-1 through 9 to determine its operating segments for purposes of determining its reporting units.

22.071 Goodwill is subject to impairment testing at the reporting unit level. A reporting unit is the same as, or one level below, an operating segment as defined in ASC paragraph 280-10-50-1. That definition is:

An operating segment is a component of a public entity that has the following characteristics:

(a) It engages in business activities from which it may recognize revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same public entity);
(b) Its operating results are regularly reviewed by the public entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and

(c) Its discrete financial information is available.

22.072 A component may be one level below an operating segment. Identifying an operating segment or a component of an operating segment as a reporting unit is not elective. An operating segment is a reporting unit if all of its components are similar, if none of its components is a reporting unit, or if it comprises only a single component. A component of an operating segment is required to be identified as a reporting unit if the component meets all of the following criteria:

1. It is a business for which discrete financial information is available;
2. Segment management regularly reviews the operating results; and
3. It has economic characteristics that are different from the economic characteristics of the other components of the operating segment.

22.073 The first two criteria are used for identification and the third criterion is used for aggregation. If two or more components of an operating segment have similar economic characteristics, they are aggregated and treated as a separate reporting unit.

22.074 The intention in using the term operating segment in defining a reporting unit is to require that entities start at the level at which management organizes its operations for making operating decisions and assessing performance. Therefore, as used above, we believe that the term operating segment refers to the units identified before any aggregation of operating segments when determining an entity's reportable segments in accordance with ASC Topic 280.

22.075 An entity that is not required to report segment information in accordance with ASC Topic 280 (e.g., a nonpublic entity) is nonetheless required to test goodwill for impairment at the reporting unit level and, therefore, should use the guidance in ASC Topic 280 to determine its operating segments for purposes of determining its reporting units.

Business

22.076 ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business from the previous framework used in ASC Topic 805. The framework in ASC Topic 805 prior to ASU 2017-01 focuses on whether a set of assets and activities is capable of being conducted and managed as a business by a market participant. The revised ASU 2017-01 framework focuses on whether the set has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, ASU 2017-01 is effective for annual periods in fiscal years beginning after December 15, 2018 and interim periods in fiscal years beginning after December 15,
2019. This ASU may be early adopted. See the discussion of Business in Section 2, *Identifying a Business Combination*.

22.077 A component of an operating segment would need to meet the definition of a business to be identified as a reporting unit (note that the requirement that a component be a business to be identified as a reporting unit does not apply at the operating segment level). The determination of whether a component constitutes a business requires judgment based on specific facts and circumstances as well as the framework applied by the entity (depending on whether it has adopted ASU 2017-01).

22.078 Operating information may exist for a component, but that does not necessarily mean the component is a business. A component that is part of a business (e.g., a product line or brand), but is not itself a business would not be a reporting unit.

22.079 If an equity method investment is an operating segment (see paragraph 280-10-55-2), then the equity method investment is a reporting unit, because the requirement that a component must be a business to be identified as a reporting unit does not apply at the operating segment level. However, if an equity method investment is a component of an operating segment, it may not be identified as a reporting unit when an equity method investment is not a business.

**Discrete Financial Information**

22.080 The term *discrete financial information* should be interpreted for a component in the same manner as under ASC Topic 280 for an operating segment. ASC paragraph 280-10-55-6 notes that a division that earns revenues and incurs expenses, but does not have any assets associated with it, could be considered an operating segment. Therefore, discrete financial information does not have to include balance sheet information and could include as little financial information as revenues and expenses. However, to test impairment in such circumstances, an entity would be required to assign assets and liabilities to reporting units, consistent with ASC paragraphs 350-20-35-39 through 35-40. The need to perform extensive assignment of assets and liabilities to derive a component-level balance sheet at a level below an operating segment may question whether the component meets the definition of a business or may indicate that it is economically dissimilar to other components. ASC Section 350-20-55

**Segment Management**

22.081 Under ASC Topic 280, segment management is either the same as or one level below the chief operating decision maker (CODM). A segment manager is accountable to and is in regular contact with the CODM with respect to operations, operating results, and plans for the segment and regularly reviews operating results. ASC Section 350-20-35 follows this same approach but with the focus on the management of the segments rather than the entire entity. A CODM or a segment manager might be an individual corporate officer or a group, such as an executive committee. The following example illustrates considerations about segment management when the entity has only one operating segment:
Example 22.8: One Operating Segment-- Management

An entity concludes that it has only one operating segment under ASC Topic 280 based on reporting lines, compensation arrangements, and the financial information that the entity’s CODM regularly reviews when allocating resources and evaluating performance. There are components of the segment that were acquired in business combinations for which goodwill is reflected on the balance sheet. Those components meet the definition of businesses under ASC Topic 805.

Scenario 1. The CODM is an individual and that individual also is the segment manager.

If the individual does not review information about components of the operating segment, ASC paragraphs 350-20-35-33 through 36 would preclude the entity from identifying those components as reporting units. If the individual reviews information about components of the operating segment, it would not be possible to determine the capacity in which the individual was acting when reviewing information about components of the segment from an ASC Topic 350 perspective. We believe that if the individual reviews information about components of an operating segment (in particular reviews the financial information to assess performance and allocated resources), ASC Topic 280 requires that those components be identified as the operating segments instead. The entity would evaluate its reporting units starting at that level.

Scenario 2. The CODM is an individual. Another individual is the segment manager. The two individuals work together to review the segment’s financial performance.

ASC Topic 280 provides for separating these functions, depending on the degree to which the individuals work together. Depending on the facts and circumstances, we believe it would be possible, although rare, for the individuals to perform their roles separately to a sufficient degree that the entity would separately evaluate the information about operating results that each individual regularly reviews. If the CODM regularly reviews information only on an aggregated basis but the segment manager reviews disaggregated information for the components, we believe the information about components of the segment that the segment manager regularly reviews would be evaluated to determine if the components meet the definition of reporting units in ASC paragraphs 350-20-35-33 through 35-38. However, we believe those circumstances would be rare. If the individuals’ roles are so intertwined as to be almost indistinguishable, they collectively should be treated as the CODM. If that were the case, the analysis would be the same as Scenario 1.

Economic Characteristics

22.082 In evaluating economic characteristics of a component of an operating segment, ASC paragraph 350-20-35-35 refers to ASC paragraph 280-10-50-11. ASC paragraph 280-10-50-11 indicates that operating segments with similar operating characteristics often exhibit similar long-term financial performance (e.g., similar long-term average gross margins for two operating segments would be expected if their economic
characteristics were similar). The criteria for aggregation in ASC paragraph 280-10-50-11 are:

- The nature of the products and services;
- The nature of the production process;
- The type or class of customer for the products or services;
- The methods used to distribute products and provide services; and
- If applicable, the nature of the regulatory environment (e.g., banking, insurance, or public utilities).

22.083 ASC paragraphs 350-20-55-1 through 55-9 note that the assessment of economic similarity is a matter of judgment that should be based on both qualitative and quantitative factors. While all the factors above are to be considered in the analysis of economic similarity, the FASB did not intend that every factor be met before economic similarity can exist when applying ASC Topic 350, nor is the determination limited to the factors described in the preceding paragraph.

22.084 ASC paragraph 350-20-55-7 provides the following additional factors, which are not intended to be all-inclusive, to consider when evaluating economic similarity:

- The manner in which an entity operates its business and the nature of those operations;
- Whether goodwill is recoverable from the separate operations of each component business or from two or more component businesses working in concert (which might be true if the components are economically interdependent);
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms; and
- Whether the components support and benefit from common research and development projects.

22.085 The sharing of assets and other resources with other components of an operating segment may indicate that the component either is not a business or may be economically similar to those other components. Likewise, transfers of assets and liabilities between components on a regular basis may demonstrate economic similarity.

**Economic Similarity between Components of Different Operating Segments**

22.086 Components that are economically similar but part of different operating segments may not be combined into a separate reporting unit. Additionally, operating segments may not be aggregated to form reporting units.
Example 22.9: Aggregation of Components of Different Operating Segments

A chemical manufacturer has three operating segments based on geographical location – Americas, Europe, and Asia. The Americas and Asia operating segments each have a specialties chemical component in addition to other economically dissimilar components. The specialties chemical components from the Americas and Asia operating segments may not be combined into a separate reporting unit (i.e., economically similar components of different operating segments may not be combined into a reporting unit).

Example 22.10: Aggregation of Operating Segments

A specialty chemical manufacturer with operations only in the United States has three operating segments based on geographical location – Northeastern, Western, and Central States. Each of the operating segments is economically similar. The operating segments may not be combined into a single reporting unit. An entity may aggregate components of an operating segment into a reporting unit if they are economically similar. However, an entity may not aggregate operating segments when determining its reporting units, even if they are economically similar. In this situation, since the Northeastern, Western, and Central States are all operating segments (not components of an operating segment), they cannot be combined. A reporting unit is determined at the operating segment level or one level below and in this situation, each geographic location constitutes an operating segment.

Identifying the Reporting Unit

22.087 Entities may have identified reporting units below the operating segment level due to differences in economic characteristics, while concurrently aggregating operating segments for purposes of identifying reportable segments under the criteria of ASC paragraph 280-10-50-11. ASC paragraphs 350-20-55-1 through 55-9 note that this could be possible particularly when the entity’s operating segments are based on geographic areas. ASC Topic 280 starts with operating segments and considers aggregating economically similar operating segments into reportable segments. Though ASC Section 350-20-35 also starts with operating segments, it considers disaggregating economically dissimilar components in each operating segment into reporting units. The level of review also is different for an operating segment versus a reporting unit; that is, the CODM reviews operations for an operating segment, and segment management reviews operations of reporting units (components of an operating segment).
Example 22.11: Identifying the Reporting Unit--Case 1

ABC Corp., a clothing retailer operating in the United States, has identified three operating segments under ASC Topic 280:

(1) Brand A
(2) Brand B
(3) Brand C

ABC has aggregated these three operating segments into one reportable segment, because they meet the aggregation criteria in ASC paragraph 280-10-50-11. To identify its reporting units under ASC Section 350-20-35, management begins with the operating segments and evaluates whether it is required to identify reporting units one level below the operating segment level. Assume in this example that ABC’s components consist of the following operating segments:

1. **Brand A - Men’s Clothing, Women’s Clothing, and Cosmetics.** The three divisions each meet the definition of a business under ASC Topic 805, and discrete financial information is regularly reviewed by the segment manager for each. The Men’s and Women’s divisions share production facilities, use similar production processes, and share employees. The distribution channels for the two divisions are the same because the two lines of clothing are carried in the same stores. The Cosmetics division operates from separate facilities, because the products are very different from the other two divisions, with very different gross margins. There is some similarity in distribution channels between the Cosmetics division and the Men’s and Women’s divisions, but the Cosmetics products also are distributed to stores that do not carry clothing. Based on these factors, management concluded that the Men’s and Women’s divisions are economically similar and should be aggregated into one reporting unit, while the Cosmetics division will be a separate reporting unit.

2. **Brand B - Women’s Sportswear and Women’s Dresses.** Discrete financial information is available for each division, is regularly reviewed by segment management, and both divisions meet the definition of a business under ASC Topic 805. The operations of the two divisions are highly integrated and have similar economic characteristics. Therefore, the two divisions are aggregated into a single reporting unit – Brand B.

3. **Brand C - United States and Europe.** Each of the components meets the definition of a business under ASC Topic 805 and discrete financial information is available for each. The two geographic locations are economically dissimilar. Therefore the reporting units are the United States and Europe.

The reporting units for ABC are illustrated below:
Example 22.12: Identifying the Reporting Unit--Case 2

ABC Corp., a clothing retailer operating in the United States, has identified three operating segments under ASC Topic 280:

(1) East
(2) Midwest
(3) West

ABC has aggregated these three operating segments into one reportable segment, because they meet the aggregation criteria in ASC paragraph 280-10-50-11. To identify its reporting units under ASC Section 350-20-35, management begins with the operating segments and evaluates whether it is required to identify reporting units one level below the operating segment level. Assume in this example that ABC’s components consist of regions within the three operating segments, such as Northeast, Mid-Atlantic, Southeast, Southcentral, Northcentral, Southwest, and Northwest. Discrete financial information is available for each of these regions, each region meets the definition of a business\(^1\) under ASC Topic 805, and segment management regularly reviews the regional operating results. In addition, assume that the regions have similar economic characteristics such as long-term average gross margins.

Although the components (i.e., the regions) are businesses for which discrete financial information is available and regularly reviewed by segment management, they are not...
reporting units because they have similar economic characteristics. Thus, ABC would identify its ASC Topic 280 operating segments as its ASC Section 350-20-35 reporting units (i.e., three reporting units).

1 Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.

Subsidiary Reporting Units

22.088 An entity may be organized with subsidiaries that are legal reporting entities (this may have been done for tax purposes), but the business is not managed using the legal entity structure. In these instances, determination of the reporting units is based on how the business is managed rather than the legal entity structure.

Nonpublic Entities

22.089 Nonpublic entities, while not required to report ASC Topic 280 segment information, nonetheless must test goodwill for impairment at the reporting unit level under ASC Section 350-20-35 unless they elect the private company and not-for-profit alternative (see Section 26). ASC paragraph 350-20-35-38

Assigning Acquired Assets and Liabilities to Reporting Units

ASC Paragraph 350-20-35-39

For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

a. The asset will be employed in or the liability relates to the operations of a reporting unit.

b. The asset or liability will be considered in determining the fair value of the reporting unit.

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the above criteria are met. Examples of corporate items that may meet those criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets.

22.090 The reporting units to which acquired assets and assumed liabilities are assigned may include the acquirer’s preexisting reporting units, assuming they are unchanged by the acquisition, and new reporting units created as a result of the acquisition.

22.091 The objective of the assignment process is to ensure that the assets and liabilities assigned to a reporting unit are the same net assets considered in determining the fair value of that unit—an apples-to-apples comparison. The FASB concluded that the
assignment of assets and liabilities to reporting units in this manner is necessary to make the goodwill impairment test that incorporates the values of those net assets operational. The methodology used to assign assets and liabilities should be reasonable, supportable, and applied in a consistent manner. ASC paragraph 350-20-35-40

Assigning Corporate Assets and Liabilities to Reporting Units

22.092 Assets and liabilities that an entity considers part of its corporate assets and liabilities and that meet both criteria in ASC paragraph 350-20-35-39 also are assigned to a reporting unit. This applies to assets acquired and liabilities assumed in a business combination, as well as assets acquired and liabilities assumed in an asset acquisition. However, an asset or liability that does not meet both criteria, such as an environmental liability related to a disposed business, is not assigned to a reporting unit. An item such as corporate debt may or may not be assigned depending on these criteria. Consideration should be given to whether any of the reporting unit’s assets collateralize the debt; the existence of intercompany debt agreements; if carve-out financial statements were prepared for the reporting unit, whether the debt would be included; and whether any corporate interest expense is assigned to the reporting unit.

Assigning Assets and Liabilities That Relate to Multiple Reporting Units

ASC Paragraph 350-20-35-40

Some assets or liabilities may be employed in or relate to the operations of multiple reporting units. The methodology used to determine the amount of those assets or liabilities to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. For example, assets and liabilities not directly related to a specific reporting unit, but from which the reporting unit benefits, could be assigned according to the benefit received by the different reporting units (or based on the relative fair values of the different reporting units). In the case of pension items, for example, a pro rata assignment based on payroll expense might be used. A reasonable allocation method may be very general. For use in making those assignments, the basis for and method of determining the fair value of the acquiree and other related factors (such as the underlying reasons for the acquisition and management’s expectations related to dilution, synergies, and other financial measurements) shall be documented at the acquisition date.

22.093 Other items that may require assignment to reporting units if the criteria in ASC paragraph 350-20-35-39 are met include corporate aircraft, and functional departments such as internal audit, risk management, marketing, treasury, in-house travel, and human resources. In making those assignments, the basis and method of determining the fair value of the acquiree and other related factors should be documented at the date of acquisition.
Unassigned Assets and Liabilities

22.094 In general, corporate headquarters, certain functional departments, or unassigned corporate assets and liabilities cannot be identified as separate reporting units to which goodwill is assigned under ASC Section 350-20-35. ASC paragraph 280-10-50-4 states: “For example, a corporate headquarters or certain functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the enterprise and would not be operating segments.” Additionally, because goodwill can only arise from a business combination, along with the requirement in ASC Section 350-20-35 that for a component of an operating segment to be identified as a reporting unit it needs to be a business as defined under ASC Topic 805, it is unlikely that a corporate headquarters, certain functional departments, or unassigned assets and liabilities would constitute reporting units. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

Assigning Assets and Liabilities to Reporting Units – Other Issues

22.095 While ASC paragraph 350-20-35-40 states that “it is possible for a reasonable allocation method to be very general,” an entity should not underestimate the complexity of attempting to assign assets, liabilities, and goodwill to reporting units. Areas that we believe will prove to be especially challenging include:

- How to assign corporate-level treasury or cash management functions. For example, some retailers move store-level cash receipts into a single account each day to maximize cash management.

- How to assign indebtedness incurred at the corporate level that is used to finance, or finance the acquisition of, subsidiary-level businesses.

- How to identify acquisition-related synergies a reporting unit realizes from an acquisition for purposes of assigning goodwill where none of the acquired assets and liabilities are assigned to the reporting unit. For example, a retailer buys a competitor and achieves sufficient critical mass to be able to negotiate lower prices on its purchases for all of its reporting units.

Single Reporting Unit Entities

22.096 ASC Section 350-20-35 does not provide explicit guidance on assigning assets and liabilities when an entity has only one reporting unit. The issue is that when the entity consists of only a single reporting unit, whether there are certain corporate assets and liabilities that do not relate to the operations of the reporting unit and should, therefore, be excluded from the reporting unit. The Basis for Conclusions of ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Unit, with Zero or Negative Carrying Amounts, notes that the EITF decided not to mandate “an approach for calculating the carrying amount of a reporting unit for purposes of Step 1 of the goodwill impairment test, even for entities with single reporting units.” The Task Force did note “the manner in which the fair value and carrying amount of the reporting unit is determined should be consistent.” Accordingly, in cases in which an entity uses the
enterprise-value-based premise (see Paragraph 22.162) to determine the fair value of its reporting unit, it would not necessarily assign all liabilities when determining the carrying amount of its reporting unit. Attempts to reconcile the reporting unit’s fair value to market capitalization will be complicated in those cases because the stock price most likely accounts for the entity’s complete statement of financial position. An entity should consider whether the criteria in ASC paragraph 350-20-35-39 have been met when assigning assets and liabilities to its single reporting unit and determine that the assets and liabilities have been assigned in a consistent manner both for determining the carrying amount and measuring fair value.

Assigning Contingent Consideration Classified as a Liability (or an Asset) to Reporting Units

22.097 Contingent consideration issued by an acquirer is recognized at its acquisition-date fair value and classified at the acquisition date as either equity, or as a liability or asset, based on applicable GAAP. The subsequent accounting for contingent consideration depends on whether the obligation is classified as equity or as a liability (or in some cases, as an asset). See Section 6, Recognizing and Measuring the Consideration Transferred, for additional discussion of the initial recognition, measurement, and classification of contingent consideration in a business combination, and Section 12, Subsequent Measurement and Accounting, for additional discussion of its subsequent accounting treatment.

22.098 Paragraph not used.

22.099 The conditions in ASC paragraph 350-20-35-39 for assigning identifiable assets and liabilities to reporting units should be considered to determine if a liability-classified (or asset-classified) contingent consideration arrangement should be assigned to a reporting unit for goodwill impairment testing purposes. See additional discussion in the subsection titled Assigning Acquired Assets and Liabilities to Reporting Units for the criteria for assigning assets and liabilities to reporting units.

22.100 If the obligation to pay contingent consideration is owed by an entity that is included in a reporting unit containing the acquired business that gave rise to the obligation (or asset), then the contingent consideration arrangement generally would be assigned to that reporting unit in its entirety. There could also be circumstances in which it may be appropriate to assign a contingent consideration arrangement to the reporting unit containing the acquired business that gave rise to the obligation (or asset), even though another entity within the consolidated group (e.g., the parent) that is not included in that reporting unit is the legal obligor. For example, this might be the case if there is an intra-entity agreement that requires the reporting unit containing the acquired entity to transfer funds to the legal obligor as reimbursement for any contingent consideration payments. The following examples illustrate the determination of whether to assign a contingent consideration arrangement to a reporting unit:
Example 22.13: Assigning Contingent Consideration to Reporting Units--Case 1

ABC Corp. has three subsidiaries (Sub A, Sub B, and Sub C) that each comprise a separate reporting unit (RU1, RU2, and RU3, respectively). Sub C, which also represents RU3, acquires DEF Corp. and the assets and liabilities of the acquired business are all assigned to RU3. The terms of the acquisition agreement provide for contingent consideration to be paid in cash by Sub C two years after the acquisition date if specified earnings targets are met. The amount of that consideration ranges between $0 and $15 million and is calculated according to a formula based on a measure of DEF’s EBITDA.

The obligation to pay contingent consideration is owed by Sub C, which is included in the same reporting unit (i.e., RU3) as the acquired business that gave rise to the obligation. Sub C’s obligation to pay contingent consideration is related to the operations of RU3 because those payments are calculated according to a formula based on a measure of DEF’s EBITDA. Additionally, Sub C’s obligation to pay contingent consideration reduces the net cash inflows and, therefore, the fair value of RU3. Accordingly, the contingent consideration should be assigned to RU3 for goodwill impairment testing purposes.

Example 22.14: Assigning Contingent Consideration to Reporting Units--Case 2

ABC Corp. has three subsidiaries (Sub A, Sub B, and Sub C) that each comprise a separate reporting unit (RU1, RU2, and RU3, respectively). ABC, which is the corporate parent, acquires DEF Corp. and the assets and liabilities of the acquired business are all assigned to RU3. The terms of the acquisition agreement provide for contingent consideration to be paid in cash by ABC two years after the acquisition date if specified earnings targets are met. The amount of that consideration ranges between $0 and $15 million and is calculated according to a formula based on a measure of DEF’s EBITDA. ABC intends to fund any contingent consideration payments through dividends from all three of its reporting units, which are profitable, and through general corporate borrowings.

The obligation to pay contingent consideration is owed by the corporate parent (i.e., ABC). However, the acquired business that gave rise to the obligation is assigned to RU3. Accordingly, further consideration of the relevant facts and circumstances is necessary to determine whether the contingent consideration arrangement should be assigned to that reporting unit. The parent’s obligation to pay contingent consideration is related to the operations of RU3 because those payments are calculated according to a formula based on a measure of DEF’s EBITDA. However, ABC does not intend to fund contingent consideration payments solely from the operations of RU3. Rather, it intends to fund those payments from the earnings of all of its reporting units and from general
corporate borrowings. RU3 does not have any legal or constructive obligation to fund its parent’s payments, so its fair value is not affected by the contingent consideration. Accordingly, the contingent consideration should be treated as a corporate obligation and not assigned to RU3 (or any other reporting unit) for impairment testing purposes.

Example 22.15: Assigning Contingent Consideration to Reporting Units--Case 3

ABC Corp. has three subsidiaries (Sub A, Sub B, and Sub C) that each comprise a separate reporting unit (RU1, RU2, and RU3, respectively). Sub C, which also represents RU3, acquires DEF Corp.; however, the assets and liabilities of the acquired business are all assigned to RU2. The terms of the acquisition agreement provide for contingent consideration to be paid in cash by Sub C two years after the acquisition date if specified earnings targets are met. The amount of that consideration ranges between $0 and $15 million and is calculated according to a formula based on a measure of DEF’s EBITDA. DEF enters into an intra-entity agreement with Sub C that requires DEF to remit payments to Sub C in amounts equal to any payments that Sub C is required to remit to the former owners of DEF pursuant to the contingent consideration arrangement.

The obligation to pay contingent consideration is owed by Sub C. However, the acquired business that gave rise to the obligation is included in a different reporting unit (i.e., RU2). Accordingly, further consideration of the relevant facts and circumstances is necessary to determine which reporting unit, if any, the contingent consideration arrangement should be assigned to. Sub C’s obligation to pay contingent consideration is related to the operations of RU2 because those payments are calculated according to a formula based on a measure of DEF’s EBITDA. Accordingly, the contingent consideration should not be assigned to RU3. Even though Sub C is the legal obligor, the intra-entity agreement requires DEF to fund any contingent consideration payments that Sub C is required to make. DEF’s obligation to remit payments to Sub C to fund any contingent consideration payments reduces the net cash inflows of DEF and, therefore, the fair value of RU2. Accordingly, the contingent consideration should be assigned to RU2 for impairment testing purposes.

Example 22.16: Assigning Contingent Consideration to Reporting Units--Case 4

ABC Corp. has three subsidiaries (Sub A, Sub B, and Sub C) that each comprise a separate reporting unit (RU1, RU2, and RU3, respectively). Sub C, which also represents RU3, acquires DEF Corp.; however, the assets and liabilities of the acquired business are all assigned to RU2. The terms of the acquisition agreement provide for contingent consideration to be paid in cash by Sub C two years after the acquisition date if specified earnings targets are met. The amount of that consideration ranges between $0 and $15 million and is calculated according to a formula based on a measure of DEF’s EBITDA.
Sub C expects ABC, its corporate parent, to fund any contingent consideration payments through equity contributions.

The obligation to pay contingent consideration is owed by Sub C. However, the acquired business that gave rise to the obligation is included in a different reporting unit (i.e., RU2). Accordingly, further consideration of the relevant facts and circumstances is necessary to determine which reporting unit, if any, the contingent consideration arrangement should be assigned to. Sub C’s obligation to pay contingent consideration is related to the operations of RU2 because those payments are calculated according to a formula based on a measure of DEF’s EBITDA. Accordingly, the contingent consideration should not be assigned to RU3. Additionally, any payments made by Sub C are expected to be funded by equity contributions from ABC, the corporate parent. RU2 does not have any legal or constructive obligation to fund contingent consideration payments, so its fair value is not affected by the contingent consideration and the contingent consideration should not be assigned to RU2. Accordingly, the contingent consideration should be treated as a corporate obligation and not assigned to a reporting unit for impairment testing purposes.

Example 22.17: Assigning Contingent Consideration to Reporting Units--Case 5

ABC Corp., a corporate holding company, has a number of operating subsidiaries but only one reporting unit. ABC acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid in cash by ABC two years after the acquisition date if specified earnings targets are met. The amount of that consideration ranges between $0 and $15 million and is calculated according to a formula based on a measure of DEF’s EBITDA. ABC determines that it continues to have only one reporting unit after the acquisition of DEF.

Because the entity has only one reporting unit, all of its assets and liabilities, including the contingent consideration arrangement, are assigned to that reporting unit.

Equity-Classified Contingent Consideration Arrangements

22.101 Outstanding equity instruments of an entity within a reporting unit, including equity-classified contingent consideration arrangements, do not impact the total equity value of that reporting unit. Additionally, the net carrying amount of a reporting unit is determined by subtracting its liabilities from its assets. That net carrying amount is not adjusted for the carrying amount of equity-classified contracts entered into by entities within the reporting unit. Accordingly, contingent consideration arrangements (whether recognized or unrecognized) that meet the conditions in other applicable U.S. GAAP for equity classification are not assigned to reporting units for impairment testing purposes. See additional discussion for the classification of contingent consideration in Section 6, beginning with Paragraph 6.027 under the subtopic titled Determining the Classification of Contingent Consideration.
Assigning Deferred Tax Assets and Liabilities

22.102 Acquired assets and liabilities are assigned to a reporting unit as of the acquisition date if (a) the asset will be employed in, or the liability relates to, the operations of the reporting unit, and (b) the asset or liability will be considered in determining the fair value of the reporting unit. Deferred tax assets and liabilities that relate to the assets and liabilities assigned to a reporting unit should also be assigned to that reporting unit. The method used to assign deferred taxes to the reporting units should be consistent with how the related asset or liability is assigned. For example, if a production facility is included in a reporting unit, any deferred tax asset or liability for the difference between the facility’s financial statement carrying amount and tax basis should be included in the reporting unit. ASC paragraphs 350-20-35-7, 35-20 through 35-21, 35-25 through 35-27, and 55-10 through 55-23.

22.103 Certain deferred tax assets and liabilities may relate to assets and liabilities that have been assigned to multiple reporting units, such as those related to certain corporate assets and liabilities or other assets and liabilities assigned to multiple reporting units under the criteria described in ASC paragraph 350-20-35-39. In those situations, the deferred tax assets and liabilities should be assigned to reporting units on a basis consistent with how the related assets or liabilities were assigned. For example, a deferred tax asset for vacation pay accruals that relates to all of the entity’s employees should be assigned to the reporting units in which the employees provide services, consistent with the method used to assign the vacation pay liability to reporting units.

22.104 The deferred taxes related to assets and liabilities not assigned to a reporting unit likewise should not be assigned to a reporting unit. For example, an environmental liability related to a disposed business may not be assigned to a reporting unit because it does not relate to the operations of any existing reporting unit and would not be acquired by a purchaser of any reporting unit. ASC paragraph 350-20-35-39.

Assigning Deferred Taxes When There Is No Corresponding Financial Statement Carrying Amount

22.105 Deferred tax assets and liabilities that exist because of a tax basis that has no corresponding financial statement carrying amount should be assigned to a reporting unit if the deferred tax asset or liability relates to the operations of the reporting unit and will be considered in determining the fair value of the reporting unit. For example, if the deferred tax assets for net operating loss carryforwards and AMT credit carryforwards that arise from the operations of a reporting unit are considered when determining the fair value of the reporting unit, those deferred tax assets should be assigned to the reporting unit.

22.106 In many cases, the net operating loss carryforwards are not reflected in the fair value of a reporting unit that is measured assuming that the unit would be bought or sold in a taxable transaction. If the fair value of a reporting unit is measured assuming a nontaxable transaction that reflects the benefit of a net operating loss carryforward, a
deferred tax asset attributable to that net operating loss carryforward could be included in the carrying amount of the reporting unit. See Example 22.22.

**Example 22.18: Assigning Deferred Tax Assets Related to Net Operating Loss Carryforwards to a Reporting Unit**

ABC Corp. is testing Reporting Unit X for impairment at its annual impairment test date. The carrying amount of assets and liabilities of Reporting Unit X are: identifiable assets, $500,000; identifiable liabilities, $200,000; and goodwill, $450,000. Additionally, there is a deferred tax asset associated with a net operating loss carryforward of $75,000. In applying the quantitative goodwill impairment test, ABC must consider whether Reporting Unit X will be sold in a taxable or nontaxable transaction.

**Scenario 1.** ABC concludes that a nontaxable transaction is not feasible because several reporting units are included in a single legal entity. As a result, it decides to structure a sale of the reporting unit as a taxable transaction.

In a taxable transaction, net operating loss carryforwards are unavailable to an acquirer and not reflected in the fair value of a reporting unit. Because these items would not be considered in arriving at fair value, ABC should not assign deferred tax assets related to net operating loss carryforwards to the carrying amount of the reporting unit. Thus, the carrying amount of Reporting Unit X would be $750,000 (identifiable assets of $500,000 + goodwill of $450,000 - identifiable liabilities of $200,000).

**Scenario 2.** ABC determines that it is feasible to sell the reporting unit in either a taxable or a nontaxable transaction, but that Reporting Unit X’s value to ABC is maximized through a nontaxable transaction. Thus, the fair value of Reporting Unit X includes the value of the tax benefit attributable to the net operating loss carryforward. As a result, the carrying amount of Reporting Unit X equals $825,000 ($750,000 from Scenario 1 + deferred tax asset of $75,000).

**22.107** Assigning operating loss carryforwards to reporting units is a straightforward process when the carryforward is generated solely from the operations of a particular reporting unit (e.g., when the reporting unit is a consolidated subsidiary for financial reporting purposes but files its own tax return). In most situations, however, the process of assigning deferred tax assets related to operating loss carryforwards to reporting units can be more difficult, especially when a reporting unit is a component of a group that files a consolidated tax return. The process used to assign the deferred tax assets to reporting units should be reasonable and systematic. An assignment approach similar to that used for intercorporate tax allocation is one example of a reasonable and systematic method of assigning deferred tax assets to reporting units. See Section 10 of KPMG’s Handbook *Accounting for Income Taxes* for additional discussion of acceptable methods for intercorporate tax allocation.
Assigning Deferred Tax Asset Valuation Allowance

22.108 A deferred tax asset valuation allowance that is recognized for a specific deferred tax asset should be assigned to the reporting unit to which the specific deferred tax asset is assigned. However, valuation allowances are frequently not asset specific. For example, an entity that recognizes a valuation allowance for the excess of deferred tax assets over deferred tax liabilities because the only source of future taxable income is the reversal of existing deferred tax liabilities, is not able to associate the valuation allowance with specific deferred tax assets. In these circumstances, the valuation allowance should be allocated to deferred tax assets before assigning the deferred tax assets to the reporting units. Various methods may be appropriate in making that allocation, depending on facts and circumstances.

Assigning Liabilities for Uncertain Tax Positions

22.109 Liabilities recognized for uncertain tax positions associated with a reporting unit also should be assigned to that reporting unit when determining its carrying amount. This assignment should be performed in a manner consistent with the entity’s assignment methodology for other current and deferred tax items.

Assigning Goodwill to Reporting Units

ASC Paragraph 350-20-35-41

For the purpose of testing goodwill for impairment, all goodwill acquired in a business combination shall be assigned to one or more reporting units as of the acquisition date. Goodwill shall be assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. The total amount of acquired goodwill may be divided among a number of reporting units. The methodology used to determine the amount of goodwill to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. In addition, that methodology shall be consistent with the objectives of the process of assigning goodwill to reporting units described in [ASC] paragraphs 350-20-35-42 through 43.

ASC Paragraph 350-20-35-42

In concept, the amount of goodwill assigned to a reporting unit would be determined in a manner similar to how the amount of goodwill recognized in a business combination is determined. That is:

a. An entity would determine the fair value of the acquired business (or portion thereof) to be included in a reporting unit—the fair value of the individual assets acquired and liabilities assumed that are assigned to the reporting unit. [ASC] Subtopic 805-20 provides guidance on assigning the fair value of the acquiree to the assets acquired and liabilities assumed in a business combination.
b. Any excess of the fair value of the acquired business (or portion thereof) over the fair value of the individual assets acquired and liabilities assumed that are assigned to the reporting unit is the amount of goodwill assigned to that reporting unit.

**ASC Paragraph 350-20-35-43**

If goodwill is to be assigned to a reporting unit that has not been assigned any of the assets acquired or liabilities assumed in that acquisition, the amount of goodwill to be assigned to that unit might be determined by applying a with-and-without computation. That is, the difference between the fair value of that reporting unit before the acquisition and its fair value after the acquisition represents the amount of goodwill to be assigned to that reporting unit.

22.110 **ASC Section 350-20-35** excludes the concept of corporate or entity-wide goodwill. All goodwill is assigned to one or more reporting units. Additionally, goodwill is assigned to all reporting units that the acquirer expects to benefit from expected synergies of the business combination, even if the acquired assets and liabilities are not assigned to that reporting unit (e.g., goodwill must be assigned to the acquirer’s preexisting reporting units if those units benefit from the acquisition, regardless of whether any of the assets or liabilities of the acquiree are assigned to those reporting units). Similar to the assignment of other assets and liabilities, the methodology for assigning goodwill should be reasonable, supportable, and consistently applied.

22.111 The amount of goodwill assigned to the reporting unit follows the approach used in the acquisition method of accounting to determine the amount of goodwill recognized in a business combination. An acquirer determines the fair value of the acquired business (or portion thereof) to be included in a reporting unit, and also determines the amounts to be recognized for the individual assets acquired and liabilities assumed that are assigned to the reporting unit under ASC Topic 805. Any excess of the fair value of the acquired business (or portion thereof) over the amounts recognized for the individual assets acquired and liabilities assumed that are assigned to the reporting unit is the amount of goodwill assigned to that reporting unit. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

22.112 If goodwill is assigned to a reporting unit that has not been assigned any of the assets acquired and liabilities assumed in an acquisition, the amount of goodwill assigned to that reporting unit might be determined as the difference between the fair value of that reporting unit before the acquisition and its fair value after the acquisition (i.e., a with and without computation).

22.113 **Tax Basis Goodwill.** The tax basis of goodwill should be assigned to reporting units. The method used to assign the tax basis of goodwill among multiple reporting units should be consistent with the method used to allocate the financial statement carrying amount goodwill. For example, if $60 of the financial statement carrying amount of goodwill from an acquisition is assigned to Reporting Unit A and $20 of the goodwill from the same acquisition is assigned to Reporting Unit B, then 75% of the tax basis of
the goodwill should be assigned to Reporting Unit A and 25% to Reporting Unit B. If reporting units are in multiple jurisdictions, or if within a reporting unit there are separate legal entities filing separate tax returns within one jurisdiction, the tax basis of goodwill should be determined separately for each tax-paying component in each tax jurisdiction.

Reorganizations Affecting the Composition of Reporting Units

ASC Paragraph 350-20-35-45

When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in [ASC] paragraphs 350-20-35-39 through 35-40 shall be used to reassign assets and liabilities to the reporting units affected. However, goodwill shall be reassigned to the reporting units affected using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of (see [ASC] paragraphs 350-20-40-1 through 40-7).

ASC Paragraph 350-20-35-46

For example, if existing reporting unit A is to be integrated with reporting units B, C, and D, goodwill in reporting unit A would be assigned to units B, C, and D based on the relative fair values of the three portions of reporting unit A prior to those portions being integrated with reporting units B, C, and D.

22.114 If an entity reorganizes in a manner that affects the composition of a reporting unit, the entity should reassign the assets and liabilities of the reporting units as if it acquired those assets and liabilities as of the date of the reorganization. However, goodwill affected by the reorganization would be reassigned to the reporting units affected using relative fair values similar to that used when a portion of a reporting unit is disposed of (see Paragraph 22.186). Changes to operating segments under ASC Topic 280 trigger potential changes in the identification of reporting units and the measurement of goodwill impairment.

IMPAIRMENT TESTING

Pre-Goodwill Impairment Analysis of the Carrying Amount of Other Assets

22.115 All assets (not just long-lived assets under ASC Section 360-10-35) that require testing for impairment would be tested and, where necessary, the carrying amount adjusted for impairment, before the quantitative goodwill impairment test is performed (i.e., the adjusted carrying amount of the asset would be used as the new basis when determining the carrying amount of the reporting unit in the goodwill impairment test). The effect of this pre-goodwill impairment analysis is that the carrying amount of the reporting unit is less likely to exceed its fair value. Only when the reporting unit’s fair value is less than its carrying amount after completing all other impairment tests, must an impairment of goodwill be recorded.

22.116 ASC Section 360-10-35 requires that the carrying amount of a long-lived asset with a finite life that is held-for-use be evaluated for recoverability whenever events or
changes in circumstances indicate that the entity may be unable to recover the asset’s carrying amount. Under ASC Section 360-10-35 it is possible for a long-lived asset’s fair value to be less than its carrying amount, but for the carrying amount to be fully recoverable on an undiscounted cash flow basis. In that situation, no impairment loss would be recognized on the identifiable long-lived assets. Assuming the fair value of all the other assets and liabilities of the reporting unit equals their carrying amounts, the carrying amount of the reporting unit could exceed its fair value, in which case goodwill is impaired. If ASU 2017-04 has been adopted (see beginning at Paragraph 22.116a), the impairment loss would be measured as the difference between the carrying amount and the fair value of the reporting unit (up to the carrying amount of goodwill). If ASU 2017-04 has not yet been adopted, Step 2 of the goodwill impairment test under ASC Section 350-20-35 would be performed to measure the amount of goodwill impairment, if any.

### Example 22.19: Interaction of ASC Sections 360-10-35 and 350-20-35 When Performing an Impairment Test

ABC Corp. is testing the goodwill of a reporting unit for impairment at its annual impairment date. For purposes of applying Step 1 of the goodwill impairment test, ABC has developed the following information:

<table>
<thead>
<tr>
<th>Reporting Unit</th>
<th>Carrying Amount</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$150</td>
<td>$130</td>
</tr>
</tbody>
</table>

While performing its ASC Section 350-20-35 impairment analysis, management becomes aware that its identifiable long-lived assets may be impaired. Because ASC Section 350-20-35 requires that identifiable long-lived assets be tested for impairment before goodwill is evaluated for impairment, ABC must evaluate the identifiable long-lived assets for impairment under the provisions of ASC Section 360-10-35 before completing its goodwill impairment testing.

**Scenario 1.** The identifiable long-lived assets are not deemed to be impaired (i.e., the undiscounted cash flows are greater than their carrying amount of $45). ABC records no impairment for these assets and does not need to revise the carrying amount of these assets to be used in the Step 1 test. Because there is no revision to the carrying amount of the assets, in applying Step 1 of the goodwill impairment test, the fair value ($130) continues to be less than the carrying amount ($150) of the reporting unit. Therefore, if ABC has adopted ASU 2017-04 (see beginning at Paragraph 22.116a), it would recognize goodwill impairment of $20. Otherwise, ABC completes Step 2 of the goodwill impairment test, with the following results:
In this case, goodwill impairment is measured as the difference between its carrying amount ($75) and its implied fair value ($65), resulting in impairment of goodwill of $10.

**Scenario 2.** The identifiable long-lived assets are deemed to be impaired, resulting in an impairment loss of $25 for those assets (difference between the carrying amount of $45 and the fair value of $20). After reducing the identifiable assets’ carrying amounts to reflect the impairment loss, the carrying amount of the reporting unit is now $125 (previous carrying amount of $150 reduced by the $25 impairment loss). Now the carrying amount of the reporting unit ($125) is less than the fair value of the reporting unit ($130). Therefore, there is no impairment of goodwill to recognize.

### The Goodwill Impairment Test

**22.116a** In January 2017, the FASB issued ASU 2017-04, *Simplifying the Test for Goodwill Impairment*, which replaces the two-step impairment test for goodwill with a one-step test that both identifies and measures goodwill impairment. Under the ASU, an entity compares the fair value of the reporting unit to its carrying amount. If impairment is identified, the entity would record that difference as an impairment loss. This eliminates the previous requirement under Step 2 to perform a hypothetical purchase price allocation to measure goodwill impairment.

**22.116b** Unique impairment testing for reporting units with zero or negative carrying amounts has also been eliminated and additional disclosure about such reporting units has been added. Specifically, the amount of goodwill allocated to reporting units with negative or zero carrying amounts and the reportable segment in which the reporting unit is included should be disclosed.

**22.116c** The ASU is applied prospectively for annual and interim goodwill impairment tests in fiscal years beginning after:

- December 15, 2019 for public business entities that file with the SEC,
- December 15, 2020 for public business entities that do not file with the SEC, or
- December 15, 2021 for entities that are not public business entities.
Early adoption is permitted for goodwill impairment tests with a measurement date on or after January 1, 2017. Once an entity has adopted ASU 2017-04, it must apply the one-step approach to all goodwill impairment tests going forward.

22.116d When early adopting in fiscal years beginning January 1, 2017 or later, an entity must apply the same impairment model consistently for all impairment tests within the same fiscal year. That is, an entity may not adopt ASU 2017-04 in the middle of a fiscal year if it has already performed one or more impairment tests during that fiscal year using the two-step model. Evaluating whether an entity did so will require judgment when an impairment test was performed earlier in the fiscal year but that test ultimately did not require a Step 2 test to measure the amount of the impairment.

22.116e Regardless of the timing of an entity's adoption of ASU 2017-04, if a reporting unit failed Step 1 but passed Step 2 in the most recent annual impairment test, goodwill of that reporting unit likely will be impaired on adoption. This is because impairment then will be measured based on Step 1, and the previously failed Step 1 would be an indicator that likely would trigger an interim impairment test on adoption.

ASC Paragraph 350-20-35-3 (Pre-ASU 2017-04)
An entity may first assess qualitative factors, as described in [ASC] paragraphs 350-20-35-3A through 35-3G, to determine whether it is necessary to perform the two-step goodwill impairment test discussed in [ASC] paragraphs 350-20-35-4 through 35-19. If determined to be necessary, the two-step impairment test shall be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).

ASC Paragraph 350-20-35-3A
An entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, including goodwill.

ASC Paragraph 350-20-35-3B (Pre-ASU 2017-04)
An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

ASC Paragraph 350-20-35-4 (Pre-ASU 2017-04)
The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill.

ASC Paragraph 350-20-35-5
The guidance in [ASC] paragraphs 350-20-35-22 through 35-24 shall be considered in determining the fair value of a reporting unit.
ASC Paragraph 350-20-35-6 (Pre-ASU 2017-04)

If the carrying amount of a reporting unit is greater than zero and its fair value exceeds its carrying amount, goodwill of the reporting unit is considered not impaired; thus, the second step of the impairment test is unnecessary. If the carrying amount of the reporting unit is zero or negative, the guidance in [ASC] paragraph 350-20-35-8A shall be followed.

ASC Paragraph 350-20-35-22

The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole.

ASC Paragraph 350-20-35-23

Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity’s individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.

Impairment Test - Qualitative Assessment

22.117 ASC paragraphs 350-20-35-3 through 35-3B permit, but do not require an entity to perform a qualitative assessment with respect to any of its reporting units to determine whether the quantitative impairment test discussed below is needed. Entities are permitted to assess based on qualitative factors whether it is more likely than not that a reporting unit’s fair value is less than its carrying amount before applying the quantitative goodwill impairment test. If it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the entity conducts the quantitative goodwill impairment test. If not, the entity does not need to apply the quantitative test. The qualitative test is elective and an entity can go directly to the quantitative test rather than making a more-likely-than-not assessment based on an evaluation of qualitative factors.

22.118 Although ASC paragraph 350-20-35-3A specifies a threshold based on whether it is more than 50% likely that the fair value of a reporting unit is less than its carrying amount, we do not believe that threshold is intended to require a probability-weighted analysis of potential outcomes to support the conclusion reached in the qualitative assessment. However, a process will be needed to identify qualitative factors that could
significantly affect the fair value of a reporting unit and to evaluate the potential effect of changes in those factors on the fair value of the reporting unit to support a conclusion that the quantitative goodwill impairment test is unnecessary.

22.119 ASC paragraph 350-20-35-3F states that if the entity had a recent fair value calculation for a reporting unit, the difference between the fair value and the carrying amount in the previous fair value calculation could be a factor in a qualitative assessment to determine whether to perform the quantitative goodwill impairment test. However, the FASB acknowledged in the Basis for Conclusions (BC13 and BC32) for ASU 2011-08, Testing Goodwill for Impairment, the relevance of a previous quantitative fair value measurement will decrease as time passes and circumstances affecting the fair value measurement assumptions and carrying amount of the reporting unit change and, therefore, the previous fair value measurement would be given less weighting in the qualitative assessment.

22.120 ASC paragraph 350-20-35-3C lists factors to consider when making the qualitative assessment, which would be performed prior to the quantitative goodwill impairment test. Additionally, the previous factors were used for determining whether a goodwill impairment assessment was needed at an interim date and whether step 2 was needed for reporting units with zero or negative carrying amounts (prior to the adoption of ASU 2017-04). The factors are:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets;
- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for an entity’s products or services, or a regulatory or political development;
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows;
- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods;
- Other relevant entity-specific events such as litigation, contemplation of bankruptcy, or changes in management, key personnel, strategy, or customers;
- Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit; and
- Sustained decrease (both absolute and relative to its peers) in share price, if applicable.

22.121 The factors are not intended to be all-inclusive. An entity may identify and should consider other relevant factors when performing the qualitative assessment, including factors that could impact the fair value of a reporting unit. Further, the relevant factors to consider could change from period to period. Different reporting units of the same entity could have different factors that are relevant to their qualitative assessments.

22.122 An entity would need to identify the most significant factors for each of its reporting units, determine the relevant events and circumstances that could impact the fair value of the reporting unit, and evaluate how those events and circumstances may have affected the reporting unit’s fair value. Entities will need to consider the totality of the evidence when reaching its conclusion about the likelihood that the fair value of the reporting unit is less than its carrying amount, considering negative evidence that may indicate that the fair value of the reporting unit has declined as well as positive or mitigating evidence.

22.123 Should an entity decide to perform the qualitative assessment for one or more of its reporting units, it will be important for management to develop a process and appropriate controls for performing that assessment. The process and conclusions should be documented by the entity with appropriate key controls identified. The process may include the following steps:

1. Develop a framework to determine when an entity will perform a qualitative assessment for a reporting unit and when it will proceed directly to the quantitative goodwill impairment test;
2. For those reporting units for which a qualitative assessment will be performed, consider the most recent fair value measurement and when that measurement was determined;
3. Identify the significant drivers of fair value for the reporting unit;
4. Determine what events and circumstances have occurred that may have affected those drivers of fair value, including positive and mitigating events and circumstances that could affect the fair value of the reporting unit;
5. Assess the likely impact of the factors identified in the previous steps on the fair value of the reporting unit;
6. Consider any transactions or events that significantly affected the carrying amount of the reporting unit;
7. Prepare an analysis based on the events, circumstances, and factors identified and document the assessment as to whether it is not more likely than not that the fair value of the reporting unit is less than its carrying amount.

22.124 Not used.
22.125 Additional considerations about each of the steps in the process above are discussed below.

Step 1

Develop a framework to determine when an entity will perform a qualitative assessment for a reporting unit and when it will proceed directly to the quantitative goodwill impairment test

22.126 As the qualitative assessment is optional, an entity should consider establishing a framework for determining when it will perform a qualitative assessment and when it will proceed directly to the quantitative test. Although a qualitative assessment can be performed for any reporting unit, there may be situations where an entity decides that it is more cost effective to go directly to the quantitative test, such as when there has been a significant decline in the reporting unit’s sales or in the macro-economic prospects of a country in which the reporting unit operates. For these reporting units, it may be less likely that a qualitative assessment would be sufficient to support a conclusion that a quantitative goodwill impairment test is not needed. Additionally, in the Basis for Conclusions (BC32) for ASU 2011-08 the FASB noted that entities or reporting units that are facing an unfavorable economic environment would likely conclude that it is necessary to perform a quantitative goodwill impairment test.

22.127 An entity could establish criteria that, if met, would result in the entity by-passing the qualitative assessment and proceeding directly to the quantitative test. The criteria likely would include an assessment of whether there have been significant adverse changes in the reporting unit that affect either its fair value or its carrying amount and whether there are significant unfavorable economic factors, including the events and circumstances listed above. Each entity will need to determine the appropriate framework and criteria that fits each of its specific reporting unit’s business models and circumstances. An entity may develop its framework to focus on when it would be cost effective to perform a qualitative assessment and when it would be more cost effective to proceed directly to the quantitative test.

22.128 As part of this assessment, an entity generally would consider the significance of the excess or cushion between a reporting unit’s most recent fair value measurement and its carrying amount and how recently that information was obtained (see step 4). In instances where the cushion was significant and the changes in circumstances and events affecting both the composition of the reporting unit and the assumptions to measure fair value have been minimal or positive, it may be more cost effective for the entity to perform a qualitative assessment (depending on other conditions). Alternatively, when the cushion was not significant and/or there are one or more adverse changes in circumstances, entities may consider it more cost effective to proceed directly to the quantitative test, because even a small change in the operations of a reporting unit or the economic environment in which it operates could indicate that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff indicated that a reporting unit may be at risk of failing the quantitative test for goodwill impairment if it had a fair value that was not substantially in excess of the carrying
amount of the reporting unit as of the date of the last impairment test. The SEC staff has encouraged entities that have at risk reporting units to expand their disclosures in MD&A to address the material implications of uncertainties associated with the methods, assumptions, and estimates underlying the entity’s critical accounting policies. In these situations, it may be more difficult for an entity to support a more-likely-than-not assessment, and as a result, it may be more cost effective to proceed directly to the quantitative test. Further, in performing the qualitative assessment, entities need to affirmatively support an assertion that they believe that it is not more likely than not that the fair value of the reporting unit is below its carrying amount.

Step 2

For those reporting units for which a qualitative assessment will be performed, consider the most recent fair value measurement and when the measurement was determined

22.129 The entity may have performed a quantitative assessment in the past. The significance of the excess or cushion between a reporting unit's most recent fair value measurement and its carrying amount is one of the factors to consider in the qualitative assessment. The amount of weight given to the previously determined quantitative measure of the fair value of a reporting unit in a qualitative assessment would decrease as time elapses and when the reporting unit's operations experience significant changes since the quantitative amount was calculated.

22.130 Entities are not required to perform a quantitative measurement of fair value at regular intervals, but may consider whether it would be appropriate or cost effective to periodically quantitatively determine the fair value of a reporting unit. Factors to consider in determining whether more frequent quantitative measurements may be appropriate, depending on the reporting unit’s particular facts and circumstances, include (1) changes in the composition of the reporting unit due to partial dispositions, acquisitions, or reorganizations, (2) maturity of the goods or services provided by the reporting unit, (3) barriers to entry for competitors, and (4) susceptibility of the reporting unit's fair value to foreign currency exchange rates, interest rates, or other macro-economic factors. Consequently, an entity may determine that it would be appropriate to perform quantitative measurements of fair value more frequently for certain of its reporting units. For example, less frequent quantitative measurements may be more appropriate for a reporting unit that has a well-established market share in a mature industry than for a reporting unit in an industry that experiences shorter product life-cycles, is subject to rapid technological changes, and has low barriers to entry.

Step 3

Identify the significant drivers of fair value for the reporting unit

22.131 In a qualitative assessment, an entity will need to identify and document the factors that significantly affect the fair value of its reporting units. As noted above, ASC paragraph 350-20-35-3C lists factors to consider when making the qualitative assessment. Entities should review these factors at regular intervals to identify new factors that could affect fair value and to ensure that the previously identified factors continue to be
significant drivers of the reporting unit’s fair value. The significant drivers of fair value would be developed from management’s understanding of the business as well as the key estimates and assumptions used in previous quantitative fair value measurements. Results from projections and analyses management prepared when it acquired entities whose goodwill is included within the reporting unit should also be considered.

**Step 4**

**Determine what events and circumstances have occurred that may have affected those drivers of fair value, including positive and mitigating events and circumstances that could affect the fair value of the reporting unit**

22.132 Once the key assumptions and drivers of fair value have been identified, management should consider the reporting unit’s business and whether there have been significant changes in either the business model or the economic environment in which the reporting unit operates. The latter should include consideration of the factors identified in the previous step and other relevant factors identified by management.

22.133 Although ASC Section 350-20-35 does not provide examples of positive evidence or mitigating factors, it does state that management should consider positive and mitigating events and circumstances in making its qualitative assessment. It will be the totality of all of the factors, both positive and negative, that an entity evaluates in its more-likely-than-not assessment.

22.134 – 22.135 Paragraphs not used.

**22.136 Examples of entity-specific factors.**

- Revenue and operating profit may have improved by 8% and 10%, respectively, for a reporting unit and similar growth may be projected for the next five years. On the surface, this may appear to indicate a very healthy business; however, this could be either a positive or a negative factor with respect to the fair value of the reporting unit. If these metrics represent a decline from what was previously projected, it would be a negative factor with respect to the fair value of the reporting unit.

- A new contract with the workforce also should be considered against previous projections of labor costs to determine whether it is a positive or negative factor in determining the fair value of the reporting unit.

- A reporting unit of a professional services firm that loses key personnel to a competitor should consider the implications of that loss to the fair value of the reporting unit.

**Step 5**

**Make an assessment of the likely impact of the factors identified in the previous steps on the fair value of the reporting unit**
22.137 Once an entity has identified the key drivers of fair value for a reporting unit, it will make an assessment of the potential impact on the reporting unit’s fair value of each of the key drivers of fair value identified, considering relevant positive and mitigating events and circumstances. Similar to other significant estimates and more-likely-than-not assessments, it will be important for management to develop a process for gathering the internal and external data to support the conclusions of the qualitative assessment. Appropriate support for each of the key factors identified and the potential impact on the fair value of the reporting unit should be considered, including the consistency of the information with other information such as operating budgets, forecasts, and strategic plans of the entity.

**Step 6**

**Consider any transactions or events that significantly affected the carrying amount of the reporting unit**

22.138 Management will need to consider any changes in the business that occurred during the reporting period that could impact the carrying amount of the reporting unit. Significant changes in the composition or carrying amount of a reporting unit’s net assets could result in it being more cost effective to proceed directly to the quantitative goodwill impairment test rather than performing a qualitative assessment. Examples of transactions and events that could significantly affect the carrying amount of a reporting unit are disposal of a portion of a reporting unit, a business combination occurring during the period, or a reorganization of the entity’s segments and reporting units.

**Step 7**

**Prepare an analysis based on the events, circumstances, and factors identified and document the assessment as to whether it is not more likely than not that the fair value of the reporting unit is less than its carrying amount**

22.139 In completing the analysis, some entities may struggle with the extent of analysis and documentation that is needed. Because the qualitative assessment acts as a screen for determining whether it is necessary to perform the quantitative goodwill impairment test, management needs to obtain sufficient evidence that will allow it to support a conclusion that it believes that it is not more likely than not that the fair value of the reporting unit is less than its carrying amount when the quantitative test is not performed. Accordingly, the level of detail needed will vary based on the facts and circumstances of each reporting unit. As discussed above, one item that could influence the level of support is the date of the reporting unit’s last quantitative determination of the fair value and how much cushion was present at that time.

22.140 Once management has completed the steps outlined above, it will need to consider the totality of the evidence gathered to reach its conclusion. We would expect management to document its considerations including how it weighted the evidence gathered, the estimated impact of the information on the fair value of the reporting unit as part of its qualitative assessment, and how management determined that it is not more
likely than not that the fair value of a reporting unit is less than its carrying amount. The extent of the evidence needed to support that conclusion would generally increase as the likelihood that the fair value of a reporting unit is less than the carrying amount increases.

22.141 An example of an event or circumstance that might indicate an impairment of goodwill is a sustained decrease in share price in both absolute terms and relative to its peers. Although not explicitly required by ASC Section 350-20-35, many SEC registrants, in response to SEC staff views expressed in speeches and comment letters, reconcile the fair values of reporting units to their market capitalization as a reasonableness test related to the aggregate fair value of reporting units. The FASB acknowledged in the Basis for Conclusions to ASU No. 2011-08, Testing Goodwill for Impairment, that the impairment guidance may result in entities using greater judgment about when and how to perform this evaluation.

22.142 Management may perform a quantitative measurement of fair value for certain of its reporting units and a qualitative assessment for others. In these situations, it could be difficult for an entity to perform the market capitalization reconciliation. Management could perform a reconciliation of market capitalization that considers the current year fair value (for the reporting units for which quantitative measurements were performed in the current year) and the results of past quantitative measurements and current qualitative assessments for the remaining reporting units as a basis for a high-level reconciliation between the fair value of the reporting units and the entity's market capitalization.

Impairment Test - First Step

22.143 An entity is permitted to bypass the qualitative assessment and proceed directly to the quantitative goodwill impairment test. Alternatively, an entity may conclude after performing a qualitative analysis that performing a quantitative test is necessary.

22.144 In the quantitative test, the fair value of the reporting unit is compared with its carrying amount (including goodwill). If the fair value of the reporting unit exceeds its carrying amount, goodwill is considered not to be impaired. However, if the carrying amount of a reporting unit exceeds its fair value, and if ASU 2017-04 has been adopted (see beginning at Paragraph 22.116a), an entity would record that difference as an impairment loss. If ASU 2017-04 has not been adopted, Step 2 of the goodwill impairment test would be performed to measure the impairment loss, if any.

Fair Value of the Reporting Unit Is Determined at the Measurement Date

22.145 Fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. The fair value of a reporting unit should be based on the conditions that exist at the valuation date and should be valued consistent with market participant assumptions. If an entity expects those conditions to change, the valuation should not be prepared as if the change already occurred. However, if market participants include in their valuation an assessment of the probability of a change in conditions, then this probability, using market participant assumptions, should be reflected in arriving at fair value. This holds true either in the probability attached to different scenarios under the expected cash flow
method, or in determining the discount rate used under the discount rate adjustment method.

22.146 According to ASC paragraph 350-20-35-4, “The quantitative goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill.” There are different perspectives as to whether a reporting unit fair value premise is best expressed through enterprise or equity value. Additional premises also exist, although enterprise and equity value are most prevalent. Equity value refers to the fair value of a reporting unit’s outstanding equity instruments; in other words, value available to equity holders after debt and other obligations have been fulfilled. In contrast, enterprise value generally refers to the fair value of a reporting unit based on the value of cash flows available to debt and equity holders collectively.

22.147 While the FASB does not mandate the use of a specific valuation premise for determining the fair value of a reporting unit (see Paragraph 22.096), it is important that the premise used in measuring fair value be consistent with the determination of the carrying amount of the reporting unit. For example, if an enterprise premise is used in determining a reporting unit’s fair value such that the fair value does not reflect cash outflows for debt, the same debt is not assigned to the reporting unit’s carrying amount.

Example 22.20: Incorporating Assumptions of Change in Conditions in Valuing the Reporting Unit--Case 1

Scenario 1. The Environmental Protection Agency introduced new rules that increase the cost of operating a mine, thereby reducing its profitability and value. ABC Corp, the mining company, believes that the rules will be reversed once the newly elected administration takes office.

In this situation, ABC should prepare its valuation of the reporting unit based on the rules in place at the date of the valuation. However, to the extent that market participants would include in their valuation an assessment of the probability of reversal of the rules, ABC’s valuation also should reflect this possibility.

Scenario 2. DEF Corp. has a reporting unit in a less developed country (LDC) that manufactures and sells the key ingredient of a consumer product. The legislature of the LDC enacted changes in the country’s tax law that makes the reporting unit’s product significantly more expensive than similar ingredients produced using an alternative commodity. DEF expects that the tax legislation will have an adverse effect on the operations of the reporting unit.

DEF expects that the adverse tax change will be reversed because (1) legal action is under way to reverse the tax and (2) the executive branch of the LDC’s government favors abolishing the discriminatory tax. However, the legislature of the LDC shows no willingness to reverse the enacted tax law.
In this situation, the fair value of the reporting unit should be based on conditions that existed at the valuation date (i.e., the current legislation). The extent to which market participants believe that the tax law will be reversed should be reflected in the assumptions used to value the business. The reporting unit should not be valued as if the tax had been reversed unless that is consistent with the assumptions of market participants.

Example 22.21: Incorporating Assumptions of Change in Conditions in Valuing the Reporting Unit--Case 2

ABC Corp. has a reporting unit in a less developed country (LDC) with a net carrying amount of $850,000 and goodwill of $100,000. The legislature of the LDC enacted changes in the country’s tax law that makes the reporting unit’s product significantly more expensive than similar ingredients produced using an alternative commodity. Based on negative public reaction, the legislature of the LDC is reconsidering its decision to change the country’s tax law.

If the tax law is revoked and the reporting unit’s profits recover to levels experienced before its introduction, the fair value of the unit would be $1,200,000. However, there is uncertainty about whether the tax law will be reversed. Consequently, market participants in valuing the business currently, would reflect the likelihood or probability of the law’s reversal. In doing so, the fair value of the reporting unit is estimated at $800,000.

Because the impairment test should be based on current conditions and reflect market participant assumptions, the fair value of the reporting unit ($800,000) should be compared with the carrying amount. Because that amount is less than the carrying amount for the reporting unit, if ABC has not adopted ASU 2017-04, it would need to complete Step 2 of the impairment test. If ABC has adopted ASU 2017-04, it would recognize goodwill impairment of $50,000 ($850,000 - $800,000).

Measuring the Fair Value of a Single Reporting Unit

22.148 In some situations, a reporting unit may have issued publicly traded equity securities. Quoted market prices, where available, generally are viewed as the best indicator of fair value. However, the quoted market price of an individual security need not necessarily be the sole measurement basis of the fair value of a reporting unit. ASC Section 350-20-35 acknowledges that quoted market prices in active markets of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities), may not necessarily represent the fair value of the reporting unit as a whole and, therefore, need not be the sole measurement basis of the fair value of the reporting unit. For instance, an acquirer often is willing to pay more for a controlling interest in equity securities to take advantage of the related synergies and other benefits than an investor would pay for a number of equity securities representing a less than controlling interest. That control premium may cause the fair value of a
reporting unit to exceed its market capitalization. (ASC paragraphs 350-20-35-22 through 35-23) Additionally, the SEC staff stated at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, in volatile market conditions, it may be appropriate for management to consider the market capitalization based on an average share price over a reasonable period of time as a better estimate of the fair value of a reporting unit (or an entity). See the discussion of Reconciliation of Market Capitalization at Paragraph 22.155.

22.149 When quoted market prices are not available, appropriate valuation techniques, including earnings or revenue multiples (i.e., market approach), or discounted cash flows (i.e., income approach), should be used.

Using Valuation Techniques to Measure the Fair Value of a Reporting Unit

22.150 In the absence of market prices, an entity must estimate fair values. Valuation techniques and assumptions used to estimate fair values require significant exercise of professional judgment. Entities should document contemporaneously why they chose the technique(s) used, the key assumptions involved, and how those assumptions are consistent with (a) other similar types of assumptions used by the entity (e.g., in strategic planning, budgeting, realization of deferred taxes, and incentive compensation arrangements); (b) available external data (e.g., economic conditions); and (c) public disclosures and statements the entity made. In other words, the entity’s methods and assumptions should be consistent across the organization and from period to period. A valuation technique or the underlying assumptions should be changed only if a substantive and compelling business and economic reason supports the change and the change results in a measurement that is equally or more representative of fair value in the circumstances (e.g., a change in weighting when multiple valuation techniques are used). The valuation techniques chosen to value the reporting unit should be consistent with the techniques used by the acquirer in its recognition and measurement of the identifiable assets acquired and liabilities assumed in a business combination. See Paragraph 22.056 for a discussion of how to account for and disclose a change in a valuation technique or its application.

22.151 ASC Topic 820 does not prescribe criteria for selecting the appropriate valuation approaches or techniques to measure the fair value of reporting units. The appropriate valuation approaches or techniques for a reporting unit depends on its value drivers, the reliability of inputs to be used, and the way in which a market participant would view and price the reporting unit.

22.152 In some cases, a single valuation approach is appropriate. For example, when valuing a reporting unit using quoted prices in an active market for comparable entities, a market approach may be appropriate. In those situations, it is important that the entities used in the comparison be reasonably comparable. For example, determining the fair value of an individual reporting unit based on a multiple of Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), or earnings or revenue from current market transactions, or financial information derived from other entities, is appropriate in situations where these entities have comparable operations with observable, comparable
economic characteristics and are similar in nature, scope and size to the reporting unit being compared.

22.153 In many cases, multiple valuation approaches are appropriate. For example, when estimating the fair value of a reporting unit, both a market approach and an income approach may be appropriate. If multiple valuation approaches are used to estimate fair value, the results of each should be considered and weighted, as appropriate, in estimating the fair value of the reporting unit. ASC paragraphs 820-10-35-24 and 35-24B

22.154 When it is appropriate to use a combination of valuation techniques to estimate the fair value of a reporting unit, we expect that each of the valuation techniques used to measure fair value would reasonably corroborate the results of the other techniques applied. In theory, each measure of fair value should converge as the calculations in each are further refined. Judgment should be applied when placing greater emphasis on one valuation technique over another. As noted in ASC Section 820-10, *Fair Value Measurement - Overall*, less reliance should be placed on internally developed models that have not been calibrated to observable transactions that were not forced liquidations or distress sales. If an entity previously determined the fair value of a reporting unit based 50% on a market approach (taking into account market capitalization) and 50% on an income approach, it would not be appropriate to rely 100% on the income approach simply because the market capitalization had fallen significantly. See the discussion of valuation analysis in Sections 16 through 21 on Fair Value Measurements.

**Reconciliation of Market Capitalization**

22.155 As an overall check on the reasonableness of the estimated fair values attributed to multiple reporting units as part of a goodwill impairment test, consideration should be given to comparing and contrasting the aggregate fair value of all of the entity’s reporting units with the entity’s market capitalization at the measurement date.

22.156 At the meeting of the SEC Regulations Committee in October 2008 and again at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff noted that SEC registrants are strongly encouraged to perform a reconciliation of the aggregate fair value of multiple reporting units to market capitalization at a goodwill impairment test date and to monitor those differences at future reporting dates. The SEC staff indicated they will ask for this analysis in their filing reviews as a check on the reasonableness of the entity’s conclusions that no goodwill impairment exists if the market capitalization is below the entity’s equity book value. Simply stating that there is an implied control premium if the market capitalization is below the entity’s equity carrying amount will not be an adequate reason to address the issue; however, the SEC staff did not provide specific comments about what would be an acceptable and persuasive response beyond a supportable control premium. However, where less than all assets and liabilities are allocated to the reporting unit in a single reporting unit entity, reconciling to market capitalization may be difficult. Further, to the extent that an enterprise value premise is used in determining the reporting units’ fair value, the entity’s market capitalization would need to be adjusted to reflect the fair value of debt when reconciling to market capitalization as a reasonableness check.
22.157 There may be situations where management has performed a quantitative measurement of fair value for certain of its reporting units and a qualitative assessment for others. In these situations, it could be difficult for an entity to perform the market capitalization reconciliation. The FASB acknowledged in the Basis for Conclusions to ASU 2011-08, Testing Goodwill for Impairment, that the impairment guidance permitting qualitative assessments as the basis for concluding that goodwill of a reporting unit is not impaired may result in entities using greater judgment about when and how to perform this evaluation. An approach management could take in these circumstances would be to perform a reconciliation of market capitalization that considers the current year fair value (for the reporting units for which quantitative measurements were performed in the current year) and also considers the results of past quantitative measurements and current qualitative assessments for the remaining reporting units as a basis for performing a high-level reconciliation between the fair value of the reporting units and the entity’s market capitalization.

Determining a Reporting Unit’s Fair Value – Assumed Tax Structure

22.158 The tax structure assumed (taxable versus nontaxable exchange) when estimating the fair value of a reporting unit is that structure that (a) is feasible, (b) will result in the highest economic value (including consideration of related tax implications), and (c) has assumptions consistent with those that market participants would incorporate into their estimates of fair value. In determining the feasibility of a nontaxable transaction, an entity should consider (i) whether the reporting unit could be sold in a nontaxable transaction and (ii) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity’s ability to treat a sale of the unit as a nontaxable transaction. ASC paragraphs 350-20-35-7, 35-20 through 35-21, 35-25 through 35-27, and 55-10 through 55-23

22.159 ASC paragraphs 350-20-35-7, 35-20 through 35-21, 35-25 through 35-27, and 55-10 through 55-23, do not define what constitutes a taxable or nontaxable transaction. We believe that these paragraphs use the term taxable transaction to describe transactions in which the tax bases of the assets acquired and liabilities assumed of the acquired entity are adjusted to their acquisition-date fair value. Similarly, we believe that these paragraphs use the term nontaxable transaction to describe transactions in which the acquiree’s tax bases of the individual assets acquired and liabilities assumed are carried over by the acquiring entity. For example, an exchange of the acquirer’s shares or cash for the acquiree’s shares generally results in a nontaxable transaction, while an acquisition of the assets and liabilities of an acquiree for cash results in a taxable transaction. In certain circumstances, a tax election may be available under Section 338 of the Internal Revenue Code, whereby the acquirer can elect to have an acquisition of shares treated as a taxable transaction. Involvement of tax professionals may be necessary to determine if an assumed tax structure will result in a taxable or nontaxable transaction.

22.160 Valuation professionals sometimes value businesses without regard to whether the structure of a possible sale transaction would be taxable or nontaxable. However, the assumed tax structure of a transaction can significantly affect the valuation of a reporting
unit. Some of the differences (not all-inclusive) that may arise between an assumed taxable and nontaxable structure of a transaction include:

- Valuations prepared assuming a taxable transaction explicitly consider the tax benefits to an acquirer of a step-up in basis including the tax deduction (often referred to as a tax amortization benefit) available to an acquirer from the ability to write off intangible assets and goodwill, regardless of whether they are recognized in the reporting unit’s financial statements.

- Forecasts prepared by management for a reporting unit’s expected future performance often include the benefits of net operating loss carryforwards, if applicable. These benefits generally are not realizable by the acquirer in a taxable transaction.

- In a nontaxable transaction, the amount of net operating loss carryforwards and built-in losses, which can be used annually by the acquirer, would be limited. Section 382 of the Internal Revenue Code imposes limits on the amount of net operating losses and built-in losses that can be applied annually against income in the event of certain ownership changes.

**Example 22.22: Determining the Reporting Unit’s Fair Value - Assumed Tax Structure**

Management believes that it can sell a reporting unit to market participants in either a taxable or nontaxable transaction. Therefore, the method assumed when estimating fair value should be the method that results in the highest economic value. Management believes it can sell the reporting unit for $70 in a nontaxable transaction or $80 in a taxable transaction. The tax basis of the reporting unit’s net assets is $35. If the reporting unit were sold in a nontaxable transaction, (e.g., exchanging cash for shares), the entity would have a $14 ($70 - $35) × 40% current tax payable resulting from the sale (due to the tax effect of the difference between the proceeds and the tax basis of the shares). If the reporting unit were sold in a taxable transaction, the entity would have an $18 ($80 - $35) × 40% current tax payable resulting from the sale.

Considering market participant assumptions, the feasibility of the alternative transactions, and other information presented, management concludes that it can realize the highest economic value from the sale of the reporting unit in a taxable transaction, as illustrated below.

<table>
<thead>
<tr>
<th>Gross proceeds (fair value)</th>
<th>Nontaxable Transaction</th>
<th>Taxable Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>$70</td>
<td>$</td>
<td>$80</td>
</tr>
<tr>
<td>Less: taxes arising from transaction</td>
<td>(14)</td>
<td>(18)</td>
</tr>
<tr>
<td>Economic value</td>
<td>$56</td>
<td>62</td>
</tr>
</tbody>
</table>

The $62 in a taxable transaction is a higher economic value than the $56 in a nontaxable transaction. Accordingly, the $80 gross proceeds in the taxable transaction is used to measure impairment.
Negative Carrying Amount of a Reporting Unit

22.161 A reporting unit to which goodwill has been assigned may have a negative carrying amount (i.e., shareholders’ deficit). An entity that has not yet adopted ASU 2017-04 (see beginning at Paragraph 22.116a) is required to perform Step 2 of the goodwill impairment test for those reporting units if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should evaluate whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors listed in ASC paragraph 350-20-35-3C are to be considered in making the assessment. The Basis for Conclusions in ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts, notes that the Emerging Issues Task Force believes that this guidance applies to reporting units with zero or negative carrying amounts regardless of the valuation premise (equity versus enterprise value) and the related approach used by an entity to calculate its carrying amount (i.e., the determination of carrying amount is computed on a basis consistent with the valuation premise).

22.162 The carrying amount of a reporting unit should be calculated as the difference between the total assets and total liabilities assigned to the reporting unit; however, ASC Subtopic 350-20 does not prescribe or limit analysis to an equity-value-based or enterprise-value-based (commonly defined as the sum of the fair value of debt and equity) premise, when determining the carrying amount of a reporting unit. While the SEC staff acknowledged at the 2008 AICPA National Conference on Current SEC and PCAOB Developments that either valuation premise may be acceptable, we believe that entities should consistently apply their valuation approaches. ASU 2010-28 did not address whether a change from the equity premise to the enterprise premise, or vice-versa, represents a change in accounting policy or a change in estimate. If an entity is considering a change from one approach to the other, it needs to justify that the change is to a preferable alternative and to consider the retrospective application requirements of ASC Topic 250. Additionally, SEC registrants must provide a preferability letter to the SEC.

22.162a Entities that have adopted ASU 2017-04 must test reporting units with zero or negative carrying amounts in the same manner as other reporting units. They must also disclose reporting units that have zero or negative carrying amounts, including the amount of goodwill allocated to them, and the reportable segment in which the reporting unit is included.

22.162b An entity's accounting policy election to perform the test on an equity-value-based or enterprise-value-based premise generally should not affect the outcome of the impairment test.

22.162c A negative carrying amount under an equity-value-based premise is not, in and of itself, an indicator that goodwill of a reporting unit is impaired. An entity is still required to measure the fair value of the reporting unit and compare that to its carrying amount to identify and calculate any impairment, as the following example illustrates.
Example 22.22a: Reporting Unit with Negative Carrying Amount

ABC Corp., an entity with several reporting units, performs its annual goodwill impairment test using an equity-value-based premise consistent with its accounting policy. ABC has adopted ASU 2017-04 and therefore performs a one-step goodwill impairment test. ABC is a single legal entity that holds debt and allocates it to the reporting units for impairment testing. In this example, it is assumed that the fair value of the debt approximates its book value.

On an equity-value-based premise, one of the reporting units (RU X) has a negative carrying amount. To maintain consistency with its accounting policy election, ABC estimates the fair value of RU X using the same premise.

RU X has net assets with a carrying amount of $(200), which consists of the following:

<table>
<thead>
<tr>
<th>Recognized assets:</th>
<th></th>
<th>Recognized liabilities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible assets</td>
<td>$450</td>
<td>Operating liabilities</td>
<td>$900</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>250</td>
<td>Debt (allocated)</td>
<td>500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>500</td>
<td>Total recognized liabilities</td>
<td>1,400</td>
</tr>
<tr>
<td>Total recognized assets</td>
<td>$1,200</td>
<td>Carrying amount of net assets</td>
<td>$(200)</td>
</tr>
</tbody>
</table>

ABC estimates the fair value of RU X using a combination of a market approach (based on guideline public company multiples, such as revenue, EBITDA and EBIT multiples) and an income approach (based on a WACC-based discounted cash flow model). Using these approaches, ABC first estimates the business enterprise fair value (BEV) of RU X as $225.1

Because ABC performs its impairment test on an equity-value-based premise, it deducts the fair value of the debt allocated to RU X from the estimated BEV value to calculate a fair value of the equity of $(275). Given that the fair value is less than the carrying amount of $(200), ABC concludes that RU X is impaired and records a goodwill impairment charge of $75.

1 Note: Were ABC to perform the impairment test on an enterprise-value-based premise, management would compare RU X's BEV to its carrying amount under an enterprise-value-based premise (calculated as total assets less operating liabilities) to determine any impairment.
Treatment of Contingent Consideration in the Quantitative Goodwill Impairment Test

22.163 As discussed in Paragraphs 22.097 – 22.100, one of the requirements for an asset or liability to be assigned to a reporting unit is that it would be considered in determining the fair value of that reporting unit. Accordingly, whenever an entity assigns a contingent consideration arrangement to a reporting unit, the fair value of that reporting unit should reflect the fair value of the contingent consideration arrangement. The following example illustrates the treatment of contingent consideration in Step 1 of a goodwill impairment test:

Example 22.23: Goodwill Impairment Test--Contingent Consideration in Step 1 of Goodwill Impairment Test

ABC Corp., a corporate holding company, has a number of operating subsidiaries but only one reporting unit. ABC has net assets with a carrying amount of $780, which consists of the following:

<table>
<thead>
<tr>
<th>Recognized assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible assets</td>
<td>$450</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>250</td>
</tr>
<tr>
<td>Goodwill</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total recognized assets</strong></td>
<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recognized liabilities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities other than contingent consideration</td>
<td>$370</td>
</tr>
<tr>
<td><strong>Contingent consideration liability</strong></td>
<td><strong>50</strong></td>
</tr>
<tr>
<td><strong>Total recognized liabilities</strong></td>
<td><strong>420</strong></td>
</tr>
<tr>
<td><strong>Carrying amount of net assets</strong></td>
<td><strong>$780</strong></td>
</tr>
</tbody>
</table>

The fair value of the one reporting unit entity is $650. The fair value of the reporting unit includes the fair values of two internally developed, unrecognized intangible assets (a patent and a customer relationship with fair values of $150 and $50, respectively). The fair value of the reporting unit also includes (as a reduction) the fair values of two contingent consideration arrangements—a recognized contingent consideration arrangement with a fair value of $50 (under ASC Topic 805) and an unrecognized contingent consideration arrangement with a fair value of $175. The unrecognized contingent consideration arrangement relates to a business combination that was consummated prior to ABC’s adoption of ASC Topic 805.

Step 1 of the goodwill impairment test under ASC Subtopic 350-20 would be performed as follows:
The carrying amount of the reporting unit’s recognized net assets exceeds the fair value. If ABC has adopted ASU 2017-04, it would recognize goodwill impairment of $130. If ABC has not adopted ASU 2017-04, it would proceed to Step 2 of the goodwill impairment test under ASC Subtopic 350-20. See additional discussion in Example 22.25 for treatment of contingent consideration in Step 2 of a goodwill impairment test.

### Impairment Test - Second Step (Prior to Adoption of ASU 2017-04)

**ASC Paragraph 350-20-35-9 (Pre-ASU 2017-04)**

The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of reporting unit goodwill with the carrying amount of that goodwill.

**ASC Paragraph 350-20-35-10 (Pre-ASU 2017-04)**

The guidance in [ASC] paragraphs 350-20-35-14 through 35-17 shall be used to estimate the implied fair value of goodwill.

**ASC Paragraph 350-20-35-11 (Pre-ASU 2017-04)**

If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess. The loss recognized cannot exceed the carrying amount of goodwill.

**ASC Paragraph 350-20-35-12**

After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis.

**ASC Paragraph 350-20-35-13**

Subsequent reversal of a previously recognized goodwill impairment loss is prohibited once the measurement of that loss is recognized.

**ASC Paragraph 350-20-35-14 (Pre-ASU 2017-04)**

The implied fair value of goodwill shall be determined in the same manner as the amount of goodwill recognized in a business combination or an acquisition by a not-for-profit entity was determined. That is, an entity shall assign the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination or an acquisition by a not-for-profit entity. Throughout this Section, the term business combination includes an acquisition by a not-for-profit entity.
ASC Paragraph 350-20-35-16 (Pre-ASU 2017-04)
The excess of the fair value of a reporting unit over the amounts assigned to its
assets and liabilities is the implied fair value of goodwill.

ASC Paragraph 350-20-35-17 (Pre-ASU 2017-04)
That assignment process . . . shall be performed only for purposes of testing
goodwill for impairment; an entity shall not write up or write down a recognized
asset or liability, nor shall it recognize a previously unrecognized intangible asset
as a result of that allocation process.

22.164 For entities that have not yet adopted ASU 2017-04, to perform the second step,
the fair value of a reporting unit is assigned to all of its assets and liabilities as if the
reporting unit had been acquired in a business combination at the date of the impairment
test. In other words, the assets and liabilities of the reporting unit are identified,
recognized, and measured as they would be under the acquisition method of accounting,
as described in ASC Topic 805. This is required even if the underlying assets of the
reporting unit were not originally acquired in a business combination accounted for under
ASC Topic 805. Fair value would be assigned to tangible net assets and to both
recognized and unrecognized intangible assets at the test date. In the period after the
original acquisition date, the reporting unit may have internally developed intangible
assets such as patents, trademarks, customer lists, customer relationships, etc., for which
the costs were expensed as incurred for accounting purposes. These internally developed
intangible assets must be considered in arriving at the fair value of the reporting unit on
the impairment test date, as well as assigning that fair value in the second step of the
impairment test. Thus, if the fair value of a reporting unit includes unrecognized
intangible assets (e.g., internally developed intangible assets), ASC Section 350-20-35
includes the internally developed intangible assets for purposes of the impairment
calculation. A reporting unit with significant (or growing) amounts of unrecognized
intangible assets is less likely to have a goodwill impairment charge than a competitor
that lacks significant amounts of unrecognized intangible assets, because it is less likely
to have an indicator of goodwill impairment under Step 1 due to the increased fair value
of the reporting unit.

22.165 The assignment process described in the preceding paragraph is for purposes of
the impairment test only. Recognized assets and liabilities are not adjusted to fair value
for financial reporting purposes nor is a previously unrecognized intangible asset
recorded in Step 2 of the goodwill impairment process.

22.166 In the second step of the impairment test, the fair value of tangible net assets and
both recognized and unrecognized intangible assets (e.g., internally developed intangible
assets) is deducted from the fair value of the reporting unit to determine the implied fair
value of reporting unit goodwill. If the implied fair value of reporting unit goodwill is
lower than its carrying amount, goodwill is impaired and written down to its implied fair
value. The recognized loss cannot exceed the carrying amount of goodwill. On
recognition of a goodwill impairment loss, the adjusted amount of goodwill becomes the
new carrying amount for future impairment testing. Once a loss is recognized, future
increases in fair value will not result in reversal of the previously recognized loss.
Example 22.24: Goodwill Impairment Test--Basic Example

Assume an entity has a reporting unit with recognized net assets of $780, including goodwill of $500. The fair value of the reporting unit is $650, including the fair value of two internally developed, unrecognized intangible assets (a patent and a customer list with fair values of $150 and $50, respectively)

<table>
<thead>
<tr>
<th>Carrying Amount</th>
<th>Fair Value</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible assets, net</td>
<td>$ 80</td>
<td>110</td>
</tr>
<tr>
<td>Recognized intangible assets, net</td>
<td>200</td>
<td>230</td>
</tr>
<tr>
<td>Goodwill</td>
<td>500</td>
<td>110</td>
</tr>
<tr>
<td>Unrecognized intangible assets</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>Total</td>
<td>$ 780</td>
<td>650</td>
</tr>
</tbody>
</table>

The implied fair value of goodwill is arrived at through a residual method. The ASC Section 350-20-35 goodwill impairment test would be performed as follows:

Step 1 - Indicator of Impairment

Fair value of reporting unit (including $200 fair value of internally developed intangibles) $ 650

Carrying amount of reporting unit net assets, including goodwill (780)

Difference $ (130)

The carrying amount of the reporting unit's net assets exceeds the fair value. If the entity has adopted ASU 2017-04, it would recognize an impairment charge of $130. If it has not yet adopted ASU 2017-04, it would proceed to Step 2 of the goodwill impairment test.

Step 2 - Measurement of Impairment (if ASU 2017-04 has not been adopted)

Fair value of reporting unit $ 650

Fair value of tangible net assets (110)

Fair value of recognized intangibles (230)

Fair value of unrecognized intangibles (patent and customer list) (200)

Implied fair value of goodwill 110

Carrying amount of goodwill (500)

Goodwill impairment loss $ (390)
Assembled Workforce

22.167 To assign a reporting unit’s fair value to its assets and liabilities in performing Step 2 of the impairment test, fair value is assigned to the assets and liabilities of the reporting unit, including intangible assets, only if they meet the criteria in ASC Topic 805 for recognition apart from goodwill. As discussed in section 4.2 of KPMG’s Issues In-Depth, Asset acquisitions, an assembled workforce may have been recognized as an intangible asset because it was part of an acquired group of assets not constituting a business (i.e., an asset acquisition). For purposes of Step 2 of the goodwill impairment test, any fair value attributable to that assembled workforce intangible asset is subsumed into the implied fair value of the goodwill of the reporting unit to which that intangible asset was assigned, as it would have been in the acquisition of a business. Thus, implied goodwill determined in Step 2 of the impairment test, which includes (for purposes of this comparison only) the fair value of any assembled workforce intangible asset of the reporting unit, would be compared to the carrying amount of goodwill of the reporting unit.

Treatment of Contingent Consideration in Step 2 of a Goodwill Impairment Test (Prior to Adoption of ASU 2017-04)

22.168 As discussed in Paragraph 22.163, whenever an entity assigns a contingent consideration arrangement to a reporting unit, the fair value of that reporting unit should be appropriately adjusted (i.e., reduced for a contingent consideration liability) to reflect the fair value of the contingent consideration arrangement. Similarly, whenever an entity assigns a contingent consideration arrangement to a reporting unit, the hypothetical application of the acquisition method in Step 2 of a goodwill impairment test should include that contingent consideration arrangement. Conversely, if a contingent consideration arrangement is not assigned to a reporting unit and, therefore, is not reflected in the reporting unit’s fair value in Step 1 of a goodwill impairment test, then the entity would not assign any amounts to that arrangement when measuring the implied fair value of goodwill in Step 2 of the goodwill impairment test. The following example illustrates the treatment of contingent consideration in Step 2 of a goodwill impairment test:

Example 22.25: Goodwill Impairment Test--Contingent Consideration in Step 2 of Goodwill Impairment Test (Prior to the adoption of ASU 2017-04)

Assume the same facts as Example 22.23. As described in that example, Step 2 of the goodwill impairment test under ASC Section 350-20-35 is required because the carrying amount of the reporting unit’s net assets ($780) exceeds its fair value ($650). Additional information necessary to perform Step 2 of that goodwill impairment test is as follows:
### Carrying Amount

<table>
<thead>
<tr>
<th></th>
<th>Carrying Amount</th>
<th>Fair Value</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets (excluding goodwill):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td>$450</td>
<td>525</td>
<td>75</td>
</tr>
<tr>
<td>Recognized intangible assets</td>
<td>250</td>
<td>300</td>
<td>50</td>
</tr>
<tr>
<td>Unrecognized intangible assets</td>
<td>—</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities other than contingent consideration</td>
<td>370</td>
<td>350</td>
<td>20</td>
</tr>
<tr>
<td>Recognized contingent consideration liability</td>
<td>50</td>
<td>50</td>
<td>—</td>
</tr>
<tr>
<td>Unrecognized contingent consideration liability</td>
<td>—</td>
<td>175</td>
<td>175</td>
</tr>
</tbody>
</table>

The implied fair value of goodwill is the residual amount that results from the hypothetical application of the acquisition method. Step 2 of the goodwill impairment test under ASC Section 350-20-35 would be performed as follows.

- **Fair value of the reporting unit:** $650
- **Less: fair value of tangible assets:** (525)
- **Less: fair value of recognized intangible assets:** (300)
- **Less: fair value of unrecognized intangible assets:** (200)
- **Plus: fair value of liabilities other than contingent consideration:** 350
- **Plus: fair value of recognized contingent consideration:** 50
- **Plus: fair value of unrecognized contingent consideration:** 175

**Implied fair value of goodwill:** 200

**Less: Carrying amount of goodwill:** (500)

**Goodwill impairment loss:** $(300)

**NOTE:** The goodwill impairment would be $130 ($780 carrying amount less $650 fair value) if ASU 2017-04 were adopted.

### Measuring Deferred Tax Assets and Liabilities in Step 2 of the Goodwill Impairment Test (Prior to Adoption of ASU 2017-04)

22.169 See KPMG’s *Accounting for Income Taxes* Paragraphs 10.033 through 10.039 and 6.022-6.023b and related examples for additional discussion about deferred tax assets and liabilities in the goodwill impairment test and measurement.

22.170 - 22.174 Paragraphs not used.
Cumulative Translation Adjustment (CTA)

22.175 ASC Section 350-20-35 does not address how an entity should consider CTA in assessing goodwill impairment when consolidated foreign entities comprise all or part of the reporting unit and the entity does not plan to dispose of the investment (i.e., the investment or related consolidated assets are held for use). ASC Section 830-30-40 is clear that no basis exists to include the CTA in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the CTA. The question is whether the carrying amount of a reporting unit is the net amount of recorded assets and liabilities, or the net equity of the reporting unit excluding CTA. If the reporting unit is not contemplated for a planned sale or liquidation, we believe that its carrying amount is the net amount of recorded assets and liabilities (i.e., the recorded assets less recorded liabilities at their currently translated amounts).

Example 22.30: Impairment Test--Cumulative Translation Adjustment

The first step of the goodwill impairment test used to identify potential impairment is to compare the fair value of the reporting unit with its carrying amount, including goodwill. For entities that have not yet adopted ASU 2017-04, Step 2 of the impairment test requires comparing the calculated implied fair value of goodwill with its carrying amount.

Assume the following values for the reporting unit:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets (including goodwill)</td>
<td>$100</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(60)</td>
</tr>
<tr>
<td>Net assets</td>
<td>$40</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(48)</td>
</tr>
<tr>
<td>CTA</td>
<td>8</td>
</tr>
<tr>
<td>Total equity</td>
<td>(40)</td>
</tr>
</tbody>
</table>

We believe that the carrying amount of net assets for the reporting unit for Step 1 of the impairment test would be $40. For entities performing Step 2 of the impairment test, none of the CTA ($8) would be assigned to the recorded amount of goodwill when comparing the implied fair value of goodwill with the recorded amount of goodwill.

Timing of the Annual Goodwill Impairment Test

ASC Paragraph 350-20-35-28

Goodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances (see [ASC] paragraph 350-20-35-30). The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.
22.176 The goodwill impairment test generally must be performed annually, but need not be performed as of year-end, and not all reporting units must be tested as of the same date. Rather, a reporting unit may be tested at any time during the fiscal year, if the test is performed at the same time each year for each reporting unit. Paragraph 22.066 describes circumstances in which impairment testing may be required between the annual tests.

22.177 If the second step of the goodwill impairment test is not completed before the financial statements are issued or available to be issued (under ASC Topic 855, Subsequent Events), and a goodwill impairment loss is both probable and reasonably estimable, we believe an entity recognizes the best estimate of the loss in its financial statements under ASC Topic 450, Contingencies. If this situation occurs, the reporting entity also must disclose that the impairment loss recognized is based on an estimate that has not been finalized, and the reasons why the estimate has not been finalized. Any adjustment to that estimated loss based on completion of the measurement of the impairment loss is recognized in the subsequent reporting period, and the nature and amount of any significant adjustments made to the initial estimate of the impairment loss are disclosed. ASC paragraphs 350-20-35-18 through 35-19 and 50-2

22.178 Management should consider external financial reporting due dates (e.g., Form 10-Q, Form 10-K) when selecting reporting unit goodwill impairment testing dates. Selecting testing dates that correspond with reporting period-ends heightens the potential that management will not have completed the impairment test by the financial statement filing deadline. Therefore, management should consider selecting impairment testing dates that allow sufficient time to avoid the need to estimate a probable loss and the related disclosures and, perhaps, the subsequent adjustments required, if an impairment test has not been completed before the issuance of its financial statements.

22.179 At the December 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stated that they have increased their focus on disclosures included in MD&A associated with goodwill impairment testing. The SEC staff discussed their expectation with respect to the types of disclosures they expect in MD&A. For example, if a reporting entity has a reporting unit that is at risk of failing the quantitative goodwill impairment test, and an impairment of goodwill allocated to that reporting unit could be material, the SEC staff would expect that reporting entity to highlight the risk of impairment in its financial statements. Further, if the fair value of a reporting unit as of the date of the last impairment test is not substantially in excess of the carrying amount, the SEC staff expects reporting entities to provide the following disclosures:

- The percentage by which the fair value of the reporting unit exceeds its carrying amount;
- The amount of goodwill allocated to the reporting unit;
- A discussion of the assumptions used and any uncertainty inherent in those assumptions; and
• A discussion of the potential events and circumstances that could have a negative effect on the assumptions.

22.180 The SEC staff stated that it has no bright lines and that judgment should be applied to determine whether the fair value of a reporting unit is substantially in excess of its carrying amount. A reporting entity should consider the level of uncertainty inherent in its assumptions, external factors affecting its industry or market, and any other data that may affect its estimate of fair value. If the fair value of a reporting unit is not substantially in excess of its carrying amount, the SEC staff believes that the risk of an impairment has risen to the level of a known uncertainty. Accordingly, a reporting entity would need to comply with the disclosure requirements related to known uncertainties in Item 303 of Regulation S-K. Item 303 states that material events and uncertainties known to management (e.g., potential goodwill impairment) should be disclosed if the events and uncertainties would cause reported financial information to not be necessarily indicative of future operating results or of future financial condition. The SEC staff believes the disclosure requirements in Item 303 may best be met by disclosing the information cited in the four bullet points above in Paragraph 22.185. Alternatively, if the fair value of a reporting unit is substantially in excess of its carrying amount, the SEC staff noted that they would expect the reporting entity to disclose that assertion.

Change in Annual Impairment Test Date

22.181 An entity may change the date of the annual goodwill impairment test if events or circumstances warrant (e.g., a significant acquisition). At the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff indicated that a preferability letter is not required if (1) an entity determines that a change in its goodwill impairment testing date does not result in a material change in the method of applying the accounting principle, which may be the case even if goodwill is material to the financial statements, and (2) the change in the goodwill impairment testing date is prominently disclosed. Under no circumstances may more than 12 months elapse between goodwill impairment test dates. Changes in the date of the annual goodwill impairment test generally would be accounted for prospectively. If the change is not considered to be a material change in the method of applying an accounting principle, an entity would not be required to follow the guidance on accounting changes in ASC Topic 250. However, even if the change is considered to be a material change in the method of applying an accounting principle, ASC Topic 250 provides that retrospective application is impracticable if it would require assumptions about management’s intent in a prior period that cannot be independently substantiated or it requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that provides evidence of circumstances that existed on the date at which those amounts would be measured (i.e., indistinguishable from the use of hindsight).

Subsidiary Financial Statements

ASC Paragraph 350-20-35-48

All goodwill recognized by a public or nonpublic subsidiary (subsidiary goodwill) in its separate financial statements that are prepared in accordance with generally
accepted accounting principles (GAAP) shall be accounted for in accordance with [ASC] Subtopic [350-20]. Subsidiary goodwill shall be tested for impairment at the subsidiary level using the subsidiary’s reporting units. If a goodwill impairment loss is recognized at the subsidiary level, goodwill of the reporting unit or units (at the higher consolidated level) in which the subsidiary’s reporting unit with impaired goodwill resides must be tested for impairment if the event that gave rise to the loss at the subsidiary level would more likely than not reduce the fair value of the reporting unit (at the higher consolidated level) below its carrying amount (see [ASC] paragraph 350-20-35-3C(f)). Only if goodwill of that higher-level reporting unit is impaired would a goodwill impairment loss be recognized at the consolidated level.

22.182 Goodwill reported by a subsidiary in its separate financial statements presented under generally accepted accounting principles is tested for impairment at the subsidiary level using the reporting units of the subsidiary. Any impairment recognized at the subsidiary level would not be recognized in consolidation unless the goodwill of the reporting unit in which the subsidiary resides in consolidation also is impaired. Impairment at the subsidiary level is an example of an event that would trigger an impairment test of goodwill at a higher level. Additionally, in a situation where the parent consolidates the subsidiary on a lag basis, the impairment loss could be recognized in the parent's consolidated financial statements earlier than it is recognized in the subsidiary's financial statements, because the parent is evaluating goodwill for impairment in the period that it occurs at the consolidated level.

**Equity Method Investments**

**ASC Paragraph 350-20-35-58**

The portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill in accordance with [ASC] paragraph 323-10-35-13 (equity method goodwill) shall not be amortized.

**ASC Paragraph 350-20-35-59**

However, equity method goodwill shall not be reviewed for impairment in accordance with [ASC] Subtopic [350-20]. Equity method investments shall continue to be reviewed for impairment in accordance with [ASC] paragraph 323-10-35-32.

22.183 Consistent with the accounting for goodwill under ASC Section 350-20-35, the portion of the difference between the cost of an investment and the amount of underlying equity in the net assets of an investee that represents goodwill (i.e., equity method goodwill) is not amortized. However, equity method goodwill continues to be tested for impairment under the provisions of ASC Section 323-10-35, rather than ASC Section 350-20-35. Under ASC Section 323-10-35, the evaluation of equity method goodwill is subsumed into an evaluation for impairment of the investment in the equity method investee in total. If an equity method investee recognizes a goodwill impairment in its separate financial statements, the investor’s share in that impairment should be included...
in the investee’s equity in earnings recognized in the financial statements of the investor. ASC paragraphs 323-10-25-2A, 30-2A through 30-2B, 35-14A and 35-32A, and 40-1

22.184 ASC Subtopic 323-10 does not specifically address the accounting for a bargain purchase arising from an investment in an equity method investee; however, paragraph 323-10-25-2A specifies that contingent consideration is recognized when the fair value of the investor’s share of the investee’s net assets exceeds the investor’s initial cost (i.e., a bargain purchase).

Goodwill Impairment Testing and Disposal of All or a Portion of a Reporting Unit When the Reporting Unit Is Less Than Wholly Owned

ASC Paragraph 350-20-35-57A (Pre-ASU 2017-04)³

If a reporting unit is less than wholly owned, the fair value of the reporting unit and the implied fair value of goodwill shall be determined in the same manner as it would be determined in a business combination accounted for in accordance with [ASC] Topic 805 or an acquisition accounting for in accordance with [ASC] Subtopic 958-805 [for not-for-profit entities]. Any impairment loss measured in the second step of the goodwill impairment test shall be attributed to the parent and the noncontrolling interest on a rational basis. If the reporting unit includes only goodwill attributable to the parent, the goodwill impairment loss would be attributed entirely to the parent. However, if the reporting unit includes goodwill attributable to both the parent and the noncontrolling interest, the goodwill impairment loss would be attributed to both the parent and the noncontrolling interest.

ASC Paragraph 350-20-35-57B

If all or a portion of a less-than-wholly-owned reporting unit is disposed of, the gain or loss on disposal shall be attributed to the parent and the noncontrolling interest.

22.185 ASC Topic 805 requires that all assets acquired and liabilities assumed in a business combination be recognized and measured in accordance with ASC Topic 805 at the acquisition date, regardless of whether there is a noncontrolling interest remaining after the acquisition. Before ASC Topic 805 was effective, generally only the goodwill attributable to the parent was recognized. However, under ASC Topic 805, when a reporting unit is less than wholly owned, the fair value of the reporting unit and the implied fair value of goodwill are determined in the same manner as in a business combination accounted for under ASC Topic 805, and any impairment loss is attributed to the parent and the noncontrolling interest. The application of this guidance is illustrated in the example below.
Example 22.31: Goodwill Attributable to Controlling and Noncontrolling Interests

On December 31, 20X9, ABC Corp. acquired an 80% controlling interest in DEF Corp. for cash of $200. The recognized amount of the identifiable assets and liabilities measured in accordance with ASC Topic 805 is $235 and $85, respectively (i.e., net identifiable assets of $150). The fair value of the 20% noncontrolling interest in DEF is $45. ABC determined the goodwill attributable to the controlling and noncontrolling interests as follows:

<table>
<thead>
<tr>
<th>Consideration paid</th>
<th>$200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncontrolling interest</td>
<td>45</td>
</tr>
<tr>
<td>Recognized equity in DEF</td>
<td>$245</td>
</tr>
<tr>
<td>Recognized amount of identifiable assets</td>
<td>(235)</td>
</tr>
<tr>
<td>Recognized amount of liabilities assumed</td>
<td>85</td>
</tr>
<tr>
<td><strong>Total goodwill of DEF</strong></td>
<td>$95</td>
</tr>
</tbody>
</table>

Consideration paid to acquire controlling interest | $200 |

Proportionate interest in recognized amount of net identifiable assets (80% × $150) | (120) |

**Goodwill attributable to Controlling Interest** | $80 |

**Goodwill attributable to Noncontrolling Interest** | $15 |

As discussed in the section Assigning Acquired Assets and Liabilities That Relate to Multiple Reporting Units beginning at 22.093, ABC assigned all of DEF’s assets acquired and liabilities assumed, including goodwill, to reporting unit G (a new reporting unit) because ABC expects reporting unit G to benefit from all of the expected synergies of the business combination. One year after the acquisition, there was an adverse change in the business environment of DEF resulting in a decrease in the fair value of reporting unit G to $225. Consequently, ABC must test the goodwill assigned to reporting unit G for impairment as follows:

**Step 1 - Indicator of Impairment**

| Fair value of reporting unit | $225 |
| Carrying amount of reporting unit G (net assets), including goodwill | (245)* |
| Difference | $ (20) |

The net carrying amount of reporting unit G exceeds its fair value. If ABC has already adopted ASU 2017-04, it concludes that the impairment charge is $20. If ABC has not yet adopted ASU 2017-04, it proceeds to Step 2 of the goodwill impairment test.
**Step 2 - Measurement of Impairment (if ASU 2017-04 has not been adopted)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of reporting unit</td>
<td>$ 225</td>
</tr>
<tr>
<td>Amount of net identifiable assets in hypothetical acquisition method (total assets minus liabilities)</td>
<td>(150)</td>
</tr>
<tr>
<td>Implied fair value of goodwill</td>
<td>75</td>
</tr>
<tr>
<td>Carrying amount of goodwill</td>
<td>(95)</td>
</tr>
<tr>
<td>Impairment</td>
<td>(20)</td>
</tr>
</tbody>
</table>

* For simplicity, this example assumes the carrying amount of reporting unit net assets, including goodwill, and fair value of the identifiable assets and liabilities assumed remained unchanged between the date of acquisition and the impairment test date.

Under either approach, the amount of goodwill impairment is determined to be $20. In accordance with ASC Topic 805, any impairment loss is attributed to the parent and the noncontrolling interest on a rational basis. As such, an impairment loss of $17 (80/95 × 20) could be attributed to ABC as the controlling (parent) interest, and an impairment loss of $3 (15/95 × 20) could be attributed to the noncontrolling interest in proportion to the original allocation of goodwill.

When testing for impairment, the test is based on the entire value of the reporting unit (even if the reporting unit is not wholly owned), then the goodwill impairment amount is attributed to the controlling interest and noncontrolling interest.

**Dispositions of All or a Portion of a Reporting Unit**

**ASC Paragraph 350-20-40-1**

When a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal.

**ASC Paragraph 350-20-40-2**

When a portion of a reporting unit that constitutes a business (see [ASC] Section 805-10-55) is to be disposed of, goodwill associated with that business shall be included in the carrying amount of the business in determining the gain or loss on disposal.

**ASC Paragraph 350-20-40-3**

The amount of goodwill to be included in that carrying amount shall be based on the relative fair values of the business to be disposed of and the portion of the reporting unit that will be retained. For example, if a business is being sold for $100 and the fair value of the reporting unit excluding the business being sold is $300, 25 percent of the goodwill residing in the reporting unit would be included in the carrying amount of the business to be sold.
ASC Paragraph 350-20-40-4

However, if the business to be disposed of was never integrated into the reporting unit after its acquisition and thus the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the current carrying amount of that acquired goodwill shall be included in the carrying amount of the business to be disposed of.

ASC Paragraph 350-20-40-5

That situation might occur when the acquired business is operated as a stand-alone entity or when the business is to be disposed of shortly after it is acquired.

ASC Paragraph 350-20-40-6

Situations in which the acquired business is operated as a standalone entity are expected to be infrequent because some amount of integration generally occurs after an acquisition.

ASC Paragraph 350-20-40-7 (Pre-ASU 2017-04)

When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained shall be tested for impairment in accordance with [ASC] paragraphs 350-20-35-3A through 35-19 using its adjusted carrying amount.

22.186 When an entity disposes of a portion of a reporting unit constituting a business, a relative fair value approach is used to assign a portion of reporting unit goodwill to the portion being disposed of. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.) For example, if a business is being sold for $100 and the fair value of the reporting unit excluding the business being sold is $300, then 25% ($100/($100 + $300)) of the goodwill residing in the reporting unit would be included in the carrying amount of the business to be sold. If the business being disposed of was operated as a stand-alone entity or is to be disposed of shortly after acquisition (i.e., was never integrated into the reporting unit), the entire carrying amount of the goodwill related to that business would be included in the carrying amount of the disposed business. Where the portion being disposed of does not constitute a business, goodwill is not assigned. If only a portion of a reporting unit is disposed of, the goodwill associated with the remainder of the reporting unit should be evaluated for impairment under ASC Section 350-20-35. If the goodwill associated with the remainder of the reporting unit were impaired, any impairment loss should be presented separately in the income statement and not subsumed into the gain or loss on disposal.

22.187 As described beginning at KPMG's Handbook Accounting for Income Taxes Paragraph 6.020, first and second component goodwill is determined in the acquisition accounting and is not subsequently re-evaluated. Therefore, when all or a portion of a reporting unit is sold, the entity would follow the same accounting as when goodwill is reduced as a result of impairment or amortization. Refer to the examples in KPMG's Handbook Accounting for Income Taxes starting in Paragraph 6.020.
22.188 As described in ASC paragraphs 350-20-35-57A through 35-57B, if the reporting unit includes goodwill attributable to a parent in a less-than-wholly owned subsidiary acquired before the adoption of ASC Topic 805 and ASC Subtopic 810-10, any impairment loss would be attributed entirely to the parent. Consistent with that guidance, when an entity disposes of all or a portion of a less-than-wholly-owned business acquired before the adoption of ASC Topic 805 and ASC Subtopic 810-10, it would not allocate goodwill to the noncontrolling interests for purposes of calculating the gain or loss on the sale of such business. Because ASC Topic 805 and ASC Subtopic 810-10 are applied prospectively (with certain limited exceptions) and acquisitions before the adoption of those Topics generally attributed goodwill to only the parent entity, it would therefore be inappropriate to attribute a portion of that same goodwill (parent only) to the noncontrolling interest upon disposition for purposes of reporting the gain or loss in the financial statements.

22.189 A difference could arise in the allocation of goodwill to a disposed business between the consolidated financial statements of a parent and the financial statements of its subsidiary. ASC paragraph 350-20-35-48 requires a subsidiary to test goodwill for impairment at the subsidiary level based on the subsidiary’s reporting units for purposes of the subsidiary’s financial statements. As further discussed in ASC paragraph 350-20-35-49, if testing at the consolidated level leads to an impairment loss, that loss is recognized at the consolidated level, which may be a different level and amount from the loss recognized in the subsidiary’s financial statements. The same underlying approach and rationale applies in determining the amount of goodwill to be allocated to a business to be disposed of by a subsidiary when that subsidiary is itself part of a larger reporting unit at the parent level. The following example illustrates the application of this guidance at the parent and subsidiary levels and demonstrates how, in this case, a difference can arise in the relative fair value allocation of goodwill to the disposed business at the parent and subsidiary levels.

Example 22.32: Difference in the Allocation of Goodwill to a Disposed Business in the Consolidated Financial Statements of a Parent and the Financial Statements of Its Subsidiary

ABC Corp has two subsidiaries, Subsidiary A and Subsidiary B. Subsidiary A has public debt outstanding and therefore issues financial statements. In Subsidiary A’s financial statements, there is only one reporting unit. Subsidiary A is disposing of a business within its reporting unit that was previously integrated into Subsidiary A and into a broader reporting unit at the ABC (parent) level. The fair value of ABC’s reporting unit that includes Subsidiary A’s reporting unit is $1,000. The fair value of Subsidiary A is $600. The fair value of the disposed business is $120. Subsidiary A has $200 of goodwill, which also is the amount of goodwill in ABC’s consolidated financial statements.
Subsidiary A Level

Relative fair value of the disposed business is 20% ($120 / $600). Therefore, goodwill associated with the disposed business is $40 ($200 × 20%). Goodwill associated with the ongoing reporting unit is $160.

ABC Level

Relative fair value of the disposed business is 12% ($120 / $1,000). Therefore, goodwill associated with the disposed business is $24 ($200 × 12%). Goodwill associated with the ongoing reporting unit is $176.

1 ASU 2017-04, *Simplifying the Test for Goodwill Impairment*, amends this guidance. See beginning at Paragraph 22.116a for more information.
3 ASU 2017-04, *Simplifying the Test for Goodwill Impairment*, amends this guidance. See Paragraph 22.116a for more information.
Section 23 - The Tax Effects of Business Combinations

See KPMG's *Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations*. 
Section 24 - The Tax Effects of Changes in Ownership Interests While Retaining Control

See KPMG's *Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations*.
Section 25 - The Tax Effects of Asset Acquisitions

See KPMG's *Accounting for Incomes Taxes, Section 10, Other Considerations.*
Section 26 – Private Company and Not-for-Profit Accounting Alternatives

Detailed Contents

Goodwill Accounting Alternative
Allocating Goodwill to Disposals
Allocating Goodwill Amortization and Impairment to Component One and Component Two
Presentation and Disclosure
Transition
   Identifiable Intangible Assets Accounting Alternative
Customer-Related Intangible Assets
Noncompete Agreements
Transition
26.000 FASB ASU 2014-02, *Accounting for Goodwill*, amends Subtopic 350-20, *Intangibles—Goodwill and Other—Goodwill*, to provide an alternative to all entities other than public business entities, not-for-profit entities, and employee benefit plans within the scope of Topics 960 through 965 (herein referred to as private companies) to amortize goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate); make an accounting policy election to test goodwill for impairment at either the entity or reporting unit level; test goodwill for impairment only when a triggering event occurs that indicates the fair value of an entity (or reporting unit) may be less than its carrying amount (i.e., an annual impairment test is not required); and measure goodwill impairment, if any, as the excess of the entity’s (or reporting unit’s) carrying amount over its fair value (step two of the goodwill impairment test is not used to measure the amount of any goodwill impairment).

26.001 ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination*, amends Subtopic 805-20, *Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest*, to provide private companies an alternative not to separately recognize and thereby subsume into goodwill any value attributable to (a) customer-related intangible assets that are not capable of being sold or licensed independently from the other business assets and (b) noncompete agreements when applying the acquisition method for a business combination, assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an equity method investee, and adopting fresh-start reporting when emerging from a Chapter 11 reorganization action. An entity that elects the alternative under ASU 2014-18 also must adopt the ASU 2014-02 goodwill alternative. However, an entity that has previously adopted ASU 2014-02 is not required to adopt ASU 2014-18.

26.001a Many private companies may have adopted the alternative treatment for goodwill because they find Step 2 of the general goodwill impairment test too burdensome or costly. In January 2017, the FASB issued ASU 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which eliminated Step 2 of the general goodwill impairment test. As a result, some private companies may wish to discontinue applying the alternative treatment and resume testing goodwill annually for impairment at the reporting unit level. A private company that has elected one or both of the accounting alternatives discussed in this Section may adopt ASU 2017-04 in certain circumstances (see Paragraphs 26.010a and 26.020a for discussion about adopting ASU 2017-04 after adopting the goodwill and identifiable intangible asset accounting alternatives, respectively). For additional information about ASU 2017-04, see Paragraph 22.116a.

26.001b In May 2019, the FASB issued ASU 2019-06, *Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Asset to Not-for-Profit Entities*, to allow not-for-profit entities to apply the goodwill and intangible asset alternative accounting policies. ASU 2019-06 is effective immediately on issuance.

26.002 This Section provides guidance on applying ASUs 2014-02, 2014-18, and 2019-06. While entities may elect these alternatives at any time after the issuance of the related standard, an entity should consider its expected future eligibility to qualify for the
accounting alternative(s) before adopting. For example, an entity that is a private company now that becomes a public business entity in the future (e.g., because its financial statements will be included in an SEC filing by another entity, or it is itself filing a registration statement with the SEC) will need to recast historical financial statements to comply with the requirements applicable to a public business entity (i.e., as if the accounting alternative(s) had not been elected). The SEC staff may not accept an assertion that recasting historical financial statements would be impracticable, even though doing so may be difficult. Management of a private company therefore should carefully consider whether it might take the company public in the future before adopting the alternative accounting treatment for goodwill.

26.002a Before applying the accounting alternatives, an entity should evaluate if it is a public business entity that cannot apply those alternatives. For example, entities meet the definition of a public business entity if their financial statements are included in a registrant's SEC filing, such as when the entity is a significant acquiree under Rule 3-05 of Regulation S-X, a significant equity method investee under Rule 3-09 of Regulation S-X, or an equity method investee whose summarized financial information is included in a registrant's SEC filing under Rule 4-08(g) of Regulation S-X.

26.002b If an entity is considered a public business entity due only to the inclusion of its financial statements within another entity's SEC filing, the entity is considered a public business entity only for the SEC filing. For its stand-alone financial statements used for other purposes, the accounting alternatives can be elected. However, the definition of public business entity is different from the definition used for public entities for pro forma disclosures in Section 13 and close evaluation should be performed.

GOODWILL ACCOUNTING ALTERNATIVE

ASC Paragraph 350-20-15-4

A private company or not-for-profit entity may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies to the following transactions or activities:

a. Goodwill that an entity recognizes in a business combination in accordance with [ASC] Subtopic 805-30 or in an acquisition by a not-for-profit entity in accordance with [ASC] Subtopic 958-805 after it has been initially recognized and measured

b. Amounts recognized as goodwill in applying the equity method of accounting in accordance with [ASC] Topic 323 on investments—equity method and joint ventures, and to the excess reorganization value recognized by entities that adopt fresh-start reporting in accordance with [ASC] Topic 852 on reorganizations.

ASC Paragraph 350-20-15-5

An entity within the scope of the preceding paragraph that elects the accounting alternative shall apply all of the related subsequent measurement, derecognition,
other presentation matters, and disclosure requirements upon election. The accounting alternative, once elected, shall be applied to existing goodwill and to all additions to goodwill recognized in future transactions within the scope of this accounting alternative.

26.003 The Accounting Alternative Subsections of ASC Subtopic 350-20 provide private companies and not-for-profit entities with an accounting alternative for the measurement of goodwill after it is initially recognized. As discussed in Paragraph 350-20-15-4, goodwill includes the goodwill recognized in a business combination, equity-method goodwill and excess reorganization value. Accordingly, a private company or not-for-profit entity may be applying the alternative even if it does not separately report goodwill (e.g., equity method goodwill is subsumed in the equity method investment account). While the alternative includes guidance on subsequent measurement, derecognition, other presentation matters, and disclosure requirements, a private company or not-for-profit entity electing the alternative should continue to follow the applicable requirements in ASC Topic 350 for other accounting and reporting matters related to goodwill that are not addressed in the Accounting Alternative Subsections of Subtopic 350-20. See Section 22, Goodwill and Other Intangible Assets, for additional information on the application of Subsections of ASC Subtopic 350-20.

SUBSEQUENT MEASUREMENT

ASC Paragraph 350-20-35-62
The following guidance for goodwill applies to entities within the scope of [ASC] paragraph 350-20-15-4 that elect the accounting alternative for the subsequent measurement of goodwill.

Amortization of Goodwill

ASC Paragraph 350-20-35-63
Goodwill relating to each business combination, acquisition by a not-for-profit entity, or reorganization event resulting in fresh-start reporting (amortizable unit of goodwill) shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate.

ASC Paragraph 350-20-35-64
An entity may revise the remaining useful life of goodwill upon the occurrence of events and changes in circumstances that warrant a revision to the remaining period of amortization. However, the cumulative amortization period for any amortizable unit of goodwill cannot exceed 10 years. If the estimate of the remaining useful life of goodwill is revised, the remaining carrying amount of goodwill shall be amortized prospectively on a straight-line basis over that revised remaining useful life.

26.004 A private company or not-for-profit entity that elects the accounting alternative will amortize goodwill on a straight-line basis over ten years, or less than ten years if they can demonstrate that a shorter useful life is more appropriate. An entity is not required to
justify a 10-year amortization period for goodwill, even in circumstances when the primary asset(s) acquired in the transaction is expected to generate cash flows for a period of less than 10 years. However, in situations when goodwill consists of significant customer-related intangibles and/or noncompete agreements for which the alternative has been applied (see additional discussion beginning in Paragraph 26.022) or perhaps when goodwill is primarily attributable to workforce in place, an entity may be able to demonstrate a shorter amortization period is appropriate if the economic benefits expected to be derived from those items also is shorter than 10 years. However, entities are neither required to identify an amortization period shorter than 10 years nor are permitted to use an amortization period longer than 10 years.

26.005 The guidance on goodwill amortization equally applies to the portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill in accordance with ASC paragraph 323-10-35-13 (equity method goodwill). It too should be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate. However, ASC paragraphs 350-20-35-81 and 35-82 state that equity method goodwill is not reviewed for impairment under the guidance below, but rather continues to be evaluated for impairment under ASC paragraph 323-10-35-32 (i.e., if an impairment is deemed to be other than temporary).

**Recognition and Measurement of a Goodwill Impairment Loss**

**ASC Paragraph 350-20-35-65**

Upon adoption of this accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level. An entity that elects to perform its impairment tests at the reporting unit level shall refer to paragraphs 350-20-35-33 through 35-38 and paragraphs 350-20-55-1 through 55-9 to determine the reporting units of an entity.

26.006 An entity applying the alternative is permitted to continue to test goodwill for impairment at the reporting unit level or can test impairment prospectively at the entity level. An entity that makes a policy election to test goodwill for impairment at the entity level does not need to demonstrate this policy election is preferable. See Section 22 for further discussion of goodwill impairment testing at the reporting unit level.

**When to Test Goodwill for Impairment**

**ASC Paragraph 350-20-35-66**

Goodwill of an entity (or a reporting unit) shall be tested for impairment if an event occurs or circumstances change that indicate that the fair value of the entity (or the reporting unit) may be below its carrying amount (a triggering event). Paragraph 350-20-35-3C(a) through (g) includes examples of those events or circumstances. Those examples are not all-inclusive, and an entity shall consider other relevant events and circumstances that affect the fair value or carrying amount of the entity (or of a reporting unit) in determining
whether to perform the goodwill impairment test. If an entity determines that there are no triggering events, then further testing is unnecessary.

**The Goodwill Impairment Test**

**ASC Paragraph 350-20-35-67**

Upon the occurrence of a triggering event, an entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of the entity (or the reporting unit) is less than its carrying amount, including goodwill. Paragraph 350-20-35-3C(a) through (g) includes examples of those qualitative factors.

**ASC Paragraph 350-20-35-70**

An entity has an unconditional option to bypass the qualitative assessment described in paragraphs 350-20-35-67 through 35-69 and proceed directly to a quantitative calculation by comparing the entity’s (or the reporting unit’s) fair value with its carrying amount (see paragraphs 350-20-35-72 through 35-78). An entity may resume performing the qualitative assessment upon the occurrence of any subsequent triggering events.

**ASC Paragraph 350-20-35-71**

If, after assessing the totality of events or circumstances such as those described in paragraph 350-20-35-3C(a) through (g), an entity determines that it is not more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount, further testing is unnecessary.

**ASC Paragraph 350-20-35-72**

If, after assessing the totality of events or circumstances such as those described in paragraph 350-20-35-3C(a) through (g), an entity determines that it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount or if the entity elected to bypass the qualitative assessment in paragraphs 350-20-35-67 through 35-69, the entity shall determine the fair value of the entity (or the reporting unit) and compare the fair value of the entity (or the reporting unit) with its carrying amount, including goodwill. A goodwill impairment loss shall be recognized if the carrying amount of the entity (or the reporting unit) exceeds its fair value.

**ASC Paragraph 350-20-35-73 (Pre-ASU 2017-04. See Paragraph 26.010a for additional discussion.)**

A goodwill impairment loss, if any, shall be measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value. A goodwill impairment loss shall not exceed the entity’s (or the reporting unit’s) carrying amount of goodwill.

26.007 When a triggering event is identified, entities have an option to first perform a qualitative assessment to determine whether a quantitative impairment test is necessary. ASC paragraphs 350-20-35-68 and 35-69 provide guidance on additional factors to consider in performing the qualitative assessment. This guidance is consistent with the
general Step Zero guidance provided to entities that are not applying the alternative (see further discussion in Section 22). An entity also has the unconditional option to skip the qualitative assessment and proceed directly to calculating the fair value of the entity (or the reporting unit) and comparing that fair value with its carrying amount, including goodwill. If the qualitative assessment indicates that it is more likely than not that goodwill is impaired, entities must perform a quantitative test that compares the fair value of the entity (or reporting unit) with its carrying amount. A goodwill impairment loss, if any, is measured as the amount the carrying amount of the entity (or reporting unit), including goodwill, exceeds its fair value (step 2 of the goodwill impairment test is not used to measure the amount of the impairment loss). The goodwill impairment loss should not exceed the entity’s (or reporting unit’s) goodwill carrying amount. We believe the same analysis applies regardless of whether an entity’s carrying amount is above, at, or below zero. Even if goodwill is deemed not to be impaired (i.e., the fair value equals or exceeds the carrying amount), the remaining useful life of goodwill is re-evaluated once a triggering event has been identified.

26.008 Entities applying the alternative should consider the general guidance in ASC paragraphs 350-20-35-22 through 34-27 for determining the fair value of the entity (or the reporting unit) and ASC paragraphs 350-20-35-39 through 35-44 for assigning acquired assets (including goodwill) and assumed liabilities to the reporting unit when determining the carrying amount of a reporting unit. See Section 22 for further discussion. All assets that require testing for impairment (e.g., a long-lived asset group under ASC Subtopic 360-10) would be tested and, where necessary, the carrying amount adjusted for impairment before the goodwill impairment test is performed. This guidance is consistent with the general guidance applicable to entities that are not applying the alternative (see further discussion in Section 22).

26.009 Deferred income taxes should be included in the carrying amount of an entity (or the reporting unit) when testing for impairment, regardless of whether the fair value of the entity (or the reporting unit) will be determined assuming it would be bought or sold in a taxable or nontaxable transaction (see ASC paragraph 350-20-35-76). See discussion in Paragraph 26.012 on how to allocate goodwill amortization and impairment to the first and second components of goodwill.

26.010 After an entity recognizes a goodwill impairment loss, the adjusted carrying amount becomes its new basis. At that time, the entity also should re-evaluate the goodwill's remaining useful life. Goodwill's total useful life (pre- and post- impairment) should not exceed 10 years. If the entity (or the reporting unit) has more than one amortizable unit of goodwill (i.e., goodwill arose in more than one business combination or reorganization), the goodwill impairment loss should be allocated to each of those amortizable units on a pro rata basis using the relative carrying amounts of goodwill or using another reasonable and rational basis (e.g., if the entity concluded that a specific acquisition drove the impairment, the entity may conclude that it is appropriate to use a specific identification method to allocate the impairment loss). Entities are not permitted to reverse previously recognized goodwill impairment losses. ASC paragraphs 350-20-35-77 and 35-78.
In January 2017, the FASB issued ASU 2017-04 to eliminate Step 2 of the goodwill impairment test. A private company that has elected the goodwill accounting alternative and has not elected the identifiable intangible asset alternative (see additional discussion in Identifiable Intangible Assets Accounting Alternative) may discontinue applying the goodwill accounting alternative without having to justify preferability of the change. Discontinuing the goodwill accounting alternative will stop the amortization of goodwill and require annual impairment tests at the reporting unit level. However, if an entity subsequently becomes a public business entity (e.g., in an initial public offering), the entity will be required to retrospectively adjust its financial statements to remove the private company accounting alternative and adopt ASU 2017-04. See Paragraph 26.002. For additional information about ASU 2017-04, see Paragraph 22.116a.

ALLOCATING GOODWILL TO DISPOSALS

ASC paragraph 350-20-40-9 states that when a portion of an entity (or a reporting unit) that constitutes a business or not-for-profit activity is being disposed of, goodwill associated with that business or not-for-profit activity should be included in its carrying amount when determining the gain or loss on disposal and that an entity should use a reasonable and rational method to determine the amount of goodwill associated with the business or not-for-profit activity to be disposed of. This differs from the general guidance on the disposal of all or a portion of a reporting unit when the alternative is not applied. That guidance (see ASC paragraphs 350-20-40-1 through 40-7) requires entities to allocate goodwill on a relative fair value basis. We believe entities may elect to use a relative fair value basis, but there also may be other reasonable methods. For example, an entity also could specifically identify the goodwill associated with the prior acquisition of the business or not-for-profit activity to be disposed of. (Note: ASU 2017-01 changes the framework for determining whether a set of assets and activities constitutes a business. For additional information, see Paragraph 2.025.)

ALLOCATING GOODWILL AMORTIZATION AND IMPAIRMENT TO COMPONENT ONE AND COMPONENT TWO

As discussed in KPMG's Accounting for Income Taxes, Section 6, at the acquisition date, no deferred taxes are provided on (a) first component goodwill (because by definition no basis difference will exist at the acquisition date), or (b) nondeductible goodwill (i.e., second component financial statement goodwill). However, deferred taxes should be recognized at the acquisition date for basis differences related to second component tax goodwill. Deferred tax effects of goodwill basis differences arise after the acquisition when (a) the deferred tax asset associated with second component tax goodwill, if any, reverses, or (b) a basis difference arises related to first component goodwill.

A deferred tax asset should be recognized when an entity’s (or a reporting unit’s) first component tax goodwill exceeds first component financial statement goodwill. This can result from impairing financial statement goodwill, but can also result from amortizing financial reporting goodwill. The goodwill accounting alternative allows
private companies and not-for-profit entities to amortize financial statement goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate).

26.014 KPMG’s *Accounting for Income Taxes*, Section 10 discusses the tax effects of goodwill amortization for private companies and not-for-profit entities.

**PRESENTATION AND DISCLOSURE**

**ASC Paragraph 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 Paragraph 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 Paragraph 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.

**Disclosures about Additions to Goodwill**

**ASC Paragraph 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 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.

**Information for Each Period for Which a Statement of Financial Position Is Presented**

**ASC Paragraph 350-20-50-5**

The following information shall be disclosed in the financial statements or the notes to the financial statements for each period for which a statement of financial position is presented:

a. The gross carrying amounts of goodwill, accumulated 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.*

**Goodwill Impairment Loss**

**ASC Paragraph 350-20-50-6**

For each goodwill impairment loss recognized, the following information shall be disclosed in the notes to the 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 Paragraph 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 a not-for-profit entity. *

* No change in disclosure requirements when the accounting alternative is not elected, except for 350-20-50-6(c) when the entity evaluates impairment at the entity level.

**26.014a** A not-for-profit entity should functionalize goodwill amortization expense and include it in the expense analysis in its financial statements, similar to depreciation of fixed assets and amortization of finite-lived intangible assets.

**TRANSITION¹**

**ASC Paragraph 350-20-65-2**

The following represents the transition information related to Accounting Standards Updates No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill, and No. 2019-06, Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on
Goodwill and Certain Identifiable Assets to Not-for-Profit Entities, referenced in paragraph 350-20-15-3A:

a. Upon adoption of the guidance in the Accounting Alternative Subsections of this Subtopic and the guidance in [ASC] paragraph 323-10-35-13, that guidance shall be effective prospectively for new goodwill recognized after the adoption of that guidance. For existing goodwill, that guidance shall be effective as of the beginning of the first fiscal year in which the accounting alternative is adopted.

b. 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 than 10 years if an entity demonstrates that another useful life is more appropriate.

c. Subparagraph superseded by Accounting Standards Update No. 2016-03.

d. Upon adoption of the accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at either the entity level or the reporting unit level.

e. A private company or not-for-profit entity that makes an accounting policy election to apply the guidance in the Accounting Alternative Subsections of this Subtopic for the first time need not justify that the use of the accounting alternative is preferable as described in [ASC] paragraph 250-10-45-2.

26.015 Based on discussions with the FASB staff, under the transition guidance we believe a private company or not-for-profit entity has flexibility in defining its adoption period as its annual or an interim reporting period (including an interim period other than the first quarter) as long as the financial statements for that period have not yet been made available for issuance. If adopted at an interim period other than the first interim period of the year, the guidance is applied prospectively to existing goodwill as of the beginning of the first fiscal year in which the accounting alternative is adopted. We believe application to annual financial statements that have not been made available for issuance will be acceptable even if an entity has made quarterly interim financial statements available for issuance before electing the alternative (e.g., an entity that has not made its 2016 annual financial statements available for issuance may apply the accounting alternative to its 2016 annual financial statements even if it had previously issued financial statements for an earlier interim period in that year). If the alternative is first elected in the annual financial statements (e.g., for the fiscal year ended December 31, 2016), the beginning of the period of adoption is the beginning of that fiscal year (i.e., January 1, 2016 for a calendar year-end company).

26.016 For some entities, adopting the goodwill accounting alternative has an effect on their valuation allowance assessment because existing deferred tax liabilities related to the first component of goodwill will now reverse as financial statement goodwill is amortized (whereas previously, those deferred tax liabilities had an indefinite reversal period).
26.017 For example, assume ABC Corp. has a deferred tax liability (DTL) related to the difference between the financial statement and tax basis of goodwill. ABC has previously recorded a valuation allowance on all of its deferred tax assets (DTA) as it has determined it is more likely than not that it will not be able to realize its DTAs. As a result of electing the alternative to amortize financial statement goodwill under ASU 2014-02, ABC has determined that the reversal of the DTL related to the basis difference of goodwill can be considered a source of taxable income in assessing the realizability of its DTAs (previously the reversal period was determined to be indefinite and the DTL was not expected to reverse in the same period as existing DTAs). The DTL related to the basis difference of goodwill will eventually be reduced to zero as ABC recognizes goodwill amortization and can now be scheduled. Based on the taxable income that would be generated by the reversal of the DTL, ABC has determined that a valuation allowance on a portion of its DTAs is no longer needed.

26.018 We believe in this situation, ABC should recognize the change in the valuation allowance through income from continuing operations because it represents a change in judgment about the recoverability of the beginning of the year DTA due to changes in the expectation of income that would be generated by the entity in the current and future periods. ASC paragraph 740-10-45-20 provides guidance that the tax effects of changes in the valuation allowance caused by changes in circumstances that result in a change in judgment about an entity's ability to realize deferred tax assets in future years should be charged to the income statement as a component of income from continuing operations. Additionally, the current year impact of the reversal of the DTL is related to amortization of goodwill, an element of continuing operations.

IDENTIFIABLE INTANGIBLE ASSETS ACCOUNTING ALTERNATIVE

SCOPE

ASC Paragraph 805-20-15-2

A private company or not-for-profit entity may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies when a private company or not-for-profit entity is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions:

a. Applying the acquisition method (as described in paragraph 805-10-05-4 for all entities and Subtopic 958-805 for additional guidance for not-for-profit entities)

b. Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with Topic 323 on investments—equity method and joint ventures

c. Adopting fresh-start reporting in accordance with Topic 852 on reorganizations
ASC Paragraph 805-20-15-3

An entity that elects the accounting alternative shall apply all of the related recognition requirements upon election. The accounting alternative, once elected, shall be applied to all future transactions that are identified in paragraph 805-20-15-2.

26.019 All the in-scope transactions identified in ASC paragraph 805-20-15-2 result in an entity applying a new basis of accounting generally consistent with the acquisition method. See Section 13 for discussion of The Acquisition Method. An entity that elects the intangible asset accounting alternative must also adopt the goodwill accounting alternative. However, an entity that has previously adopted the goodwill accounting alternative is not required to adopt the intangible asset accounting alternative.

26.020 An entity that elects the alternative for in-scope transactions does not need to justify that the use of the alternative is preferable as described in ASC paragraph 250-10-45-2. See additional discussion in the Transition section.

RECOGNITION

ASC Paragraph 805-20-25-30

An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. However, under the accounting alternative, an acquirer shall not recognize separately from goodwill the following intangible assets:

a. Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business

b. Noncompetition agreements.

26.020a In January 2017, the FASB issued ASU 2017-04 to eliminate Step 2 of the goodwill impairment test. An entity that previously elected the identifiable intangible asset alternative and the goodwill accounting alternative (i.e., including certain intangible assets in goodwill and amortizing that goodwill) may adopt ASU 2017-04. Adopting ASU 2017-04 will require these entities to (a) discontinue their use of both alternatives; (b) retrospectively eliminate the alternatives as required by ASC Topic 250; and (c) justify the change as preferable (we generally believe the alternative accounting policies to be less preferable). For additional information about ASU 2017-04, see Paragraph 22.116a.

CUSTOMER-RELATED INTANGIBLE ASSETS

26.021 Examples of customer-related intangible assets are discussed in ASC paragraphs 805-20-55-20 through 55-28 and include:

a. Customer lists

b. Order or production backlog
c. Customer contracts and related customer relationships  
d. Noncontractual customer relationships

26.022 As discussed in ASC paragraphs 805-20-55-12 and 55-20 through 55-28, customer lists and noncontractual customer relationships do not arise from contractual or other legal rights, but may meet the separability criterion, and if so, are identifiable. Order production backlog and customer contracts and related customer relationships arise from contractual or other legal rights and therefore are identifiable without regard to separability (i.e., they also may be separable, but separability is not a necessary condition because they meet the contractual-legal criterion). See Section 7 for additional discussion of the separability criterion, contractual-legal criterion, and customer-related intangibles.

26.023 ASC paragraph 805-20-25-31 provides examples of customer-related intangibles that may meet the criterion for separate recognition under the intangible asset accounting alternative including (but not limited to):

   a. Mortgage servicing rights  
   b. Commodity supply contracts  
   c. Core deposits  
   d. Customer information (for example, names and contact information)

26.024 While the language in ASC 805-20-25-30(a) that identifies those customer relationship intangibles that may NOT be subsumed into goodwill (i.e., those that are “capable of being sold or licensed independently from other assets of a business”) is different from the separability criterion discussed in ASC paragraph 805-20-55-3 (i.e., those that are “capable of being separated or divided from the acquirer and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability”), we believe if a customer-related intangible asset meets the separability criterion, it may also meet the standard for separate recognition under the intangible asset accounting alternative (i.e., an entity will be unable to subsume it into goodwill). However, entities should consider all relevant facts and circumstances in determining whether a customer-related intangible does or does not meet the standard for separate recognition. The standard in evaluating the alternative (similar to the standard for evaluating the separability criterion) is whether a customer-related intangible asset is capable of being sold or licensed independently, whether or not the entity has an intention of selling the asset (see paragraph BC18 in the Basis for Conclusions to ASU 2014-18).

26.025 ASC paragraph 805-20-25-31 states that many of the examples of customer-related intangibles that require separate recognition also are contract-based intangible assets; however, we do not believe that all contract-based intangibles are, by definition, ineligible for the alternative (i.e., not all contract-based intangibles would necessarily require separate accounting). For example, some contract-based intangibles have contractual limitations on transfer (see Paragraph 26.026), resulting in the holder being incapable of selling or licensing them independently. Accordingly, to determine whether
an intangible (contract-based, or not) is eligible to be subsumed into goodwill, the entity will need to evaluate if it is capable of being sold or licensed independently from other assets of a business. An entity may not currently have a process in place to do that analysis on a contract-based intangible, because the intangible would require separate accounting (absent the intangible asset accounting alternative) even if it could not be sold because it meets the contractual-legal criterion. We believe entities primarily will focus on whether the asset is legally protected, separately transferable, and capable of providing discrete cash flows, which are the attributes that the PCC and Board believe users consider the most relevant in determining whether an intangible asset warrants separate accounting (see paragraph BC29 in the Basis for Conclusions to ASU 2014-18).

26.026 In evaluating whether a customer-related intangible is capable of being sold or licensed independently from other assets of a business, an entity should consider contractual limitations on transfer (in a similar way limitations are considered in the separability criterion analysis as discussed in ASC paragraph 805-20-55-4). The PCC and the Board note in the Basis for Conclusions to ASU 2014-18 that the examples of intangibles that require separate accounting represent relationships and information that can often be sold without input from the customer or their agreement to the transfer. Paragraph BC18 states that if the transfer depends on the decision of a customer, it would be clear that the entity is not capable of selling that customer-related intangible asset separately from the other assets of the business and therefore those intangible assets may be eligible for the accounting alternative.

ASC Paragraph 805-20-25-32

Contract assets, as used in Topic 606 on revenue from contracts with customers, are not considered to be customer-related intangible assets for purposes of applying this accounting alternative. Therefore, contract assets are not eligible to be subsumed into goodwill and shall be recognized separately.

26.027 Topic 606 defines a contract asset as:

An entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity’s future performance).

Contract assets are reclassified to receivables once an entity has an unconditional right to payment. Therefore, an acquired contract asset is recognized separately and does not qualify for the accounting alternative.

ASC Paragraph 805-20-25-33

A lease is not considered to be a customer-related intangible asset for purposes of applying this accounting alternative. Therefore, favorable and unfavorable leases are not eligible to be subsumed into goodwill and shall be recognized separately.

26.028 Although ASC paragraph 805-20-25-33 does not specifically address the value associated with leases in place at the acquisition date (in-place lease intangible assets) or customer relationships associated with a lease, we believe that because a lease is
specifically identified as not being considered a customer-related intangible asset for the purpose of applying the alternative, none of the identifiable intangible assets associated with an acquired lease are eligible for the alternative and all would require separate recognition. See Section 7 for additional discussion of intangibles arising from acquired lease contracts.

26.029 While favorable lease contracts are not eligible for the alternative, paragraph BC20 in the Basis for Conclusions of ASU 2014-18 states that other favorable customer contracts are eligible to be subsumed into goodwill. However, an entity will need to evaluate whether the favorable contract is capable of being sold or licensed independently from other assets of a business, and, if so, it must be recognized separately from goodwill. Unfavorable customer contracts (or other intangible liabilities recognized as result of below-market terms) are not eligible for the alternative as they are not intangible assets (i.e., offsetting of customer-related intangible liabilities against customer-related assets is not permitted).

NONCOMPETE AGREEMENTS

26.030 Section 7 describes noncompete agreements as:

Agreements that place restrictions on a person’s or a business’ ability to compete with another entity and, as such, meet the contractual-legal criterion for recognition as intangible assets. The restrictions generally relate to specified markets and/or specified products or activities for some period of time. These agreements may be entered into on a stand-alone basis, or may be embedded in another agreement, such as an acquisition agreement or an employment contract.

26.031 The PCC and the Board stated in the Basis for Conclusions to ASU 2014-18 that an entity is not required to assess whether a noncompete agreement is capable of being sold or licensed separately from the other assets of the business and that noncompete agreements would seldom, if ever, meet the criteria for recognition.

26.032 We understand (and the Basis for Conclusions acknowledges in paragraph BC19) that some entities consider noncompete agreements part of the business combination and some do not (i.e., they represent transactions separate from the business combination) because noncompete agreements are not specifically addressed in the business combinations guidance. The PCC and Board decided not to provide additional guidance on this issue. Entities that do not account for noncompete agreements in applying acquisition accounting will not be affected by the alternative.

26.033 See Section 7 for additional discussion of noncompete agreements.

ASC Paragraph 805-20-15-4

An entity that elects this accounting alternative must adopt the accounting alternative for amortizing goodwill in the Accounting Alternative Subsections of [ASC] Topic 350-20 on intangibles—goodwill and other. If the accounting
alternative for amortizing goodwill was not adopted previously, it should be adopted on a prospective basis as of the adoption of the accounting alternative in [ASC] Subtopic [805-20]. For example, upon adoption, existing goodwill should be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. However, an entity that elects the accounting alternative for amortizing goodwill is not required to adopt the accounting alternative in [ASC] Subtopic [805-20].

26.034 If the intangible asset accounting alternative is elected, an entity also is required to adopt the accounting alternative for amortizing goodwill, in which case goodwill resulting from a business combination is amortized on a straight-line basis over a period of 10 years. An entity also may amortize its goodwill over a shorter period if it can demonstrate that another useful life is more appropriate, which may be the case when goodwill consists of a significant amount of customer-related intangibles and/or noncompete agreements for which the intangible asset accounting alternative has been applied. See additional discussion beginning in Paragraph 26.003.

TRANSITION

ASC Paragraph 805-20-65-2

The following represents the transition information related to Accounting Standards Updates No. 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination, and No. 2019-06, Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Assets to Not-for-Profit Entities, referenced in [ASC] paragraph 805-20-15-1A:

a. Upon adoption of the Accounting Alternative Subsections of this Subtopic, that guidance shall be effective prospectively to the first transaction that is identified in [ASC] paragraph 805-20-15-2 after the adoption of the accounting alternative.

b. Customer-related intangible assets and noncompetition agreements that exist as of the beginning of the period of adoption shall continue to be subsequently measured in accordance with [ASC] Topic 350 on intangibles—goodwill and other. That is, existing customer-related intangible assets and noncompetition agreements should not be subsumed into goodwill upon adoption of the Accounting Alternative Subsections of this Subtopic.

c. Subparagraph superseded by Accounting Standards Update No. 2016-03.

d. A private company or not-for-profit entity that makes an accounting policy election to apply the guidance in the Accounting Alternative Subsections of this Subtopic for the first time need not justify that the use of the accounting alternative is preferable as described in [ASC] paragraph 250-10-45-2.

26.035 If elected, the accounting alternative is applied on the occurrence of the first in-scope transaction after the adoption of the accounting alternative and to all subsequent transactions.
transactions thereafter and retrospective application is not permitted (only new customer-related intangible assets and noncompete agreements arising from transactions after the adoption date are eligible for the accounting alternative).

26.036 Based on discussions with the FASB staff, under the transition guidance we believe an entity has flexibility in defining its adoption period as its annual or an interim reporting period (including an interim period other than the first quarter) as long as the financial statements for that period have not yet been made available for issuance. Once an entity elects its adoption period, the beginning of that fiscal year will become the date on which goodwill amortization will begin for existing elements of goodwill (as discussed in Paragraph 26.015).

26.037 For example, assume a calendar year entity completed business combinations in September 2016 and October 2016 and issued September 30, 2016 interim financial statements. We believe the entity will have two options for initial adoption of the accounting alternatives. The first option would be for the entity to define its period of adoption as its annual 2016 reporting period, which is permitted because the annual 2016 financial statements have not yet been made available for issuance. Under that approach, the entity would apply the intangible asset accounting alternative to its entire annual period including both the September 2016 and October 2016 business combinations (because the September 2016 transaction was the first in-scope transaction in the annual period of adoption and the alternative is applied prospectively to all subsequent in-scope transactions). The entity also would amortize existing goodwill for the entire 2016 annual period (i.e., begin amortizing as of January 1, 2016).

26.038 A second option would be for the entity to define its period of adoption as the fourth quarter of 2016, which is permitted because the fourth quarter 2016 financial statements have not yet been made available for issuance. Under that approach, the entity would apply the intangible asset accounting alternative only to its October 2016 business combination. In this situation, the entity's annual 2016 financial statements would reflect the September 2016 business combination being accounted for without the intangible asset accounting alternative applied and the October 2016 business combination with the intangible asset accounting alternative applied. Although the period of adoption is the fourth quarter, goodwill amortization would begin at the beginning of the fiscal year (January 1, 2016) for goodwill that existed on that date. Goodwill amortization would begin in September 2016 for goodwill recognized in connection with the September 2016 business combination and in October 2016 for goodwill recognized in connection with the October 2016 business combination. Under that approach, the entity would not be able to apply the intangible asset accounting alternative to the September 2016 transaction because financial statements for that period (i.e., the third quarter of 2016) had already been available for issuance. The entity would most likely use this adoption option when it has already finalized (or nearly finalized) its acquisition accounting for the September 2016 business combination and does not want to incur the cost to revise its acquisition accounting for that transaction for the purposes of its annual financial statements.
We believe the intangible asset accounting alternative may only be adopted for transactions occurring during periods for which financial statements have not been issued (or made available for issuance). For example, assume an entity completed a business combination in December 2015 and issued the 2015 financial statements indicating the acquisition accounting was provisional. That entity would not be able to apply the intangible asset accounting alternative to that December 2015 transaction on the basis that the acquisition accounting was not finalized until 2016. The fact that acquisition accounting was provisional in the previously-issued financial statements is not a factor in determining that transaction's eligibility for the intangible asset accounting alternative because ASC paragraph 805-20-15-2 speaks specifically about applying the guidance in the period when it is required to recognize the fair value of intangible assets for an in-scope transaction (e.g., the acquisition date) rather than the period in which the accounting for that transaction is completed.

1 In March 2016, the FASB issued ASU 2016-03, Effective Date and Transition Guidance: A Consensus of the Private Company Council. ASU 2016-03 amended the guidance in ASC paragraph 350-20-65-2 by (a) removing the effective date of the alternative thereby allowing a private company to elect the goodwill accounting alternative at the beginning of any annual reporting period to existing goodwill for the first time without a preferability assessment, and (b) requiring that the election be applied to all goodwill arising from subsequent business combinations occurring after the adoption of the accounting alternative. Under ASU 2019-06, the same transition guidance applies to not-for-profit entities.

2 ASU 2016-03 amended the guidance in ASC paragraph 805-20-65-2 by (a) removing the effective date of the alternative thereby allowing a private company to elect the intangible asset accounting alternative for the first time without a preferability assessment, and (b) requiring that the election be applied prospectively to the first transaction after the adoption of the accounting alternative. Under ASU 2019-06, the same transition guidance applies to not-for-profit entities.
Section 27 - Application of Pushdown Accounting

Detailed Contents

Background
When and How to Apply Pushdown Accounting
Recognition
  Example 27.1: Pushdown to Subsidiaries of an Acquired Entity
Determining Whether a Change-in-Control Event Has Occurred
Transaction Costs
Accounting for Goodwill
Treatment of Bargain Purchase Gains
Accounting for Acquisition-Related Liabilities
Effective Date
How to Apply the New Standard
  Example 27.2: Acquisition of Less Than a Majority of Outstanding Stock
  Example 27.3: Effect of a Call Option
  Example 27.4: Applying Pushdown Accounting
Financial Statement Presentation
  Example 27.5: Financial Statement Presentation
  Presentation of Contingent Expenses of the Acquiree
Acquisition-Related Debt
  Example 27.6: Joint and Several Obligation
Acquisition-Related Goodwill
  Example 27.7: Goodwill Allocation
Acquiree with Foreign entities
Acquisition Costs
Contingent Consideration
Electing Fair Value Option
Application of Pushdown Accounting at a Later Date
  Example 27.8: Change in Accounting Principle
  Example 27.9: Rolling Forward Subsequent Activity
Forgoing the Election to Apply Pushdown Accounting
Management Responsibilities for ICOFR
  Acquirer’s Consolidated Financial Statements
  Acquiree Separate Financial Statements
Change in Tax Basis
SEC and Call Report Considerations
An acquired entity is allowed, but not required, to apply pushdown accounting upon acquisition by a new controlling parent. The FASB provides specific guidance on how to account for goodwill, bargain purchase gains, and acquisition-related liabilities in the acquired entity’s financial statements.

ASC Paragraph 805-50-25-4

An acquiree shall have the option to apply pushdown accounting in its separate financial statements when an acquirer—an entity or individual—obtains control of the acquiree. An acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

a. By transferring cash or other assets
b. By incurring liabilities
c. By issuing equity interests
d. By providing more than one type of consideration
e. Without transferring consideration, including by contract alone as discussed in paragraph 805-10-25-11.

ASC Paragraph 805-50-25-6

The option to apply pushdown accounting may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree. An acquiree shall make an election to apply pushdown accounting before the financial statements are issued (for a Securities and Exchange Commission (SEC) filer and a conduit bond obligor for conduit debt securities that are traded in a public market) or the financial statements are available to be issued (for all other entities) for the reporting period in which the change-in-control event occurred. If the acquiree elects the option to apply pushdown accounting, it must apply the accounting as of the acquisition date.

ASC Paragraph 805-50-25-8

Any subsidiary of an acquiree also is eligible to make an election to apply pushdown accounting to its separate financial statements in accordance with the guidance in paragraphs 805-50-25-4 through 25-7 irrespective of whether the acquiree elects to apply pushdown accounting.

ASC Paragraph 805-50-25-9

The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.

The election to apply pushdown accounting may be made by the acquired entity in the period in which there is a new controlling parent. However, once pushdown accounting is elected, it is irrevocable. The election to apply pushdown accounting can be made separately for each change-in-control event. Additionally, the acquired entity’s subsidiaries can choose to apply pushdown accounting whether or not the acquired entity does.
BACKGROUND

27.002 *Pushdown accounting* refers to establishing a new basis of accounting in the separate financial statements of the acquired entity (or acquiree) after it is acquired. The acquisition adjustments recorded by the acquirer in a business combination under ASC Topic 805 are pushed down to the acquiree’s separate financial statements.

27.003 Before the FASB issued ASU 2014-17, *Pushdown Accounting*, U.S. GAAP provided limited guidance for determining when, if ever, pushdown accounting should be applied. If non-SEC registrants considered applying pushdown accounting, they generally looked to the SEC guidance. Additionally, pushdown accounting was generally not required when the acquiree had public debt or preferred stock outstanding.

<table>
<thead>
<tr>
<th>Rescinded SEC Guidance on Pushdown Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase transaction</td>
</tr>
<tr>
<td>An acquisition of more than 95% of an entity*</td>
</tr>
<tr>
<td>An acquisition of between 80% and 95% of an entity (inclusive)*</td>
</tr>
<tr>
<td>An acquisition of less than 80% of an entity*</td>
</tr>
</tbody>
</table>

*Under the new standard, pushdown accounting is permitted but not required upon acquisition by a new controlling parent.*

WHEN AND HOW TO APPLY PUSHDOWN ACCOUNTING

27.004 The acquirer does not need to apply acquisition accounting to enable the acquiree to elect pushdown accounting, although that may be one of the factors the acquiree considers when evaluating the benefits and costs. For example, if the acquirer was an investment company or individual, it may not be required to apply acquisition accounting. However, the acquiree would be able to elect to apply pushdown accounting if the acquirer is a new controlling parent.

27.005 Transactions including the formation of a joint venture, acquisitions of assets or groups of assets that do not constitute a business, combinations of entities under common control, and certain other transactions that are identified in ASC paragraph 805-10-15-4
are not within the scope of the standard because they do not fall under the scope of business combinations accounting.

27.006 ASU 2014-17 provides guidance on pushdown accounting for both public and nonpublic entities that are a business or nonprofit activity upon a change-in-control event. Previously, some non-SEC registrants applied the SEC’s guidance by analogy to determine whether and at what level to apply pushdown accounting. Now the standard simplifies when pushdown accounting may be applied because it specifies that it can be used by both public and nonpublic entities when there is a change-in-control event.

RECOGNITION

27.007 An acquired entity has the option to apply pushdown accounting in its separate financial statements upon acquisition by a new controlling parent. An acquirer might obtain control of an acquiree in a number of ways including:

- Transferring cash or other assets;
- Incurring liabilities;
- Issuing equity interests;
- Providing more than one type of consideration; and
- Without transferring consideration, including by contract alone as discussed in ASC Topic 805.

27.008 An acquired entity may make the election to apply pushdown accounting each time it is acquired by a new controlling parent. Once an entity elects to apply pushdown accounting to a specific change-in-control event, that decision is irrevocable.

27.009 A consolidated subsidiary of an acquired parent also has the option to apply pushdown accounting in its separate financial statements irrespective of whether the acquired parent applies pushdown accounting in its consolidated financial statements.
Example 27.1: Pushdown to Subsidiaries of an Acquired Entity

Entity A (Acquirer) acquires 80% of Entity B (acquired parent) and its wholly owned subsidiary Entity C (acquired subsidiary).

After considering the informational needs of its separate financial statement users, Entity B chooses not to apply pushdown accounting.

Entity C performs a similar evaluation as Entity B and elects to apply pushdown accounting. Its new basis is consistent with that established by Entity A even though Entity B did not apply pushdown accounting.

For purposes of Entity B’s separate consolidated financial statements, Entity C’s financial information would be based on Entity C’s historical information (not pushdown information) even though Entity C applies pushdown accounting in its separate financial statements.

ASC Paragraph 805-50-25-5

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

27.010 ASC paragraph 805-50-25-5 uses the definition of control used in the consolidation guidance in ASC Subtopic 810-10. This Subtopic indicates that a controlling financial interest generally results from one entity obtaining, either directly or indirectly, more than 50% of the outstanding shares of another entity. In some instances, the power to control an entity may exist at a lesser percentage of ownership or from other means (e.g., through a contractual arrangement or as the primary beneficiary of a variable interest entity).
27.011 The EITF and FASB considered whether consolidated subsidiaries of an acquired parent that elected pushdown accounting must make the same election. The EITF and FASB ultimately concluded that each entity in the acquired consolidated group could decide whether to apply pushdown accounting in its separate financial statements because different entities within the group may have different financial statement users with different information needs.

DETERMINING WHETHER A CHANGE-IN-CONTROL EVENT HAS OCCURRED

27.012 Consolidation guidance generally is used to identify whether control has changed. In situations where a business combination has occurred but applying the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer, ASC paragraphs 805-10-55-11 through 55-15 should be considered to determine which entity is the acquirer (see Paragraphs 4.004 - 4.022). If the acquiree is a variable interest entity, the primary beneficiary of the acquiree, as determined by ASC Subtopic 810-10, always is considered the acquirer. See SEC and Call Report Considerations for more information.

Initial Measurement

ASC Paragraph 805-50-30-10

If an acquiree elects the option in [ASC] Subtopic [805-50] to apply pushdown accounting, the acquiree shall reflect in its separate financial statements the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquiree by applying the guidance in other Subtopics of [ASC] Topic 805. If the acquirer did not establish a new basis of accounting for the individual asset and liabilities of the acquiree because it was not required to apply [ASC] Topic 805 (for example, if the acquirer was an individual or an investment company -- see [ASC] Topic 946 on investment companies), the acquiree shall reflect in its separate financial statements the new basis of accounting that would have been established by the acquirer had the acquirer applied the guidance in other Subtopics of [ASC] Topic 805.

ASC Paragraph 805-50-30-11

An acquiree shall recognize goodwill that arises because of the application of pushdown accounting in its separate financial statements. However, bargain purchase gains recognized by the acquirer, if any, shall not be recognized in the acquiree’s income statement. The acquiree shall recognize the bargain purchase gains recognized by the acquirer as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree).

ASC Paragraph 805-50-30-12

An acquiree shall recognize in its separate financial statements any acquisition-related liability incurred by the acquirer only if the liability represents an obligation of the acquiree in accordance with other applicable Topics.
An entity that elects to apply pushdown accounting in its separate financial statements on a change-in-control event will reflect the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquired entity by applying ASC Topic 805. Additionally, if pushdown accounting is elected, an entity is required to disclose sufficient information to enable financial statement users to evaluate the nature and effect of pushdown accounting.

If the acquirer does not apply ASC Topic 805 for the assets and liabilities of the acquiree (e.g., if the acquirer is an individual or an investment company), the acquiree may still elect pushdown accounting by applying the new basis in its separate financial statements consistent with what would have been the acquirer’s basis if it had applied ASC Topic 805.

In applying pushdown accounting, the carrying amounts of the assets and liabilities in the financial statements of the acquired entity are adjusted to reflect the acquisition accounting adjustments recorded (or that would have been recorded) in the consolidated financial statements of the acquiring entity as of the date control was obtained. If pushdown accounting is applied, the separate financial statements of the acquired entity must reflect all of the acquisition adjustments; partial pushdown accounting is not permitted.

**TRANSACTION COSTS**

Transaction costs incurred by the acquirer are not part of the new basis of the acquired entity. Therefore, the acquirer’s transaction costs are not pushed down to the separate financial statements of the acquired entity.

**ACCOUNTING FOR GOODWILL**

If the acquiree elects to apply pushdown accounting, goodwill arising from the application of ASC Topic 805 is recorded in the separate financial statements of the acquiree. The amount of parent goodwill pushed down to the acquiree may be different from the amount of goodwill assigned to the parent’s reporting units that include the acquiree, because the parent may assign some of the acquiree’s goodwill to other parent reporting units that may benefit from the acquisition. See the section on Acquisition-Related Goodwill for more information.

**TREATMENT OF BARGAIN PURCHASE GAINS**

A bargain purchase gain, if any, recognized by the acquirer that results from the application of ASC Topic 805 is not recorded in the income statement of the acquiree when the acquiree elects to apply pushdown accounting. The acquiree recognizes a bargain purchase gain as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree) in its separate financial statements.
ACCOUNTING FOR ACQUISITION-RELATED LIABILITIES

27.019 Acquisition-related liabilities, including debt incurred by an acquirer, is recognized in the separate financial statements of the acquired entity only if that entity is required to do so under other U.S. GAAP (e.g., if the entity is a named obligor or if it meets the requirements of joint and several liability arrangements).

27.020 When determining how to treat acquisition-related liabilities, the EITF and FASB considered the definition of a liability in FASB Concepts Statement No. 6 that states, “Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” Therefore, the EITF and FASB concluded that an acquired entity would recognize a liability incurred by the acquirer only if that obligation is the acquired entity’s liability.

Subsequent Measurement

ASC Paragraph 805-50-35-2

An acquiree shall follow the subsequent measurement guidance in other Subtopics of [ASC] Topic 805 and other applicable Topics to subsequently measure and account for its assets, liabilities, and equity instruments, as applicable.

27.021 If an acquiree elects to apply pushdown accounting in its separate financial statements, in subsequent reporting periods it would follow the subsequent measurement guidance in ASC Topic 805. This topic addresses items such as reacquired rights, indemnification assets, and contingent consideration. Guidance on how to subsequently measure goodwill and other intangible assets is provided in ASC Topic 350.

Disclosures

ASC Paragraph 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 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 of other Subtopics of [ASC] Topic 805.

ASC Paragraph 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 asserts that do not qualify for separate recognition, or other factors. In a bargain purchase (see [ASC] 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 results 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 periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete [see [ASC] 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 [ASC] paragraph 805-50-50-5.

27.022 An acquiree that elects to apply pushdown accounting in its separate financial statements must disclose, in the period in which pushdown accounting was applied (or in the reporting period in which a pushdown adjustment was recorded by the acquiree), sufficient information to enable financial statement users to evaluate the effect of applying pushdown accounting. Accordingly, the acquiree should consider the disclosures in other Subtopics of ASC Topic 805. ASC paragraph 805-50-50-6 indicates that these disclosures may include:

- The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.
- The acquisition date.
- The acquisition-date fair value of the total consideration transferred by the acquirer.
- 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 pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.
A qualitative description of the factors that make up the goodwill recognized, including expected synergies from combining operations of the acquiree, intangible assets that do not qualify for separate recognition, or other factors. In a bargain purchase, the amount 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.

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 pushdown accounting being incomplete).

The disclosures listed above are not an all-inclusive list of the disclosure requirements. The acquiree is required to disclose enough information to meet the disclosure objectives of ASC Subtopic 805-50.

The EITF decided that when an entity elects pushdown accounting, it must make sufficient disclosures to enable financial statement users to evaluate the nature and effect of pushdown accounting. An acquired entity does not need to disclose information about its decision not to apply pushdown accounting.

The disclosure requirements for entities that apply pushdown accounting are generally consistent with the disclosure requirements for entities applying business combination accounting.

**EFFECTIVE DATE**

The new standard may be applied by an acquirer to a change-in-control event occurring:

- On or after November 18, 2014; or
- Before November 18, 2014, if the financial statements for the period of the change-in-control event have not been issued (i.e., an SEC filer or a conduit bond obligor) or made available to be issued (all other entities).

Subsequent to November 18, 2014, the new standard also may be applied by an acquiree as of the acquisition date of its most recent change-in-control event as a change in accounting principle under ASC Topic 250 if:

- The acquisition date of the change-in-control event is before November 18, 2014, and
- The financial statements of the reporting period that includes the acquisition date have been issued (an SEC filer or a conduit bond obligor).

See Application of Pushdown Accounting at a Later Date for additional information.
27.028 Pushdown accounting, including pushdown of debt under SAB Topic 5.J, that has been applied by an acquiree prior to the effective date of the new standard is irrevocable.

HOW TO APPLY THE NEW STANDARD

27.029 Under pushdown accounting, the carrying amounts of the assets and liabilities in the financial statements of the acquiree are adjusted to reflect the acquisition adjustments recorded in the consolidated financial statements of the acquiring entity as of the date control was obtained. The separate financial statements of the acquiree must reflect all of the acquisition adjustments; partial pushdown accounting is not permitted.

27.030 In pushdown accounting, the acquired entity is considered a new reporting entity for accounting purposes. The retained earnings of the acquiree are eliminated and the net effect of the pushdown adjustments is recognized as an adjustment to each of the affected capital accounts attributable to common shareholders. When the acquiring entity acquires 100% of the outstanding common stock of the acquiree, the equity (i.e., capital stock and additional paid-in capital) of the acquiree after the application of pushdown accounting will generally equal the purchase price. However, if the acquiree recognizes a portion of the parent’s debt associated with the acquisition, either because it is jointly and severally liable or it is the legal obligor, the acquiree’s equity would not equal the purchase price. Additionally, if the parent entity recorded a bargain purchase gain because the purchase price was less than the acquired entity’s fair value, the equity of the acquiree, after the application of pushdown accounting, will equal the purchase price plus the bargain purchase gain. The bargain purchase gain is not recognized in the acquiree’s stand-alone financial statements.

Example 27.2: Acquisition of Less Than a Majority of Outstanding Stock

Assume that upon the acquisition of 40% of the outstanding stock of an entity that is not a VIE the buyer obtains control over the entity as defined in ASC Topic 810. Control is generally obtained when one entity obtains, either directly or indirectly, more than 50% of the outstanding shares of another entity. In some instances the power to control an entity may exist at a lesser percentage of ownership.

Although the buyer acquires less than a majority of the outstanding stock, the entity may elect to apply pushdown accounting because the acquisition of 40% of the stock was a change-in-control event.

Example 27.3: Effect of a Call Option

In 20X4, Bank A acquires an interest of 48% of Bank B’s common stock from a third party. Bank A also acquires a call option to purchase an additional 20% of Bank B’s common stock from the third party in two years at the same price per share. Assume that Bank B is not a VIE and that the transaction does not give Bank A control over
Bank B. Therefore, Bank B may not elect to apply pushdown accounting in 20X4 because there is no change-in-control event, because Bank A’s 48% ownership and call option does not give it control over Bank B.

On exercise of the call option, Bank A’s ownership will increase to 68% interest of the common stock. Assume that the exercise of the call option gives Bank A control over Bank B, which is still not a VIE. Therefore, at the time of that change-in-control event, Bank B may elect to apply pushdown accounting in its separate financial statements when Bank A becomes the new controlling parent through the exercise of the call.

Example 27.4: Applying Pushdown Accounting

ABC Corp. acquires all of the outstanding common stock of DEF Corp. for $1,000. ABC accounts for the acquisition as a business combination under ASC Topic 805. DEF elects to apply pushdown accounting in its separate financial statements.

As of the date of the acquisition, the book value of DEF’s net assets is $650. DEF’s equity accounts reflect common stock of $100, additional paid-in capital of $200, and retained earnings of $350.

The fair value of DEF’s identifiable net assets acquired is $800. Therefore, $200 is allocated to goodwill ($1,000 purchase price less the $800 fair value of identifiable net assets).

DEF records the following entry to record the pushdown accounting adjustments.

Identifiable net assets $150
Goodwill 200
Retained earnings 350
Additional paid-in capital $700

DEF’s financial statements before and after applying pushdown accounting as of the date of the acquisition reflect the following:

<table>
<thead>
<tr>
<th></th>
<th>Before Pushdown</th>
<th>After Pushdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable net assets</td>
<td>$  650</td>
<td>$  800</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>Total net assets</td>
<td>$  650</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>200</td>
<td>900</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>350</td>
<td>—</td>
</tr>
<tr>
<td>Total equity</td>
<td>$  650</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>
FINANCIAL STATEMENT PRESENTATION

27.031 The application of pushdown accounting represents a termination of one basis of accounting and the creation of a new basis. Therefore, the acquiree should not combine the periods prior to and subsequent to the date that pushdown accounting is applied. To emphasize the change in accounting basis, a vertical line generally separates the predecessor and successor financial statement periods if those periods are presented together. The financial statements would also clearly describe the basis of presentation as a result of applying pushdown accounting.

Example 27.5: Financial Statement Presentation

Parent acquires ABC Corp. on March 31, 20X5, and ABC applies pushdown accounting on that date. If ABC presents both the predecessor and successor periods in its financial statements, ABC’s December 31, 20X5 statements of income, comprehensive income, cash flows, and changes in shareholder’s equity would include a 3-month predecessor period and a 9-month successor period separated by a vertical line. The columns related to the two accounting entities would generally be labeled Predecessor and Successor or a similar designation. The notes to the financial statements would include relevant information for the predecessor and successor periods.

The following illustrates the format of columns for ABC’s statement of income for the predecessor and successor periods:

<table>
<thead>
<tr>
<th>Successor</th>
<th>Predecessor</th>
<th>Predecessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1 – December 31, 20X5</td>
<td>January 1 - March 31, 20X5</td>
<td>20X4</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$XX</td>
<td>$XX</td>
</tr>
</tbody>
</table>

PRESENTATION OF CONTINGENT EXPENSES OF THE ACQUIREE

27.032 Acquirees often incur expenses related to the business combination. Certain expenses are contingent solely on the consummation of the business combination (e.g., investment banking fees paid by the acquiree or share-based awards that accelerate vesting if the issuer has a change-in-control event). When pushdown accounting is applied to acquiree financial statements, we believe that preparers have a policy election to present such expenses in either the predecessor period or on-the-line, as discussed below. These expenses should not be recognized in the successor period.
• Predecessor presentation - The expense is recognized in the predecessor period. There is no longer a risk that the consummation of the business combination will not occur and, therefore, any cost should be recognized at the closing of the predecessor period.

• On-the-line presentation - *On-the-line* refers to the vertical line that separates the predecessor period from the successor period and means that neither the predecessor nor the successor financial statements include the contingent fees as expenses. This presentation is analogous to the guidance in ASC paragraphs 805-20-55-50 and 55-51 that certain costs triggered by the consummation of the business combination should not be recognized until consummation occurs, and would not be recognized in the period preceding the business combination.

27.033 Whichever method is used should be applied consistently to all costs triggered solely by the consummation of a business combination. Additionally, preparers should disclose their policy, the facts and circumstances and amounts.

27.034 The SEC staff addressed the presentation of expenses incurred by the acquiree that are contingent on the closing of a business combination when pushdown accounting is applied. The staff stated that registrants should determine whether each expense 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.

27.034a We believe that the staff’s reference to contingent expenses being recorded in the successor income statement refers to situations where the change-in-control event is not the sole event triggering the expense, such as double trigger awards as discussed in Example 11.12.

**ACQUISITION-RELATED DEBT**

27.035 Acquisition-related liabilities incurred by the acquirer are recognized by the acquiree in its separate financial statements if it is required to do so under U.S. GAAP. Acquisition-related liabilities include debt, which may be incurred by the acquirer to finance the acquisition of the acquiree or to finance the acquiree’s operations. The SEC staff previously provided guidance about when the acquiring entity’s debt, interest expense, and debt issuance costs should be pushed down to the acquiree in accordance with SAB Topic 5.J. However, that guidance was rescinded by SAB 115. Pushdown accounting, including pushdown of debt under SAB Topic 5.J, applied before the effective date of the new standard and SAB 115, is irrevocable.

**Example 27.6: Joint and Several Obligation**

ABC Corp. forms and contributes $100 to New Co. on April 1, 20X5. New Co. acquires a controlling financial interest in DEF Corp. on May 31, 20X5, for $200.
New Co. borrows $100 from a bank to complete this acquisition. Because New Co. was formed to acquire DEF and has minimal operations, the bank requires that DEF be jointly and severally liable for repaying the loan.

Whether or not pushdown accounting is elected, generally DEF should record the debt and interest expense in its separate financial statements based on the guidance in ASC Subtopic 405-40 after considering whether each of the co-obligors are able to repay the debt.

27.036 When the acquirer incurs acquisition-related debt that is not pushed down to the acquiree, the acquiree would record additional paid-in capital in its separate financial statements.

27.037 Debt and other liabilities may be required to be reflected in the acquiree’s separate financial statements as a result of applying other U.S. GAAP even if the acquiree does not apply pushdown accounting. For example, to finance the acquisition, if the acquirer incurred debt with the acquiree being named as the legal obligor, that debt would need to be presented in the acquiree’s financial statements even if the acquiree does not apply pushdown accounting.

27.038 The SEC’s criteria for when debt should be pushed down was rescinded by SAB 115 (see ASU 2015-08). If an acquired entity’s assets or equity are pledged as collateral against the acquirer’s debt, the acquiree is no longer required nor permitted to reflect that debt in its separate financial statements unless it is otherwise required to do so under U.S. GAAP. However, disclosures of such arrangements may be appropriate under other requirements.

ACQUISITION-RELATED GOODWILL

27.039 If pushdown accounting is applied, all goodwill related to the acquisition is pushed down to the acquiree and presented as goodwill in the acquiree’s separate financial statements, even if some of the goodwill is allocated to the other reporting units in the acquirer’s consolidated financial statements (see Paragraphs 22.115 - 22.119). If the acquiree is a public business entity, the goodwill is subject to an annual impairment test under ASC Subtopic 350-20 (see Paragraphs 22.069). Private company and not-for-profit acquirees may elect an alternative to amortize goodwill on a straight-line basis over 10 years or less if another useful life is more appropriate (see Paragraph 26.004). If the alternative is elected, the private company or not-for-profit entity also makes an accounting policy election to test goodwill at either the entity level or the reporting unit level and test for impairment only when a triggering event occurs.

Example 27.7: Goodwill Allocation

ABC Corp. acquires an 80% controlling financial interest in DEF Corp. on January 1, 20X4, for $200 and DEF elects to apply pushdown accounting. ABC recognizes
goodwill of $40 as a result of applying ASC Topic 805. Under ASC Topic 350, ABC allocates goodwill to its reporting units (RU) as follows:

RU 1 - $5 (expects to benefit from the synergies of the combination);
RU 2 - $10 (expects to benefit from the synergies of the combination); and
RU 3 - $25 (includes all operations of DEF).

Notwithstanding this allocation by ABC to its reporting units, DEF will recognize goodwill of $40 in its separate financial statements.

When DEF performs its goodwill impairment test, it must follow ASC Topic 350 guidance to assign goodwill to its reporting units and test the $40 for impairment. An impairment loss from DEF as a result of impairment testing performed at each of ABC’s reporting units results in a similar impairment loss.

27.040 While an impairment loss recognized in a subsidiary’s separate financial statements may not necessarily be recognized in the parent’s consolidated financial statements, it may represent a triggering event for the parent company.

27.041 The guidance in ASC Topic 350 requires that the parent assign all goodwill acquired in a business combination to one or more reporting units on the date of acquisition. Acquisition-related goodwill should be assigned to the reporting units of the acquirer that are expected to benefit from the synergies of the combination.

27.042 The ways in which goodwill is allocated to the acquired entity and the parent’s other reporting units may create differences between the amount of goodwill pushed down to the acquiree’s separate financial statements (i.e., all of the goodwill from the transaction) and the goodwill allocated to the acquiree at the parent level. Effectively, some of the acquiree’s goodwill might be allocated to other reporting units in the acquirer’s consolidated financial statements.

27.043 If a private company or not-for-profit entity that has been acquired by a public business entity elects the alternative accounting available for goodwill, the acquiree’s subsequent accounting for goodwill will be different from the acquirer. Because the alternative may only be elected by a private company or not-for-profit entity, the effect of this election would need to be reversed in the parent’s consolidated financial statements.

ACQUIREE WITH FOREIGN ENTITIES

27.044 We believe an acquiree with foreign entities applying pushdown accounting in its stand-alone financial statements must follow the same guidance on foreign currency
translation of goodwill and other acquisition accounting adjustments that applies to the acquirer. See discussion beginning at Paragraph 22.064a.

ACQUISITION COSTS

27.045 The acquirer may incur acquisition costs in a business combination. These costs include:

- Finder’s fees;
- Advisory, legal, accounting, valuation, and other professional or consulting fees;
- General administrative costs, including the cost of maintaining an internal acquisition department; and
- Registering and issuing debt and equity securities.

27.046 Acquisition-related costs incurred by the acquirer should be recorded as expenses by the acquirer in the periods in which the costs are incurred and the services are received, with the exception of the costs to issue debt or equity securities that are recognized under other guidance. Because acquisition costs are expensed by the acquirer when incurred and are not part of the new basis of the acquiree, they are not to be pushed down to the acquiree.

27.047 An acquirer may incur acquisition costs in a business combination and require the acquiree to reimburse them. Because the acquirer’s acquisition costs are not an expense of the acquiree, the acquiree should record the reimbursement as a distribution to the acquirer (i.e., not as an expense).

CONTINGENT CONSIDERATION

27.048 Consideration transferred in a business combination may include contingent consideration. Contingent consideration could arise from an obligation by the acquirer to transfer additional cash, other assets or equity interests to the former owners of an acquiree as part of the exchange for control if specified future events occur or conditions are met. It may also include an acquirer’s right to the return of previously transferred consideration if specified conditions are met. Under ASC Topic 805, the acquirer recognizes the acquisition-date fair value of the contingent consideration issued by the acquirer.

27.049 ASC Subtopic 805-50 does not provide guidance about whether the contingent consideration should be pushed down to the acquiree. We believe that a contingent consideration asset or liability should be pushed down to the acquiree only if the acquiree is legally obligated to pay or has the right to receive the contingent consideration. The contingent consideration would not be pushed down to the acquiree if it represents a legal right or obligation of the acquirer, not the acquiree. If that occurs and pushdown accounting is applied, the offset for the obligation that is not pushed down will be an
increase to additional paid-in capital. If the contingent consideration is not a legal obligation of the acquiree, the acquiree would not report the fair value changes of the obligation in its separate financial statements.

27.050 The treatment of contingent consideration being pushed down to an acquired entity would be similar to the treatment of an acquirer’s acquisition-related debt that is pushed down to an acquired entity’s separate financial statements.

ELECTING FAIR VALUE OPTION

27.051 ASC Section 825-10-25 specifies that entities may elect to measure financial assets and liabilities at fair value, referred to as the fair value option (FVO) for financial instruments, and also specifies when the FVO may be elected.

ASC Paragraph 825-10-25-4 (Before adoption of ASUs 2016-01 and 2016-13)²

An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:

a. The entity first recognizes the eligible item.

b. The entity enters into an eligible firm commitment.

c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting (for example, a transfer of assets from a subsidiary subject to [ASC] Subtopic 946-10 to another entity within the consolidated reporting entity not subject to that Subtopic).

d. The accounting treatment for an investment in another entity changes because either of the following occurs:

1. The investment becomes subject to the equity method of accounting (for example, the investment may previously have been reported as a security accounted for under either [ASC] Subtopic 320-10 or the fair value option in [ASC] Subtopic [825-10]).

2. The investor ceases to consolidate a subsidiary or variable interest entity (VIE) but retains an interest (for example, because the investor no longer holds a majority voting interest but continues to hold some common stock).

e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or other-than-temporary-impairment.
ASC Paragraph 825-10-25-4 (After adoption of ASUs 2016-01 or 2016-13)\(^3\)

An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:

a. The entity first recognizes the eligible item.

b. The entity enters into an eligible firm commitment.

c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting (for example, a transfer of assets from a subsidiary subject to [ASC] Subtopic 946-10 to another entity within the consolidated reporting entity not subject to that Subtopic).

d. The accounting treatment for an investment in another entity changes because the investment becomes subject to the equity method of accounting.

1. Subparagraph superseded by Accounting Standards Update No. 2016-01.

2. Subparagraph superseded by Accounting Standards Update No. 2016-01.

e. (After the adoption of ASU 2016-01 but before adoption of ASU 2016-13.) An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or other-than-temporary-impairment or accounting for equity securities in accordance with Topic 321.

e. (After the adoption of ASUs 2016-01 and 2016-13.) An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or accounting for securities in accordance with either Topic 321 on investments-equity securities or Topic 326 on measurement of credit losses.

ASC Paragraph 825-10-25-5

Some of the events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option as discussed in [ASC] paragraph 825-10-25-4(e) are:

a. Business combinations, as defined in [ASC] Subtopic 805-10

b. Consolidation or deconsolidation of a subsidiary or VIE

c. Significant modifications of debt, as defined in [ASC] Subtopic 470-50.
27.052 An entity's election to apply pushdown accounting on a change-in-control event results in the entity's applying new basis in its accounting, using the principles in ASC Topic 805. As a consequence, an entity that elects pushdown accounting also may, at that same date, elect the FVO for any of its eligible financial instruments as prescribed in the Fair Value Option portion of ASC Section 825-10-25.

APPLICATION OF PUSHDOWN ACCOUNTING AT A LATER DATE

27.053 If the acquiree does not elect to apply pushdown accounting on a change-in-control event, it can elect to apply pushdown accounting in a subsequent reporting period subject to the requirements for a change in accounting principle. In accordance with ASC paragraph 250-10-45-2, an entity may change an accounting principle only if it justifies that the alternative accounting principle is preferable. The change in accounting principle would be applied retrospectively to the date pushdown accounting could have been elected (i.e., the change-in-control event date).

27.054 Although a change to elect pushdown accounting at a later date is subject to the change-in-accounting principles requirements, including a conclusion that the new accounting principle (to apply pushdown accounting) is preferable, an initial decision to apply pushdown accounting in the period of the change-in-control event is not subject to a preferability analysis. Once an entity elects to apply pushdown accounting to a specific change-in-control-event, that decision is irrevocable.

27.055 If pushdown accounting is applied at a later date, the acquiree would retrospectively adjust its financial statements to reflect the acquirer’s basis at the date control was obtained and roll forward for subsequent activity between the date control was obtained and the date pushdown accounting was elected. Retained earnings would be reset to zero at the acquisition date and reflect subsequent earnings or losses based on the new basis established in the pushdown from the acquisition date forward to when the election to apply pushdown accounting was made.

Example 27.8: Change in Accounting Principle

ABC Corp. acquires a 90% controlling financial interest in DEF Corp. (subsidiary) on March 31, 20X5, and DEF does not elect to apply pushdown accounting in its separate financial statements. On December 31, 20X6, DEF elects to apply pushdown accounting. This election would be treated as a change in accounting principle (assuming pushdown accounting is deemed to be preferable). Under ASC Topic 250, DEF would apply the change retrospectively and revise its prior financial statements to reflect the application of pushdown accounting at the date it could have elected to apply it (March 31, 20X5, the date of the change-in-control event). The net assets to be pushed down are the parent’s basis at March 31, 20X5, rolled forward for subsequent activity from March 31, 20X5, through December 31, 20X6.
example 27.9: rolling forward subsequent activity

ghi corp. acquires all the outstanding common stock of jkl corp. for $1,000 on
january 1, 20x5. ghi accounts for the acquisition as a business combination under
asc topic 805. as of the date of the acquisition, the book value and fair value of
jkl's identifiable net assets are $650 and $800, respectively. ghi records goodwill of
$200 ($1,000 purchase price - $800 fair value of identifiable net assets).

jkl does not elect to apply pushdown accounting in its separate financial statements
on the change-in-control event but elects to apply (and justifies as preferable)
pushdown accounting on january 1, 20x6. upon the election to apply pushdown
accounting, the amount of net assets (including goodwill) to be pushed down ($800 +
200) is rolled forward for subsequent activity from january 1, 20x5 through january 1,
20x6.

assume from january 1, 20x5 through january 1, 20x6, jkl has depreciation on an
existing building of $40, acquires additional inventory of $200, collects $50 of
receivables, and incurs debt of $80. the $40 of depreciation includes the additional
depreciation based on the fair value of the assets at the acquisition date. goodwill is
tested annually for impairment rather than amortized; no impairment loss was
recognized during the period. upon the election to apply pushdown, jkl would record
the following net assets. the corresponding adjustment would be reflected in jkl's
equity.

<table>
<thead>
<tr>
<th>Net assets to be pushed down at acquisition date (january 1, 20x5)</th>
<th>Subsequent Activity</th>
<th>Election to apply pushdown accounting (january 1, 20x6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>property, plant, and equipment</td>
<td>400</td>
<td>(40)</td>
</tr>
<tr>
<td>inventory</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td>receivables</td>
<td>300</td>
<td>(50)</td>
</tr>
<tr>
<td>goodwill</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>liabilities</td>
<td>(200)</td>
<td>(80)</td>
</tr>
<tr>
<td>total net assets</td>
<td>$1,000</td>
<td>30</td>
</tr>
</tbody>
</table>

27.056 a u.s. registrant that adopts a change in accounting principle is required to file
with the sec a letter from its independent accountant indicating its view that the
alternative principle is preferable. those letters, called preferability letters, should
describe why the accounting principle adopted is preferable to the prior accounting
principle applied.
27.057 For U.S. SEC registrants, preferability letters must be included as Exhibit 18 in the first applicable filing under the Securities Exchange Act of 1934 (i.e., Form 10-Q or Form 10-K) following the accounting change. The letter need only be filed once. A preferability letter is required in Form 10-K only when the change in accounting principle occurred in the fourth quarter.

FORGOING THE ELECTION TO APPLY PUSHDOWN ACCOUNTING

27.058 An entity that has been acquired by a new controlling parent may decide not to apply pushdown accounting. This decision could be made for a number of reasons. If pushdown accounting is not applied by an entity acquired by a new controlling parent, practical difficulties could arise in subsequent periods due to the burden of managing and maintaining two sets of accounting records for the acquired entity. These difficulties could occur, for example, from having to perform two separate impairment analyses, maintaining two sets of records to track depreciation and amortization balances along with the corresponding tax balances, and recording different gains and losses when individual assets are sold. These difficulties could be further compounded if multiple reporting entities are acquired and they make different elections with respect to pushdown accounting. Entities should consider these practical difficulties during their decision-making process.

27.059 The EITF and FASB decided that when an entity elects pushdown accounting, certain disclosures will be required to enable financial statement users to evaluate the nature and effect of pushdown accounting. Furthermore, the EITF and FASB decided that an entity is not required to assess whether a change-in-control event has occurred at each reporting date.

MANAGEMENT RESPONSIBILITIES FOR ICOFR

ACQUIRER’S CONSOLIDATED FINANCIAL STATEMENTS

27.060 When the acquirer is an SEC registrant subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, it will need to design, implement, and assess the operating effectiveness of internal controls over financial reporting (ICOFR) related to the financial reporting implications the newly acquired entity may have on its consolidated financial statements. While the SEC permits the acquirer to exclude the internal controls that operate at the acquired business from management’s report on ICOFR in the year of acquisition, the acquirer’s management is still required to assess its own internal controls over the recognition, measurement, and disclosure implications of the acquisition. In the subsequent year, the acquirer’s management will need to assess the design and operating effectiveness of the internal controls over the acquiree.
ACQUIREE SEPARATE FINANCIAL STATEMENTS

27.061 If the acquiree is required to assess the effectiveness of ICOFR either because it or its parent company is subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, its management will also need to ensure it has controls around the financial statement recognition, measurement, and disclosure implications resulting from the application of pushdown accounting. Examples could include internal controls around the accurate initial and subsequent recording of pushdown accounting journal entries, ensuring those balances are accurately reflected in the acquired entity’s financial statements, appropriately recognizing acquisition-related liabilities, and having appropriate internal controls around new disclosure requirements.

CHANGE IN TAX BASIS

27.062 Deferred income taxes generally should be recognized for temporary differences related to the assets and liabilities included in both the consolidated and stand-alone financial statements. The amounts of those temporary differences for the acquired entity’s assets and liabilities may not be the same in the consolidated and separate financial statements because business combination accounting adjustments reflected in the consolidated financial statements may not have been pushed down to the acquired entity’s separate financial statements.

27.063 When an acquisition is treated as a taxable transaction (resulting in a step-up in the basis of the assets and liabilities for tax purposes) and the acquired entity does not apply pushdown accounting in its separate financial statements, the step-up in basis of the financial statement carrying amount is not reflected in the acquired entity’s financial statements. In this instance, the change in the temporary difference due to the change in tax basis is recognized as an adjustment to equity. Further, a valuation allowance recorded as of the acquisition date for the newly created deferred tax assets should also be recognized with an adjustment to equity. However, any subsequent change to the valuation allowance or change in the valuation allowance for existing deferred tax assets (including the write-off of existing deferred tax assets that the acquired entity can no longer realize as a result of the business combination) should be recognized as a component of income from continuing operations.

SEC AND CALL REPORT CONSIDERATIONS

27.064 The SEC issued SAB 115 (see ASU 2015-08) that rescinded its guidance on pushdown accounting previously contained in SAB Topic 5.J (ASC paragraph 805-50-S99-1). This action conforms SEC guidance to the new standard. The SEC staff also announced at the March 19, 2015 EITF meeting that the previous SEC staff announcements at EITF meetings (ASC paragraph 805-50-S99-2) and SEC Observer comments (ASC paragraph 805-50-S99-3) were being withdrawn.

27.065 ASC paragraph 805-50-S99-2, formerly EITF Topic D-97, stated (before being withdrawn) that the SEC staff believes that pushdown accounting is required if a
company becomes substantially wholly owned by a group of investors who act together as effectively one investor and are able to control the form of ownership of the investee and collaborate on its subsequent control (the collaborative group). For example, pushdown accounting would have been applied when three investors were part of a collaborative group based on the guidance in ASC paragraph 805-50-S99-2 and the investors acquired 30%, 30%, and 40%, respectively.

27.066 Because the collaborative group guidance is withdrawn, an entity acquired by a group of new investors who collaborate (e.g., 30%, 30%, and 40% without a contractual agreement that gives one party control), would not be able to elect pushdown accounting because no one investor obtains control of the entity.

27.067 A consolidated group of companies or an individual company frequently consists of multiple divisions or subsidiaries that would individually qualify as a business as defined in S-X Article 11. However, the parent company may not maintain or receive audited financial statements of each business component separately. When a registrant acquires a portion of a larger business (e.g., division), the audited financial statements of the acquired portion are required if that acquired business is itself deemed significant to the registrant. These financial statements often are referred to as carve-out financial statements.

27.068 The SEC staff updated its Financial Reporting Manual, which provides general guidance about financial reporting matters, to conform to the issuance of ASU 2014-17 and the rescission of SAB Topic 5.J. The SEC staff made changes to Section 7410 to remove the requirements to push down the parent’s basis in a separate component’s financial statements. Therefore, pushdown accounting would be elective for carve-out financial statements.

27.069 Call Report. The Federal Financial Institution Examination Council (federal banking agencies) issued Supplemental Instructions for December 2014 Call Reports that address pushdown accounting. The federal banking agencies rescinded the existing requirement for pushdown accounting that was consistent with SAB Topic 5.J and adopted ASU 2014-17 for Call Report purposes. However, consistent with prior Call Reports, an entity’s primary federal regulator may require or prohibit the use of pushdown accounting for Call Report purposes based on the regulator’s evaluation of whether the election appears not to be supported by the facts and circumstances of the business combination.

2 ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, and ASU 2016-13, Measurement of Credit Losses on Financial Instruments, modify subparagraphs (d) and (e) of ASC paragraph 825-10-25-4.
ASU 2016-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019.
Early adoption is permitted for nonpublic business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

ASU 2016-13 is effective for public business entities that are SEC filers for annual and interim periods in fiscal years beginning after December 15, 2019. For all other public business entities, it is effective for annual and interim periods in fiscal years beginning after December 15, 2020. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2021, and interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018.

3 ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, and ASU 2016-13, Measurement of Credit Losses on Financial Instruments, modify subparagraphs (d) and (e) of ASC paragraph 825-10-25-4.

ASU 2016-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for nonpublic business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

ASU 2016-13 is effective for public business entities that are SEC filers for annual and interim periods in fiscal years beginning after December 15, 2019. For all other public business entities, it is effective for annual and interim periods in fiscal years beginning after December 15, 2020. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2020, and interim periods in fiscal years beginning after December 15, 2021. Early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018.
Detailed Contents

Change in Reporting Entity
Common Control
  Definition of Common Control
  Entities Controlled by a Common Ownership Group
    Example 28.1: Entities Controlled by Common Ownership
Combinations Between Entities or Businesses with a High Degree of Common Ownership
  Example 28.2: Transfer or Exchange Between Entities with a High Degree of Common Ownership
Accounting for A Change in Noncontrolling Interests from a Common Control Transaction
Transfers of Net Assets or Equity Interests between Entities Under Common Control
  Accounting and Reporting by the Receiving Entity
    Example 28.2a: Accounting by the Receiving Entity in a Combination of Entities under Common Control
    Example 28.2b – Adjustment to Consideration Payable after Common Control Ends (Asset Acquisition)
    Example 28.3: Change in Reporting Entity of Receiving Entity
Presentation of Prior Period Financial Statements
  Example 28.4: Prior Period Financial Statements of Receiving Entity
Conforming Accounting Methods
  Presentation of Historical Earnings per Share
  Distribution of Cash or Assumption of Liabilities
    Example 28.5: Accounting for Distribution of Cash or Assumption of Liabilities
Costs Related to Combinations of Entities Under Common Control
Goodwill Impairment
  Example 28.6: Two Methods of Goodwill Impairment
Identifying the Predecessor Entity When Entities Are Not Under Common Control for All Comparative Periods
  Example 28.7: Identifying the Predecessor Entity
Accounting and Reporting by the Transferring Entity
  Financial Statement Presentation of Contributed Net Assets or Equity Interests
  Recognition of Differences Between Amounts Contributed and Proceeds Received
Impairment Considerations
  Example 28.8: Trigger for Impairment Evaluation
ASC Topic 805 carries forward the previously existing guidance on accounting for combinations involving entities under common control. ASC Topic 805 specifically excludes combinations between entities or businesses under common control from the scope of the business combinations guidance. Common control transactions do not meet the definition of a business combination because there has not been an acquisition by parties outside the continuing control group (i.e., no change-in-control event). Combinations between entities or businesses under common control involve exchanges or movements of net assets or equity interests between entities controlled, directly or indirectly, by the same parent, investor, or ownership group that has agreed to vote in concert.

ASC Subtopic 805-50 provides guidance about accounting for transactions between entities under common control. Even though the disclosure requirements apply specifically to the receiving entity, we believe the transferring entity should consider making similar disclosures.

Overview

ASC Paragraph 805-50-05-4

As noted in [ASC] paragraph 805-10-15-4(c), the guidance related to business combinations does not apply to combinations between entities or businesses under common control.

ASC Paragraph 805-50-05-5

Some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. In practice, the method that many entities have used to account for those transactions is similar to the pooling-of-interests method. The Transactions between Entities under Common Control Subsections provide guidance on preparing financial statements and related disclosures for the entity that receives the net assets.

Scope

ASC Paragraph 805-50-15-5

The guidance in the Transactions between Entities under Common Control Subsections applies to all entities.

ASC Paragraph 805-50-15-6

The guidance in the Transactions between Entities under Common Control Subsections applies to combinations between entities or businesses under common control. The following are examples of those types of transactions:

a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.

b. A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.
c. A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.

d. A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.

e. A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.

f. A limited liability company is formed by combining entities under common control.

g. Two or more not-for-profit entities (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

**ASC Paragraph 805-50-15-6A**

The guidance in the Transactions between Entities under Common Control Subsections does not apply to the initial measurement by a primary beneficiary of the assets, liabilities, and noncontrolling interests of a VIE if the primary beneficiary of a VIE and the VIE are under common control. Guidance for such a VIE is provided in [ASC] Section 810-10-30.

**ASC Paragraph 805-50-15-6B**

Mergers and acquisitions between or among two or more NFPs, all of which benefit a particular group of citizens, shall not be considered common control transactions solely because those entities benefit a particular group. The mission, operations, and historical sources of support of two or more NFPs may be closely linked to benefiting a particular group of citizens. However, that group neither owns nor controls the NFPs.

**Recognition**

**ASC Paragraph 805-50-25-2**

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at the date of transfer. See the Transactions between Entities under Common Control Subsection of [ASC] Section 805-50-45 for guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.
Initial Measurement

ASC Paragraph 805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

ASC Paragraph 805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. [ASC] Section 250-10-45 provides guidance if retrospective application is impracticable.

Other Presentation Matters

ASC Paragraph 805-50-45-1

[ASC] Paragraph 805-50-25-2 establishes that the assets and liabilities transferred between entities under common control are to be initially recognized by the receiving entity at the transfer date. This Subsection provides guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.

ASC Paragraph 805-50-45-2

The financial statements of the receiving entity shall report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intra-entity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intra-entity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented shall be eliminated to the extent possible.
ASC Paragraph 805-50-45-3
The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities need not be eliminated. However, [ASC] paragraph 805-50-50-2 requires disclosure.

ASC Paragraph 805-50-45-4
Similarly, the receiving entity shall present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

ASC Paragraph 805-50-45-5
Financial statements and financial information presented for prior years also shall be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries shall indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years shall only be adjusted for periods during which the entities were under common control.

Disclosure

ASC Paragraph 805-50-50-1
[ASC] Paragraphs 805-50-45-1 through 45-5 provide guidance on financial statement presentation in the period of transfer and for periods before the transfer of assets and liabilities between entities under common control. This Subsection addresses incremental disclosures related to such a transaction.

ASC Paragraph 805-50-50-2
The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities is not required to be eliminated under the guidance in [ASC] paragraph 805-50-45-3 but shall be disclosed.

ASC Paragraph 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 Paragraph 805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with [ASC] Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

CHANGE IN REPORTING ENTITY

28.002 The FASB carried forward without reconsideration ASC Subtopic 805-50 guidance for accounting for transfers of net assets or exchanges of equity interests between entities under common control. ASC paragraph 805-50-05-5 states that some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. ASC Topic 250, Accounting Changes and Error Corrections, defines a change in the reporting entity as financial statements that, in effect, are those of a different reporting entity and that the changes generally are limited to (1) presenting consolidated or combined financial statements in place of financial statements of individual entities, (2) changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and (3) changing the entities included in combined financial statements. If the equity interests or net assets transferred between entities under common control meet the definition of a business, the transaction will result in a change in reporting entity that is accounted for by recognizing the net assets received at the ultimate parent’s book value and retrospectively revising all comparative periods presented. This accounting is sometimes referred to as the as-if pooling-of-interests method.

28.003 If the equity interests or net assets transferred between entities under common control do not constitute the transfer of a business, including when a nonsubstantive holding company is added to an existing entity or consolidated group, a change in reporting entity has not occurred. Transfers of assets between entities under common control that do not result in a change in reporting entity are generally accounted for prospectively (i.e., comparative periods are not recast). The following flowchart illustrates the process for evaluating the accounting treatment for a common control transaction from the receiving entity’s perspective:
Does common control exist ("control" as described in ASC 810-10)?

- No
  - Treat transaction as an asset acquisition (ASC 805-50) or a business combination (ASC 805)

- Yes
  - Is the form of the transaction considered to be an asset or a business?
    - Business
      - Record at carrying value, apply retrospective adjustment
    - Asset
      - Record at carrying value\(^1\), apply prospectively

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\(^1\) As an exception, it is generally acceptable for routine transfers of inventory for which valuation is not in question between entities under common control in the ordinary course of business to be accounted for as sales (including gain recognition by the transferor and a step-up in basis for the transferee). Additionally, if the form of the transaction is a transfer of financial assets between subsidiaries of a common parent or from a parent to a subsidiary, the entities must consider the requirements in ASC Topic 860, *Transfers and Servicing*, when determining whether to recognize the transfer as a sale. See Paragraph 28.030.

## COMMON CONTROL

### DEFINITION OF COMMON CONTROL

28.004 Only transactions in which all combining entities in the transaction are controlled by the common parent or a controlling ownership group that has agreed to vote in concert both before and after the combination qualify as combinations of entities under common control. As a general rule, ownership by one entity, directly or indirectly, of over 50% of the outstanding voting shares of another entity represents control. Control could also be achieved by means other than majority ownership of outstanding voting shares (i.e., contractual, agreement, or irrevocable assignment of ownership rights). Two or more entities may be deemed to be under common control when they are subject to control by the same parent, investor, or ownership group that has agreed to vote in concert. As used here, *control* has the same meaning as used in the FASB’s guidance on consolidation (ASC 810-10). See Section 2 of this book for a discussion on the definition of control.

28.005 The term common control is not defined in ASC Topic 805. EITF Issue No. 02-5, “Definition of ‘Common Control’ in Relation to FASB Statement No. 141,” discusses whether separate entities are under common control when there is common majority ownership by an individual, a family, or a group affiliated in some other manner. The
EITF did not reach a consensus. However, during the discussion, the SEC Observer stated that the SEC staff believes common control exists in the following situations:

a. An individual or enterprise holds more than 50% of the voting ownership interest of each entity.

b. Immediate family members hold more than 50% of the voting ownership interest of each entity and there is no evidence that those family members will not vote their shares in concert. Immediate family members include a married couple and their children, but not the married couple’s grandchildren. Situations in which entities are owned in varying combinations among living siblings and their children require careful consideration regarding the substance of the ownership and voting relationships in determining whether the related entities are under common control.

c. A group of shareholders holds more than 50% of the voting ownership of each entity, and that group provides contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert.

28.006 While this SEC Observer comment was not carried forward into the Codification, our experience is that this observer comment generally holds in practice. Judgment is required to determine whether common control exists in situations other than those described above.

28.007 See KPMG’s Consolidation of Variable Interest Entities for discussion of means of control other than voting ownership interests, such as ownership of another variable interest, as consideration should be given to all of the facts and circumstances surrounding the relationships between the parties.

ENTITIES CONTROLLED BY A COMMON OWNERSHIP GROUP

28.008 Under ASC paragraph 805-50-30-5, the receiving entity should measure the net assets received in a combination of entities that are under common control at the historical cost of the ultimate parent.

Example 28.1: Entities Controlled by Common Ownership

Five owners are subject to an owners’ agreement that includes the necessary provisions to treat the five owners as a controlling ownership group. The five owners hold the following percentages of voting common stock in four combining enterprises.
Owners A, B, C, D, and E have agreed to a business combination in which those owners will exchange their interests in Co W, Co X, Co Y, and Co Z for interests in NEWCO. Co W, Co X, Co Y, and Co Z each constitute a business. The business combination should be treated as a combination of entities under common control.

NEWCO’s consolidated financial statements for periods before the business combination would include the historical cost basis of Co X’s, Co Y’s, and Co Z’s assets and liabilities for all prior periods in which the controlling ownership group held a controlling financial interest in the combining entities. The interests held by the unaffiliated owners in Co X and Co Z would be presented as noncontrolling interests in NEWCO’s consolidated financial statements for all periods presented (see Section 15, Noncontrolling Interests in Consolidated Financial Statements if the unaffiliated owners’ interests in Co X and Co Z are acquired by NEWCO).

NEWCO’s consolidated financial statements for all periods presented would reflect the historical cost basis of Co W on the equity method because the controlling ownership group did not hold a controlling financial interest in Co W during those periods.

COMBINATIONS BETWEEN ENTITIES OR BUSINESSES WITH A HIGH DEGREE OF COMMON OWNERSHIP

28.009 A transaction between entities with a high degree of common ownership, but that are not under common control, should be assessed to determine whether the transaction lacks substance. Paragraph 6 of FASB Technical Bulletin No. 85-5, Issues Relating to Accounting for Business Combinations, stated, “if the exchange lacks substance, it is not a purchase event and should be accounted for based on existing carrying amounts.” Although FASB Technical Bulletin No. 85-5 was superseded by Statement 141(R), we believe this guidance remains relevant for transactions that lack economic substance.

28.010 The SEC staff has indicated that in a transfer or exchange between entities with a high degree of common ownership, they often compare the percentage owned by shareholders in the combined entity to the percentages owned in each of the combining entities before the transaction. When the percentages have changed (even by small
amounts) or the owned interests are not in substance the same before and after the transaction, the SEC staff believes a substantive transaction has occurred and historical cost accounting is not appropriate.

**Example 28.2: Transfer or Exchange Between Entities with a High Degree of Common Ownership**

Assume that Investor A and Investor B each own 50% of Company X and Company Y. Investor A and Investor B are unrelated and they have no agreement that would cause them collectively to be a controlling group over their investees. Company X acquires Company Y by exchanging new shares of Company X for all of the outstanding shares of Company Y previously held by Investor A and Investor B. After the transaction, each investor continues to own 50% of Company X and Company X owns 100% of Company Y.

**Structure before the transaction**

<table>
<thead>
<tr>
<th>Ownership Interests</th>
<th>Company X</th>
<th>Company Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Investor B</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Should Company X account for the acquisition of Company Y as a business combination?

The percentage that each investor owns in the combined company is the same percentage they each owned before the transaction. Therefore, we believe the transfer of ownership is a non-substantive exchange and should be accounted for by Company X at carry over basis on an as-if pooling-of-interests basis. We note, however, that even small changes in the ownership percentages or other economic factors could result in the conclusion that a transaction has substance and should be accounted for as a business combination under ASC Topic 805.
ACCOUNTING FOR A CHANGE IN NONCONTROLLING INTERESTS FROM A COMMON CONTROL TRANSACTION

28.011 Under ASC paragraphs 810-10-45-21A through 45-24, the accounting and reporting requirements for changes in noncontrolling interests in a subsidiary require that an increase in a parent’s (including a common control group) ownership interest in a subsidiary is accounted for as an equity transaction. Additionally, a decrease in ownership of a subsidiary while maintaining control also is accounted for as an equity transaction unless a scope exception is provided. Therefore, for these transactions, no gain or loss is recognized in income in the parent’s financial statements. This also means that there is no change in the carrying amount of the subsidiary’s assets or liabilities. This accounting treatment is consistent with the view that noncontrolling interest holders are a part of the ownership interest in the consolidated entity. Therefore, transactions involving the interests held by those noncontrolling owners should be reflected as equity transactions in the consolidated financial statements.

28.012 If the parent retains a controlling financial interest in a subsidiary, the transaction will be recorded as an equity transaction. Accordingly, the carrying amount of the noncontrolling interest is adjusted to reflect the change in ownership in a subsidiary as a result of the transaction.

28.013 If a parent ceases to have a controlling financial interest in a subsidiary, then the parent is required to deconsolidate the subsidiary as of the date it loses control over that subsidiary. For more information on accounting for noncontrolling interests in consolidated financial statements, see Section 7 of this book. However, if a parent deconsolidates a subsidiary through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in ASC Topic 845 applies.

TRANSFERS OF NET ASSETS OR EQUITY INTERESTS BETWEEN ENTITIES UNDER COMMON CONTROL

ACCOUNTING AND REPORTING BY THE RECEIVING ENTITY

28.014 Under ASC paragraph 805-50-30-5, assets and liabilities transferred or shares exchanged between entities under common control are accounted for at the historical cost of those entities’ ultimate parent, in a manner similar to which a pooling-of-interests was accounted for under APB 16, Business Combinations (as-if pooling-of-interests accounting). If the carrying amount of the assets and liabilities transferred differs from the historical cost of the parent of the entities under common control, for example, because push-down accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.
Example 28.2a: Accounting by the Receiving Entity in a Combination of Entities under Common Control

An investment fund (the Fund) has two portfolio companies (Company A and Company B) that the Fund is planning to combine as entities under common control by contributing the stock of Company A to Company B in preparation for an IPO. Company A was acquired by the Fund a number of years ago and pushdown accounting has never been applied to the separate financial statements of Company A. As an investment company, the Fund never completed acquisition accounting in its financial statements because the investment in Company A was accounted for at fair value after acquisition.

The consolidated financial statements of Company B will reflect the Fund’s basis in Company A because ASC paragraph 805-50-30-5 requires that the financial statements of the receiving entity reflect the transferred assets and liabilities at the historical cost of the parent as though acquisition accounting had been applied from the date the Fund acquired Company A, with amounts adjusted for subsequent depreciation, amortization, accretion, impairment, etc. (essentially forcing pushdown accounting to be applied).

28.015 Any difference in the amount paid (or payable) by the transferee versus the historical cost of the assets (i.e., parent basis) transferred to the transferee is recorded as an adjustment to equity by the transferee/subsidiary and investment by the parent (i.e., as a capital contribution or distribution). A subsequent adjustment to the amount paid (or payable) to the transferor is also recorded in equity. We believe the subsequent adjustment should be recorded in equity even if common control no longer exists at the time of the subsequent adjustment to the amount paid (or payable), unless the reporting entity has adopted a new basis of accounting (e.g., as a result of applying pushdown accounting following a subsequent acquisition). See ASC Subtopic 845-10, Nonmonetary Transactions - Overall for a discussion of exchanges, transfers, and other nonmonetary transactions.

Example 28.2b: Adjustment to Consideration Payable after Common Control Ends (Asset Acquisition)

On June 30, 20X8, Subsidiary acquires from Parent a newly constructed power plant that is pending regulatory inspection in a common control transaction. Subsidiary records the asset at Parent’s carrying amount ($30). Total consideration is $50, consisting of $45 of cash at the acquisition date and a $5 payment contingent on regulatory certification of the plant (expected to occur in October 20X8). The contingent payment is akin to a holdback and is considered highly certain to occur, and Subsidiary recognizes a liability of $5 at the date of transfer. As described in Paragraph 28.015, the difference between Parent’s carrying amount of the asset and the amount paid (or payable) is recorded as an adjustment ($20 reduction) to equity.
On August 30, 20X8, Parent sells the stock of Subsidiary to an unrelated acquirer and common control ends. Subsidiary elects not to apply pushdown accounting in its stand-alone financial statements. At that time, the $5 consideration is still payable as certification has not yet occurred. In October 20X8, the regulator identifies deficiencies in the plant that Subsidiary must remediate before certification. As a result, Subsidiary negotiates with (its former) Parent to settle the outstanding payment at $3.

We believe Subsidiary should record the $2 adjustment to the liability in equity in its stand-alone financial statements, consistent with how it would have recorded the adjustment if common control still existed. That is, the net result is the same as if the consideration had been fixed at $48 at the time of the common control transaction.

If Subsidiary had elected to apply pushdown accounting, that would have created a new basis of accounting for both the asset and the liability, and Subsidiary would record the adjustment to the liability in its income statement.

If Parent and Subsidiary had not been under common control at the time of the transfer, the guidance on asset acquisitions would have applied. Subsidiary would have recorded the asset initially at its cost ($50, plus any acquisition-related costs), and the $2 adjustment would have reduced the carrying amount of the asset (see KPMG’s Issues In-Depth, Asset acquisitions, Section 3.5 and Section 4.8).

28.015a If a transaction is a transfer of financial assets within the scope of ASC Topic 860, Transfers and Servicing, it should be evaluated and accounted for under that guidance. Evaluating whether a transfer of financial assets between entities under common control is recognized as a sale under ASC Topic 860 requires careful consideration of the relationship between the involved parties. See paragraph 860-10-55-78 for additional application guidance for transfers of financial assets between subsidiaries of a common parent and paragraph 860-10-55-17D for guidance on transfers from a parent to a consolidated subsidiary.

28.016 If a transaction results in the acquisition of all, or part, of a noncontrolling equity interest in a subsidiary, the acquisition of the noncontrolling interest is accounted for as an equity transaction under ASC Topic 810, Consolidation. Likewise, if a common control transaction results in an increase in the noncontrolling interest of a subsidiary (i.e., disposition of a portion of the parent's interest in a subsidiary while the parent retains control after the transaction), the transaction is also accounted for as an equity transaction under ASC Topic 810. No gain or loss is recognized in consolidated net income or comprehensive income as a result of changes in noncontrolling interests when the ultimate parent retains control of the subsidiary.
Example 28.3: Change in Reporting Entity of Receiving Entity

Parent Company owns 100% of the voting stock of Subsidiary B and 100% of the voting stock of Subsidiary C. Subsidiary B and Subsidiary C own 45% and 40% of the voting stock of Subsidiary D, respectively. An unrelated entity owns the remaining 15% of Subsidiary D’s voting stock.

Subsidiary C transfers its 40% ownership of Subsidiary D to Subsidiary B.

The Parent Company's noncontrolling interest in Subsidiary D is $150. Its carrying value of controlling financial interest in Subsidiary D is $850 (representing 85% of Subsidiary D’s equity).

The transfer of Subsidiary C's equity interest in Subsidiary D to Subsidiary B is a common control transaction and is recorded by Subsidiary B at the parent’s carrying amount of $400 ($850 × (40% / 85%). This transaction does not affect the consolidated financial statements of Parent Company because its total ownership interest in Subsidiary D has not changed. However, if Subsidiary B presents stand-alone consolidated financial statements, the transfer of Subsidiary C’s 40% interest in Subsidiary D would result in a change in reporting entity for Subsidiary B. Consequently, Subsidiary B will include Subsidiary D in its financial statements using the as-if pooling-of-interests method described in ASC Subtopic 805-50 and, accordingly, Subsidiary B would retrospectively consolidate Subsidiary D and include Subsidiary D’s results of operations in its consolidated results of operations for all periods presented (assuming that Subsidiary D is a business and was under common control for all historical periods).

PRESENTATION OF PRIOR PERIOD FINANCIAL STATEMENTS

28.017 In as-if pooling-of-interests accounting, financial statements of the previously separate companies for periods before the combination are recast on a combined basis for all prior periods that the entities are under common control, assuming a change in reporting entity has occurred. ASC paragraph 805-50-45-5 specifies that the financial statements of previously separate entities are not combined for periods before the date that common control was established. When applying the guidance for a change in reporting entity, the financial statements should be presented for all periods as if the combination occurred at the inception of common control or as of the earliest period presented if the entities are under common control for all periods presented, unless it is impracticable to do so (see ASC paragraph 250-10-45-9).
Example 28.4: Prior Period Financial Statements of Receiving Entity

Company A has a controlling financial interest in Company B. On January 1, 20X2, Company A acquires a controlling financial interest in Company C. Company A merges Company C into Company B on January 1, 20X3 with Company B being the surviving subsidiary.

Company B’s financial statements for periods before January 1, 20X2 (the date common control was established) are not recast. Rather, Company B’s financial statements for periods before January 1, 20X2 continue to reflect only Company B’s financial position and results of operations. The historical financial statements of Company C are combined with those of Company B as of January 1, 20X2.

CONFORMING ACCOUNTING METHODS

28.018 When applying the as-if pooling-of-interests method of accounting for combinations of entities under common control, the accounting principles used by the transferring entity may differ from those used by the receiving entity. In this circumstance, the carrying amounts of the transferred entity may be adjusted to the basis of accounting used by the receiving entity if the change is preferable under ASC Topic 250. Under ASC paragraph 805-50-30-6, a change in accounting to conform to the receiving entity’s accounting policies that is determined to be preferable is applied retrospectively.

PRESENTATION OF HISTORICAL EARNINGS PER SHARE

28.019 In an as-if pooling for transactions among entities under common control, the entities’ balance sheets, results of operations, and cash flows are added together and reported as if the entities had always been combined (starting with the earliest period that the entities are under common control). We believe that an entity generally should apply this same concept to EPS computations. An entity should retrospectively adjust prior period EPS to reflect the restated income or loss it would have reported in prior periods if the entities under common control had always been combined, similar to a stock split if shares are issued to stockholders of the contributing entity.

28.020 Generally, the numerator should equal the sum of the numerators of the combined entities and the denominator should reflect aggregate adjusted weighted average outstanding shares, based on equivalent shares of the combined entity. However, if either of the combined entities have potential common stock, the guidance in ASC paragraph 260-10-55-16 applies and the surviving entity should determine if the retroactive restatement of income from continuing operations causes potential common stock originally considered to be dilutive to become antidilutive (or vice versa).
DISTRIBUTION OF CASH OR ASSUMPTION OF LIABILITIES

28.021 In certain situations, cash may be disbursed or liabilities may be assumed in combinations of entities under common control. Any difference between the amount of cash disbursed or the fair value of the liabilities assumed and the historical cost of the net assets acquired is accounted for as an equity transaction (i.e., a dividend or a capital contribution).

Example 28.5: Accounting for Distribution of Cash or Assumption of Liabilities

Parent Company owns 100% of the voting stock of Subsidiary A and 60% of the voting stock of Subsidiary X. Parent Company transfers its 60% interest in Subsidiary X to Subsidiary A for cash of $220. Parent Company's carrying amount of its investment in Subsidiary X is $200.

On receipt of Subsidiary X, Subsidiary A should record (1) its investment in Subsidiary X at $200 (Parent Company's carrying amount) and (2) a dividend to Parent Company of $20. Parent Company should record a net decrease in its investment in Subsidiary X of $200, an increase in its investment in Subsidiary A of $200, and a dividend from Subsidiary A of $20 for the difference between the cash received of $220 and the carrying amount of its investment in Subsidiary X of $200.

COSTS RELATED TO COMBINATIONS OF ENTITIES UNDER COMMON CONTROL

28.022 Although ASC Topic 805 excludes combinations of entities under common control from the scope of the business combinations guidance, the accounting for costs related to a combination of entities under common control is consistent with its guidance. ASC Topic 805 requires acquisition costs incurred in a business combination to be expensed in the period incurred, unless they are costs related to the issue of debt or equity instruments, in which case they are accounted for under applicable guidance. See Section 7 for more information on accounting for acquisition-related costs.

28.023 A combining entity that will be merged with entities under common control may have developed or may intend to develop a plan to integrate the businesses of the combining entities. That plan may include, among other things, terminating employees, disposing duplicative facilities, consolidating or relocating equipment and facilities, integrating information systems, or canceling lease contracts and executory contracts. A combining entity will recognize as liabilities only those costs that qualify for recognition if the requirements in ASC Topic 420 are met. For more information on the guidance in ASC Topic 420, see Section 7.
GOODWILL IMPAIRMENT

28.024 Goodwill presented in the financial statements of entities combined under common control should continue to be tested for impairment under ASC Topic 350. The authoritative literature does not provide explicit guidance to determine the reporting units or the process to test goodwill for impairment with respect to the comparative periods presented in the receiving entity’s financial statements. In our experience, two methods have developed in practice.

28.025 The first method continues to use the historical reporting units for the combined entity, as if the combination under common control had not occurred until the date of the actual combination (Method A). This method alleviates the need for management to make hypothetical judgments about the operations and management of the combined entity for periods preceding the combination. However, this method requires management to evaluate the reporting structure of the combined entity after the combination. The guidance in ASC paragraph 350-20-35-45 should be followed to allocate goodwill to newly identified reporting units on reorganization of the reporting structure:

ASC Paragraph 350-20-35-45
When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in [ASC] paragraphs 350-20-35-39 through 35-40 shall be used to reassign assets and liabilities to the reporting units affected. However, goodwill shall be reassigned to the reporting units affected using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of (see [ASC] paragraphs 350-20-40-1 through 40-7).

28.026 Under the second method, reporting units are identified as if the combination occurred at the beginning of the earliest period presented (Method B). This method requires management to make assumptions about how the operations of the combined entity would have been managed in prior periods as if the entities had been combined in those periods. This is the case even if doing so is not consistent with how the separate operations were managed during those periods. A benefit of this approach is that it does not require a reorganization of the reporting structure at the date of the actual combination.

Example 28.6: Two Methods of Goodwill Impairment

Method A
Company X was merged into Company Y in a combination of entities under common control on January 1, 20X4. Before the combination, Company X had one reporting unit (RU1X) and Company Y had two reporting units (RU1Y and RU2Y). After the combination, reporting unit RU1X was integrated with reporting units RU1Y and RU2Y. Company Y (the entity receiving the net assets of Company X) used Method
A to determine its reporting units to test goodwill for impairment after the transaction.

For Company Y’s financial statements for the year ended December 31, 20X4 and its comparative year ended December 31, 20X3, Company Y identified reporting units RU1X, RU1Y, and RU2Y to test goodwill impairment for the year ended December 31, 20X3 (period prior to combination). Because goodwill was tested for impairment (without impairment) at these three reporting units for the year ended December 31, 20X3, no impairment would be recognized for 20X3 in the recast 20X3 financial statements of Company Y. For the year ended December 31, 20X4, goodwill in reporting unit RU1X was assigned to reporting units RU1Y and RU2Y based on the relative fair values of the two portions of reporting unit RU1X prior to those portions being integrated with reporting units RU1Y and RU2Y, respectively.

**Method B**

Company X was merged into Company Y in a combination of entities under common control on January 1, 20X4. Before the combination, Company X had one reporting unit (RU1X) and Company Y had two reporting units (RU1Y and RU2Y). After the combination, reporting unit RU1X was integrated with reporting units RU1Y and RU2Y. Company Y (the entity receiving the net assets of Company X) used Method B to determine its reporting units to test goodwill for impairment after the transaction.

For Company Y’s financial statements for the year ended December 31, 20X4 and its comparative year ended December 31, 20X3, Company Y identified reporting units RU1Y and RU2Y with RU1X integrated amongst RU1Y and RU2Y as if the operations of RU1X had always been integrated into those reporting units. In order to assess goodwill impairment, management will need to make assumptions about how those operations would have been managed before the common control transaction. Depending on the assumptions made, impairment at one or more reporting units could have been triggered in the historical period.

**IDENTIFYING THE PREDECESSOR ENTITY WHEN ENTITIES ARE NOT UNDER COMMON CONTROL FOR ALL COMPARATIVE PERIODS**

**28.027** Identifying the predecessor entity is necessary when the entities included in the common control transaction were not under common control for all comparative periods presented. Under ASC paragraph 805-50-45-5, the financial statements of previously separate entities should not be combined for periods before the date that common control was established. In the postcombination financial statements, only the predecessor entity should be included in comparative periods preceding the date that common control existed. In 2006, the SEC staff commented that the predecessor entity is typically the entity that was first controlled by the parent entity or control group. In our experience, this perspective provides a practical approach for identifying the predecessor entity and
prevents the parent entity from using the legal form of the transaction to determine the financial reporting of the combined reporting entity.

Example 28.7: Identifying the Predecessor Entity

Parent Co. acquired Company Y and Company X on January 1, 20X1 and 20X2, respectively. Parent Co. transferred Company Y to Company X for cash consideration on December 31, 20X2.

Q. Which entity is the predecessor entity?

Q. What financial information would be included in the financial statements for combined Company Y and Company X for the two year period ended December 31, 20X2?

A. Because Company Y was controlled by Parent Co. before Company X, Company Y is the predecessor entity.

The financial statements of the combined entity for the two years ended December 31, 20X2 would include the following:

- Financial statements of Company Y for the year ended December 31, 20X1. Company X’s financial statements are not included for the year ended December 31, 20X1 because common control of Company X did not exist for that period.
- Financial statements of Company Y and Company X presented on a consolidated basis for the year ended December 31, 20X2.

28.028 If the entity first controlled by the parent is trivial or otherwise lacks substance, it may be appropriate to conclude that this entity is not the predecessor. If common control was established prior to the periods presented in combined financial statements it is unnecessary to determine the predecessor entity since the financial statements of the previously separate entities will be combined for all periods presented.

ACCOUNTING AND REPORTING BY THE TRANSFERRING ENTITY

28.029 ASC Subtopic 805-50 addresses the accounting by the receiving entity in combinations of entities under common control but does not provide guidance on the accounting by the transferring entity.
FINANCIAL STATEMENT PRESENTATION OF CONTRIBUTED NET ASSETS OR EQUITY INTERESTS

28.030 ASC Topic 805 is silent on the accounting by the entity that transfers the net assets or equity interests. Generally, we believe the transferring entity should report the transfer as a disposal pursuant to ASC Subtopic 360-10. Under ASC paragraph 360-10-40-4, “a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed” and should be accounted for as held and used until such date as provided under ASC paragraph 360-10-45-15. The transferring entity should continue to classify the asset or asset group as held and used until it is disposed (i.e., no presentation of discontinued operations prior to disposal). If the transferring entity distributes the asset or group to owners in a spin-off, that disposal shall then be reported in discontinued operations if it meets the conditions in ASC paragraphs 205-20-45-1A through 45-1C.

28.030a Consistent with the accounting and reporting by the receiving entity, if a transaction between subsidiaries of a common parent represents a transfer of financial assets, it should be evaluated and accounted for under the guidance in ASC Topic 860. Evaluating whether a transfer of financial assets between entities under common control is recognized as a sale under ASC Topic 860 requires careful consideration of the relationship between the involved parties. See paragraph 860-10-55-78 for additional application guidance for transfers of financial assets between subsidiaries of a common parent and paragraph 860-10-55-17D for guidance on transfers from a parent to a consolidated subsidiary.

28.031 Generally, we do not believe it is appropriate to recast the transferring entity’s historical financial statements to eliminate the transferred entity from its financial statements as if the subsidiary had never been owned by the transferring entity (i.e. retrospective adjustment of prior period financial statements, often referred to as the de-pooling method). However, in certain limited circumstances in which a common control transfer of the net assets or equity interests results in a change in reporting entity of the transferring entity, the transferring entity may consider the guidance in ASC paragraph 505-60-S99-1 (SAB Topic 5-Z.7).

28.032 ASC paragraph 505-60-S99-1 addresses whether a company, which disposes of a business in a spin-off transaction prior to filing an initial registration statement with the SEC, may characterize the transaction as a change in reporting entity and restate its financial statements as if the company never had an investment in the disposed of business. ASC paragraph 505-60-S99-1 provides criteria for considering if there has been a change in reporting entity by the transferring entity. While ASC paragraph 505-60-S99-1 does not specifically address transactions between entities under common control, the criteria may be used in limited circumstances to determine whether a change in reporting entity has occurred from the transferring entity’s perspective.
28.033 It is important to note that all of the criteria in ASC paragraph 505-60-S99-1 must be met for the transferring entity to conclude that a change in reporting entity has occurred. This conclusion may be acceptable if the entities under common control:

- Are dissimilar businesses (dissimilarity is intended to mean substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by ASC Topic 280);
- Are 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 transaction; and
- Will not have material financial commitments, guarantees, or contingent liabilities to each other after the transaction.

28.034 We believe careful consideration should be applied in determining whether a change in reporting entity of the transferring entity has truly occurred. If any of the criteria are not met, the presumption is retrospective adjustment of the prior period financial statements is ordinarily not appropriate.

RECOGNITION OF DIFFERENCES BETWEEN AMOUNTS CONTRIBUTED AND PROCEEDS RECEIVED

28.035 Because there has not been a change in basis for the control group, we do not believe a transferring entity should recognize a gain or loss upon transferring net assets or equity interests to an entity under common control. A difference between the carrying amount of net assets transferred and proceeds received, should be recognized by the transferring entity as an equity transaction (i.e., recognized as a contribution/distribution from/to shareholders). Recognizing the difference as an equity transaction is consistent with the guidance in ASC Subtopic 845-10 with respect to nonreciprocal transfers to owners.

ASC Paragraph 810-10-40-5

If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in [ASC Subtopic 845-10, Accounting for Nonmonetary Transactions,] applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in [ASC] paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent . . . .

ASC Paragraph 845-10-30-10

Accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination shall be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (see [ASC] paragraph 360-10-40-4) of the nonmonetary assets distributed.
[ASC] Subtopic 505-60 provides additional guidance on the distribution of nonmonetary assets that constitute a business to owners of an entity in transactions commonly referred to as spinoffs. A pro rata distribution to owners of an entity of shares of a subsidiary or other investee entity that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spinoff. Other nonreciprocal transfers of nonmonetary assets to owners shall be 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.

28.036 Without authoritative literature specific to the transferring entity, we believe these paragraphs of ASC Section 845-10-30 provide appropriate guidance. Thus, the accounting effectively is a reorganization of the mutual parent company. This guidance is also consistent with the principles of ASC Subtopic 805-50, which specifies that the acquirer account for a combination of entities under common control at the ultimate parent’s carrying amount but is silent with respect to the transferring entity’s accounting.

IMPAIRMENT CONSIDERATIONS

28.037 The transferring entity should consider whether the planned transfer indicates that the assets to be transferred should be tested for recoverability. ASC paragraph 360-10-35-2 provides circumstances that trigger a recoverability analysis for assets to be held and used. Paragraph 360-10-35-21(f) states that one of those triggers is “a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.” We believe many have considered by analogy the guidance in ASC paragraph 360-10-40-4 for combinations of entities under common control.

ASC Paragraph 360-10-40-4

For purposes of [ASC] Subtopic [360-10], a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset (asset group) is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In such a case, an undiscounted cash flows recoverability test shall apply prior to the disposal date. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value. The provisions of this Section apply to nonmonetary exchanges that are not recorded at fair value under the provisions of [ASC] Topic 845.
To the extent that both the transferring and the receiving entities are part of the same consolidated group, paragraph 360-10-35-21(f) is not applicable for the purpose of preparing the parent entity's consolidated financial statements, as the transfer does not represent a disposal from the parent's perspective.

28.038 A loss on disposal is recorded if the fair value of the disposal group that constitutes a business is less than its carrying amount.

Example 28.8: Trigger for Impairment Evaluation

Background

An entity considers whether to dispose of a business through a transfer to an entity under common control and, while no final decision has been made, it believes it is more likely than not that the transfer will occur in the next 12 months.

Q. If an entity expects that it is more likely than not it will transfer a business to an entity under common control, is that a trigger for impairment evaluation?

A. Yes. ASC paragraph 360-10-35-21 provides the indicators that trigger a recoverability analysis for assets to be held and used. ASC paragraph 360-10-35-21(f) states that one of those triggers is “a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.”

ASC paragraph 360-10-40-4 indicates that if an asset to be held and used is tested for recoverability, the cash flows should be based on the remaining life of the asset, assuming the disposal transaction will not occur. That paragraph also states that “in addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value.”

1 Prior to adoption of ASU 2014-09, Revenue from Contracts with Customers, and ASU 2017-05, the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets, conveyances of oil and gas mineral rights and transfers of in-substance real estate are excluded from the guidance on changes in ownership while the parent maintains control. After adoption of ASU 2014-09 and ASU 2017-05, conveyances of oil and gas mineral rights and transfers of goods or services to a customer in the scope of ASC Topic 606 are excluded from this guidance.
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