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Business combinations and noncontrolling interests

Partially updated May 2024

About the Business combinations guide

PwC is pleased to offer our updated accounting and financial reporting guide, *Business combinations and noncontrolling interests*.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Bankruptcies and liquidations (BLG)*
- *Carve-out financial statements (CO)*
- *Consolidation (CG)*
- *Crypto assets (CA)*
- *Derivatives and hedging (DH)*
- *Equity method investments and joint ventures (EM)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Foreign currency (FX)*
- *Income taxes (TX)*

- *Insurance contracts (IG)*
- *Leases (LG)*
- *Loans and investments (LI)*
- *Not-for-profit entities (NP)*
- *Property, plant, equipment and other assets (PPE)*
- *Revenue from contracts with customers (RR)*
- *Stock-based compensation (SC)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in May 2024

Chapter 2: Acquisition method

- A standard setting note was removed from **BCG 2.5**, and content in **BCG 2.5.11**, **BCG 2.5.15**, **BCG 2.5.16.3**, **BCG 2.5.16.3A**, and **BCG 2.5.17** was updated for ASU 2024-02, *Codification Improvements—Amendments to Remove References to the Concepts Statements*.
- As ASC 326 is effective for all entities, **BCG 2.5.2A** was removed.
- **BCG 2.6.3** was updated to address the determination of the fair value of equity securities issued by the acquirer as part of the consideration transferred when there are restrictions associated with those securities.
- **BCG 2.7.1.4** was updated to clarify the accounting by the acquirer for the acquiree’s acquisition-related costs that remain unpaid at the acquisition date.
- **BCG 2.9** was enhanced to address the accounting for a measurement period adjustment that is identified in the period after the balance sheet date but before the financial statements are issued or available to be issued.

Chapter 9: Accounting for goodwill post acquisition

- ASU 2017-04 is effective for all entities. The chapter has been updated to remove all guidance regarding step two of the goodwill impairment test, which was superseded. The qualitative assessment remains unchanged, but all references to “step one” and “step two” of the goodwill impairment test have been changed to the “quantitative” assessment. Accordingly, certain questions, examples, and figures have been renumbered to conform with these updates.
- **BCG 9.4.7** was removed. The related guidance on litigation that arises between the acquirer and the former owners of the acquiree related to the business combination was moved to **BCG 2.7**.

- **Example BCG 9-23** in **BCG 9.10.4** was updated to clarify the guidance on the accounting for impairment testing of goodwill allocated to a disposal group classified as held-for-sale but that has not yet been sold.
- **BCG 9.11.1.8** was removed. Presentation and disclosure guidance related to goodwill accounting alternatives for private companies is included in **FSP 8.10.2** and **FSP 8.10.3**.

Revisions made in February 2024

Chapter 1: Overview of accounting for business combinations

- **BCG 1.1.2** was updated to refer to the accounting by a joint venture, upon formation, in the joint venture's separate financial statements after adoption of ASU 2023-05, which is addressed in Chapter 6 of PwC's *Equity method investments and joint ventures* guide.

Chapter 8: Accounting for indefinite-lived intangible assets

- **BCG 8.4** was updated to add a summary of the new guidance on the accounting for and disclosure of crypto assets after adoption of ASU 2023-08, which is addressed in PwC's *Crypto assets* guide.

Revisions made in September 2023

Chapter 2: Acquisition method

- **BCG 2.7.1.3** was updated to add **Example BCG 2-29**, which illustrates the accounting for transaction costs incurred by the acquiree on behalf of the seller as well as costs incurred directly by the seller in the acquiree's pre-acquisition financial statements.

Chapter 5: Partial acquisitions and changes in NCI

- **Example BCG 5-11** in **BCG 5.4.4** was updated to clarify existing guidance on accounting for a reallocation of accumulated other comprehensive income upon a change in ownership that does not result in a change of control.

Chapter 7: Common control transactions

- **Example BCG 7-9** in **BCG 7.1.3.3** was enhanced to provide additional analysis on the accounting by the receiving entity in a common control transaction, including consideration of the application of pushdown accounting.

Chapter 10: Pushdown accounting

- **BCG 10.1.11** was removed. The related guidance, which addressed presentation and disclosure considerations for an acquiree that elects pushdown accounting, is included in FSP 17.6.

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***Chapter 1:
Overview of accounting for
business combinations—
updated February 2024***

1.1 Overview: accounting for business combinations

This chapter discusses the key characteristics of a business and identifies which transactions require the application of business combination accounting. Business combination accounting is referred to as the “acquisition method” in ASC 805, *Business Combinations*. See discussion of the acquisition method in BCG 2. Determining whether the acquisition method applies to a transaction begins with understanding whether the transaction involves the acquisition of one or more businesses and whether it is a business combination within the scope of ASC 805.

All transactions in which an entity obtains control of one or more businesses qualify as business combinations, as described in the FASB’s Master Glossary. ASC 805-10-25-1 further establishes the principle for identifying a business combination.

Excerpt from ASC Master Glossary

business combination: A transaction or other event in which an acquirer obtains control of one or more businesses.

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

1.1.1 Definition of control

A business combination is defined as a transaction or other event in which an acquirer obtains control of one or more businesses. Under ASC 805, control is defined as a having a controlling financial interest, as described in ASC 810-10-15-8. There are two primary consolidation models in ASC 810, *Consolidation*: the variable interest entity (VIE) and voting interest entity (VOE) models. A reporting entity that has a variable interest in a legal entity not subject to a scope exception would need to first determine whether the VIE model applies. Only if the entity is determined not to be a VIE would the VOE model be applied. Acquisition accounting under ASC 805 is applied irrespective of whether control is gained under the VIE or VOE model. See PwC’s *Consolidation* guide (CG) for further information about the determination of the appropriate model to apply and assessing whether control has been obtained.

1.1.2 Transactions excluded from the scope of ASC 805

The following types of transactions are specifically excluded from the scope of ASC 805:

- **Formation of joint ventures:** In practice, the term “joint venture” is usually referred to rather loosely. Structures or transactions that are not joint ventures for accounting purposes are commonly called joint ventures. However, the scope exception in ASC 805 for the creation or formation of a joint venture applies only if the transaction meets the accounting definition of a joint venture or corporate joint venture under ASC 323, *Investments – Equity Method and Joint Ventures*. By definition, no one party obtains control in the creation of a joint venture. The most distinctive characteristic of a joint venture is participants’ joint control over the decision-making

process, although other characteristics must also be met (e.g., the purpose of the entity must be consistent with that of a joint venture). ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, changed the accounting by a joint venture, upon formation, in the joint venture’s separate financial statements. See EM 6.4A and EM 6.4 for additional information about the accounting by a joint venture upon formation before and after the adoption of ASU 2023-05, respectively. If the transaction does not meet the definition of a joint venture or corporate joint venture, the transaction does not meet the scope exception and should be evaluated under ASC 805.

- **Acquisition of an asset or a group of assets that does not constitute a business:** The acquisition of an asset or a group of assets that is not a business should not be accounted for as a business combination. See PPE 2 for additional information on asset acquisitions and BCG 1.2 for additional information on assessing whether an acquired group of assets constitutes a business.
- **Combinations involving entities or businesses under common control:** As discussed in ASC 805-50-15-6, common control transactions are transfers and exchanges between entities that are under the control of the same parent, or are transactions in which all of the combining entities are controlled by the same party or parties before and after the transaction and that control is not transitory. See BCG 7 for the accounting for such a transaction. Sometimes NewCos are formed as part of a common control transaction, which is discussed in ASC 805-50-15-6 and BCG 7.
- **Certain combinations between not-for-profit organizations and acquisitions made by not-for-profit organizations:** Certain combinations between and acquisitions by not-for-profit organizations are excluded from the scope of ASC 805. Due to the nature and purpose of these organizations, these combinations might not involve the exchange of equal economic values. Such combinations are accounted for in accordance with ASC 958, *Not-for-Profit Entities*. See PwC’s *Not-for-profit entities* (NP) guide for details on accounting for not-for-profit entities.
- **Financial assets and financial liabilities of a consolidated VIE that is a collateralized financing entity:** Financial assets and financial liabilities of a consolidated VIE that is a collateralized financing entity are excluded from the scope of ASC 805. See CG 6.1.1 and FV 6.2.7 for additional information.

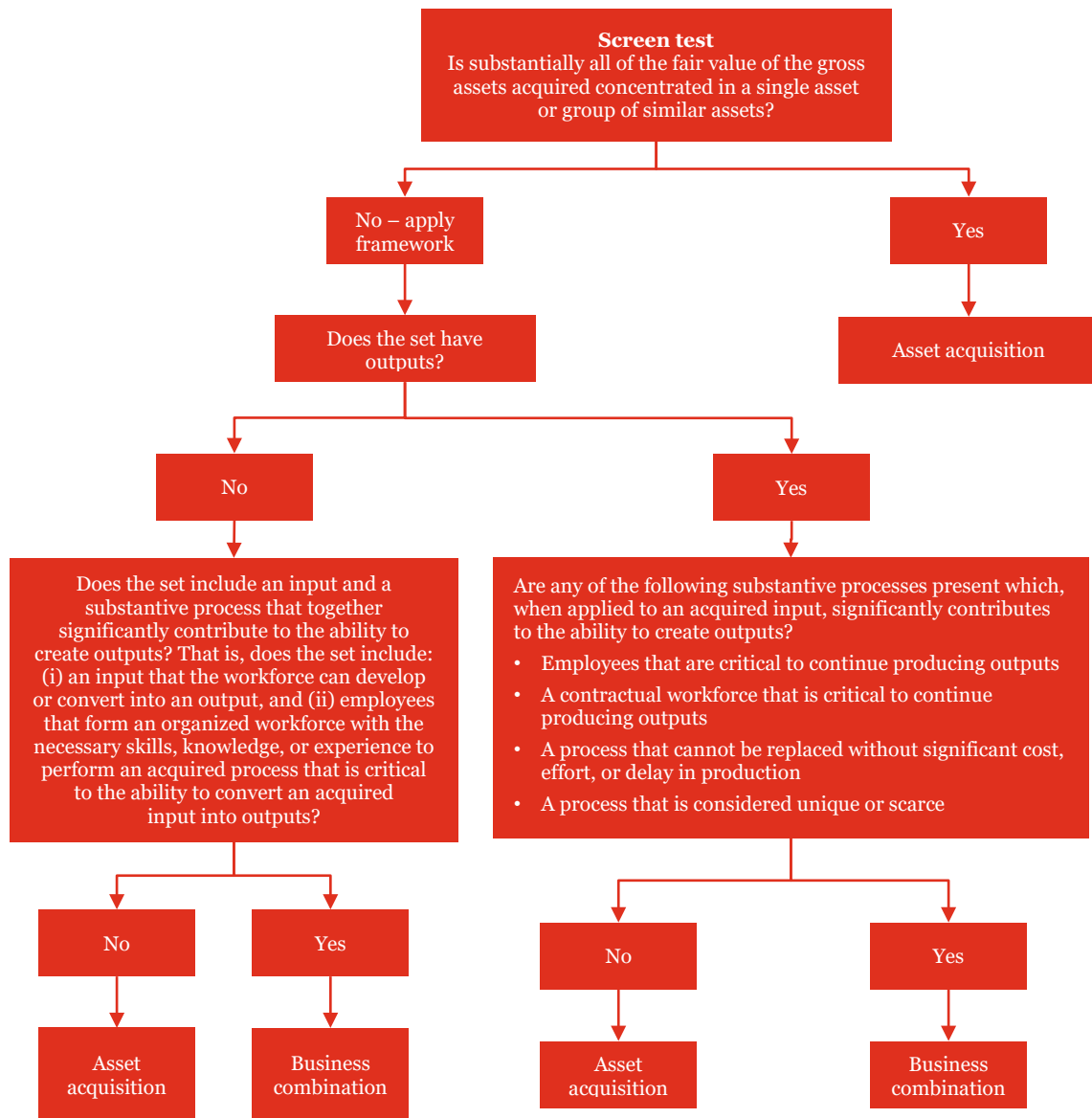
1.2 Definition of a business

ASC 805 provides a framework for entities to use in evaluating whether an integrated set of assets and activities (collectively a “set”) should be accounted for as an acquisition of a business or a group of assets. It includes an initial screen to determine if substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If that screen is met, the set is not a business. The framework also specifies the minimum required inputs and processes necessary to be a business.

Figure BCG 1-1 provides a summary of the framework for evaluating whether an acquired set is a business or a group of assets.

Figure BCG 1-1

Framework for evaluating whether an acquired set is a business or a group of assets



1.2.1 The screen test

The screen test is designed to identify, with little cost or effort, a transaction that is clearly more akin to an asset acquisition and remove it from the scope of the business combinations guidance.

In applying the screen test, an entity determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If so, the set is not considered a business. While the standard does not define what constitutes “substantially all,” this term is used in other areas of GAAP (e.g., revenue, leases). There is no bright line, but it is typically interpreted to mean at least 90%. When there is uncertainty around whether the quantitative threshold of the screen test is met because the ratio is close to 90%, additional factors should be considered. Such additional factors may indicate that a set is a business, and therefore the framework

should be applied to determine whether the set is a business. Additional factors that may indicate that the set is a business include, but are not limited to, the following (no one factor is determinative):

- Types of assets included in the set. For example, a set that includes distinct types of assets rather than a single primary asset or group of complementary assets.
- Goodwill. For example, the presence of more than an insignificant amount of goodwill. However, goodwill is not required for a set to be a business. See BCG 1.2.3 for additional information.
- The set operates independently. For example, a production operation or division that is independent and is inclusive of other substantive elements within the set.

In situations when it is apparent that performing a quantitative test would indicate the transaction is an asset acquisition, the initial screen may be performed qualitatively. For example, assume a reporting entity acquires a license for a drug candidate and an at-market service contract. If the at-market contract is qualitatively determined to have little or no fair value, then based on the significance of the license, it is clear that the threshold is met. In contrast, if a set includes multiple licenses for dissimilar drug candidates, and each has more than an insignificant fair value, the reporting entity could qualitatively determine that the threshold is not met. However, even if a reporting entity believes that a single asset has been acquired, a deal valuation model that includes cash flows that go beyond the economic life of the identified asset or incorporates a terminal value based on recurring anticipated cash flows (i.e., capitalization of a final year's cash flows) may indicate the existence of other assets or business goodwill, and a quantitative test should likely be performed.

1.2.1.1 *Single asset for the purpose of applying the screen test*

As discussed in ASC 805-10-55-5B, a single asset for the purpose of applying the screen test includes any individual asset or group of assets that could be recognized and measured as a single asset under the business combination guidance. For example, ASC 805 allows certain complementary intangible assets with similar useful lives to be grouped as a single asset. Refer to BCG 4.4 for guidance on complementary intangibles.

Certain assets are considered a single asset for the purpose of applying the screen test. This grouping is only applicable for the screen test, and all assets acquired continue to be recorded separately in acquisition accounting, consistent with US GAAP. Below are two scenarios in which separately recorded assets must be considered a single asset for the purpose of applying the screen test:

- A tangible asset that is attached to another tangible asset should be considered a single asset. This includes an intangible asset representing the right to use a tangible asset (e.g., a building with an associated ground lease). To be considered attached, assets cannot be physically removed and used separately without incurring significant costs. For example, land and a building would generally be recognized as separate assets in a business combination but would be considered a single asset when performing the screen test.
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets should be considered a single asset (e.g., a building and an associated in-place lease intangible asset).

Question BCG 1-1

For purposes of the screen test, is an assembled workforce considered a single identifiable asset?

PwC response

No. ASC 805-20-55-6 does not permit an assembled workforce to be recognized as a separately identifiable intangible asset in a business combination. An acquirer may attribute value to the existence of an assembled workforce, but that value is subsumed into goodwill. Therefore, an assembled workforce cannot be a single asset for purposes of applying the screen test. However, the value attributed to an assembled workforce would be included in the denominator of the screen test as part of the gross assets acquired (see BCG 1.2.1.3).

We believe that it would be rare for a reporting entity to acquire only a workforce without also acquiring processes, technology, or equipment. If a reporting entity acquires a workforce that is not generating outputs, judgment will be required to determine if the transaction is a business combination or an asset acquisition. If it is determined that the transaction is an asset acquisition, the assembled workforce would be recognized as a discrete intangible asset on the balance sheet and amortized over its useful life.

Question BCG 1-2

When two or more assets are combined as a single asset for the purpose of applying the screen test, how should the assets be recorded within a reporting entity's books and records?

PwC response

The assets used for the screen test can be different from the assets recorded for financial reporting. Assets that are attached and inseparable should be considered a single asset for the purpose of applying the screen test. For example, land, the building on the land, and a related in-place lease intangible asset would be considered a single asset for the purpose of applying the screen test. However, for financial reporting purposes, three separate assets would be recorded in the reporting entity's financial statements. The three separate assets would be accounted for separately under their respective accounting guidance.

1.2.1.2 *Similar assets for the purpose of applying the screen test*

The screen can also be met if the fair value of the set is concentrated in a group of similar assets. Entities should consider the nature of the assets and the risks associated with managing and creating outputs when determining if assets should be grouped as similar. If the risks are not similar, the assets cannot be combined for the screen test. Identifying similar assets based on the nature of the assets and their risk characteristics is an area that requires significant judgment. Risks that might need to be considered depend on the nature of the asset, but could include class of customers, commercialization risk, location, size, market risk, and regulatory risk. If the assets are not similar, the determination of whether the acquired set constitutes a business should be made using the framework as the acquired processes used to manage the assets may be substantive.

ASC 805-10-55-5C states that the following should not be considered similar assets for the purpose of performing the screen:

- A tangible asset and an intangible asset
- Intangible assets in different major intangible asset classes (e.g., customer-related intangibles and trademarks)
- A financial and a nonfinancial asset
- Different major classes of financial assets (e.g., accounts receivable and investments)
- Different major classes of tangible assets (e.g., inventory and fixed assets)
- Assets within the same major asset class that have significantly different risk characteristics (e.g., real estate investments that consist of residential and commercial properties)

Question BCG 1-3

Does a right-of-use asset need to be considered in the screen test used to determine whether the transaction is a business combination or an asset acquisition?

PwC response

Yes, the right-of-use asset should be included in the screen test.

A single asset for purposes of the screen test includes any individual asset or group of assets that could be recognized and measured as a single asset under the business combination guidance (ASC 805). In accordance with ASC 842, a right-of-use asset is recognized as a single asset. The right-of-use asset includes the favorable or unfavorable terms of the lease under the business combinations guidance, as discussed in BCG 4.3.3.7.

Consideration should also be given to whether the right-of-use asset and other separately recorded assets should be considered a single asset for purposes of applying the screen test. This grouping is only applicable for the screen test, and all assets acquired should be recorded separately in acquisition accounting. One scenario in which separately recorded assets are considered a single asset for the purpose of applying the screen is a tangible asset that is attached to another tangible asset, as well as an intangible asset that represents the right to use an underlying tangible asset (e.g., a building with an associated right-of-use asset in a ground lease, leasehold improvements with an associated right-of-use asset in an office lease).

A right-of-use asset should be considered when grouping similar assets as well. The screen can also be met if the fair value of the set is concentrated in a group of similar assets. Entities should consider the nature of the assets and the risks associated with managing and creating outputs when determining if assets should be grouped as similar. For example, a company that leases multiple office buildings that each represent separate lease components should assess whether the lease components are considered similar assets that should be grouped for the purpose of applying the screen test.

Example BCG 1-1 discusses a reporting entity's acquisition of real estate and the consideration of similar assets for the purpose of applying the screen test.

EXAMPLE BCG 1-1

Acquisition of real estate

Company A is a real estate company that owns and manages a group of rental properties. In order to grow its business, Company A purchases a set of ten residential homes (including the land, building, and property improvements) and the in-place leases associated with the properties. The residential homes acquired are located in the same city but are dissimilar in terms of size and layout. No employees or other assets are acquired with the homes and in-place leases.

Has Company A purchased a business or a group of assets?

Analysis

The acquired assets should be considered similar for the purpose of applying the screen test. Although the homes are different in size and layout, the nature of the assets and the risks associated with operating the properties are similar. The in-place leases are related to the real estate and would be considered part of the group of similar assets when applying the screen.

As the land, building, leasehold improvements, and in-place leases are considered similar for the purpose of applying the screen test, 100% of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets. The set meets the screen test and would be considered an asset acquisition. When accounting for the asset acquisition, the assets would be recorded separately in accordance with US GAAP.

1.2.1.3 Gross assets for the purpose of applying the screen test

For the purpose of applying the screen test, the fair value of the gross assets acquired is determined based on the guidance in ASC 805-10-55-5A and is not necessarily the same as the consideration transferred. This may be caused, for example, by liabilities assumed, which are factored into the determination of purchase price but are excluded from gross assets in the denominator of the screen test. Liabilities assumed, with the exception of unfavorable in-place lease liabilities that are combined with the related leased asset (ASC 805-10-55-5B(b)), are excluded from gross assets acquired. The purpose of using gross assets acquired rather than net assets or total consideration paid is to avoid having the amount of leverage in the asset group impact the analysis. Examples of liabilities excluded from gross assets for purposes of the screen test include debt (e.g., a mortgage on an acquired building) and asset retirement obligations (AROs) (e.g., an ARO on acquired long-lived assets; see BCG 2.5.7.2).

Gross assets will also differ from the consideration transferred in a partial acquisition (i.e., it is impacted when there are noncontrolling interests and previously held interests). When a transaction results in control of a legal entity being obtained, even if less than 100% of the entity is acquired, gross assets used in the screen should include the consideration transferred plus the fair value of any noncontrolling interests and previously held interests. For example, in the acquisition of a 60% controlling interest in an entity, the gross assets would include the 60% acquired interest plus the 40% noncontrolling interest (i.e., 100% of the gross assets would be used as the denominator in the screen). Similarly, this would apply for previously held equity interests. For example, if a company owned an

initial 10% interest and subsequently acquired a 70% controlling interest, the gross assets would include the fair value of the 10% previously held equity interest, the 70% acquired interest, and the 20% noncontrolling interest.

The fair value of gross assets includes any consideration transferred in excess of the fair value of the net assets acquired (i.e., what would otherwise be recorded as goodwill in a business combination). As noted in BCG 1.2.1.1, this includes any amount attributable to an assembled workforce. However, as described in ASC 805-10-55-5A, gross assets acquired excludes the following items:

- Cash and cash equivalents
- Deferred tax assets
- Goodwill resulting from the effects of deferred tax liabilities

These items are excluded as the FASB did not believe the tax form of the transaction and whether cash and cash equivalents were included should affect the determination of whether the set is a business.

ASC 805-10-55-5A does not address whether gross assets should be reduced when a bargain purchase gain exists. Although a bargain purchase gain is not expected to be recognized frequently, we believe a bargain purchase gain should be excluded from the denominator. Otherwise, the bargain purchase gain would reduce the fair value of the gross assets acquired and potentially distort the outcome of the screen test (similar to if liabilities were included in the denominator).

Example BCG 1-2 illustrates a reporting entity acquiring a pharmaceutical company and the related accounting considerations, including the screen test.

EXAMPLE BCG 1-2

Acquisition of a pharmaceutical company

Company A is a pharmaceutical company. Company A acquires a 60% controlling interest in Company T in a nontaxable transaction for \$240. The fair value of Company T's net assets includes \$200 of cash, deferred tax assets of \$50, and in-process research and development assets (IPR&D) of \$100. The fair value of the noncontrolling interest is \$160.

Are substantially all of Company A's net assets concentrated in a single or group of similar assets?

Analysis

The gross assets acquired are \$150, comprised of the \$240 of consideration transferred plus noncontrolling interest of \$160 less cash of \$200 and deferred tax assets of \$50. The excess of the gross assets acquired over the single asset represents what would be recorded as goodwill in a business combination.

The calculation of the screen test is as follows:

Single asset	= \$100 (IPR&D)
Gross assets acquired	= \$150

As only 67% of the gross assets acquired are concentrated in a single asset, the screen test is not determinative that the set is an asset acquisition and the framework must be applied.

1.2.2 **The framework: definition of a business**

It is critical to determine whether the acquired set is a business because the accounting treatment for a business combination under ASC 805 differs from the accounting for an asset acquisition. ASC 805-10-55-3A defines a business.

Excerpt from ASC 805-10-55-3A

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

In order to be a business, a set needs to have an input and a substantive process that together significantly contribute to the ability to create outputs. The framework to evaluate whether an input and a substantive process are present includes different criteria to consider depending on whether the set has outputs or does not have outputs. The framework includes more stringent criteria for sets without outputs to be considered businesses. The definition of “outputs” is consistent with how outputs are described in ASC 606, *Revenue from Contracts with Customers* (i.e., the ability to generate goods or services provided to customers). ASC 805 defines a business, inputs, processes, and outputs.

ASC 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.

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

The nature of the elements (i.e., inputs, processes, and outputs) of a business varies based on industry, structure (i.e., locations of operations), and stage of development. The analysis of whether the necessary elements in an acquired group constitute a business is fact specific. For example, a new business may have fewer inputs or processes, and may only have a single output (or no outputs) compared to a mature business. As discussed in ASC 805-10-55-6, while nearly all businesses have liabilities, an acquired group need not have any liabilities to be considered a business. Conversely, a transferred set of assets and activities, including liabilities, may not represent a business. An acquired group or acquired input that contains no processes is not a business.

The assessment of whether a set is capable of being conducted and managed as a business should not be performed based on entity-specific facts and circumstances; rather, it should be based on a market participant view. Therefore, neither how the seller previously managed the set, nor how the buyer intends to manage the acquired set is relevant to the analysis.

Even though individual processes that are used to create outputs may be insignificant on their own, entities should consider if they could be substantive in the aggregate. Furthermore, while processes are usually documented, they do not need to be. For example, this could be the case with an organized workforce. An organized workforce could be an input, a process, or both. For example, a consulting firm might include employees (inputs) that utilize their intellectual capacity (a process) to generate outputs. However, an organized workforce is not in itself a business.

1.2.2.1 Definition of a business: outputs not present

When a set does not have outputs, in order to demonstrate an input and substantive process that together significantly contribute to the ability to create outputs, the set will need to include: (1) employees that form an organized workforce and (2) an input that the workforce could develop or convert into outputs. When a set does not have outputs, the workforce needs to be actively contributing to the development of outputs. Without employees, there are inherent limitations on the processes that can be performed to create outputs. ASC 805-10-55-5D clarifies how to determine if a set is a business when outputs are not present.

ASC 805-10-55-5D

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

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

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

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

An organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process that when applied to another input, is critical to the ability to develop or convert the acquired input into outputs. An acquired workforce consisting of a small number of people (e.g., scientists working on a research and development project) may satisfy these requirements. Judgment will be required to determine whether the process performed by the organized workforce is critical to the ability to convert another acquired input into outputs. To make this judgment, the likelihood of producing an output if the acquired process was not present should be evaluated.

An organized workforce must consist of employees. That is, an organized workforce accessible through a contractual arrangement is not considered substantive enough to actually contribute to the development of outputs when outputs are not otherwise present in an acquired set. While the guidance does not include a formal definition of an employee, we believe it would be reasonable to use the definition of an employee included in the FASB guidance on stock compensation (ASC 718). Therefore, an employee would be someone who will have an employer-employee relationship with the acquirer based on common law as a result of the acquisition.

The guidance requires that the inputs be substantive and have the ability to create or contribute to the creation of outputs when one or more processes are applied to it. Ancillary assets, those that do not contribute to producing outputs, would not be considered inputs for purposes of determining whether the set has inputs.

In certain circumstances, outputs may be limited. In this situation, judgment is required when determining whether to evaluate the set as a set with outputs or a set without outputs. However, we generally believe that a set with limited outputs should be evaluated as a set without outputs.

1.2.2.2 *Definition of a business: outputs present*

A set will have outputs when there is a continuation of revenue before and after the transaction. However, the continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. When determining whether a process has been acquired, the presence of contractual arrangements that provide for the continuation of revenues, such as customer contracts, customer lists, and leases, would not be indicative of an acquired process and should be excluded from the analysis.

ASC 805-10-55-5E includes four examples of substantive processes, which when applied to an acquired input, significantly contribute to the ability to create outputs.

ASC 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.

It is not uncommon for various processes to be performed by third parties through contractual arrangements (e.g., asset managers). However, just because the set includes access to a workforce does not necessarily mean that the workforce is substantive. Similar to the framework for when outputs are not present, an entity will need to consider if the workforce accessed through a contractual arrangement is critical to continue producing outputs. For instance, the duration and renewal terms of a contract may be an indication of how critical the functions performed are.

An organized workforce can be an indicator of a substantive process. However, when outputs are present, an organized workforce is not required for the set to be considered a business. A substantive process can exist without an organized workforce (e.g., if the set includes an automated process through acquired technology or infrastructure).

See Example BCG 1-3 for an example of an acquisition of brands, Example BCG 1-4 and Example BCG 1-5 for examples of an acquisition of a license agreement, and Example BCG 1-6 for an example of an acquisition of office buildings.

EXAMPLE BCG 1-3**Acquisition of brands**

Company T is a global beverage manufacturer. Company T sells the worldwide rights of its oat milk brand, including all related intellectual property, to Company A. Company A also acquires (1) existing

customer contracts, and (2) an at-market supply contract with the manufacturer of the oat milk, but it does not acquire any employees.

Has Company A acquired a business or a group of assets?

Analysis

The set is not a business. Since the set includes outputs through the continuation of revenues with customers, Company A would evaluate whether there is an acquired substantive process. Revenue contracts with customers are excluded from the analysis. The set does not include an organized workforce and the oat milk production process was not acquired by Company A; therefore, no substantive processes were acquired. Although it is likely that economic goodwill exists as a result of revenue derived from future customers, the goodwill will be reflected in the fair value of the assets acquired.

EXAMPLE BCG 1-4

Acquisition of a license agreement

Pharma Co. is a clinical-stage biopharmaceutical company that has an advanced drug in Phase 2 of clinical trials. Company A enters into a license agreement with Pharma Co. for the exclusive global license to the drug's intellectual property, including R&D, manufacturing, and commercialization. No employees or other assets are acquired with the license agreement. The drug being licensed is not yet generating revenues. Company A also enters into two limited-time period arrangements at market rates, including a supply arrangement for product materials and an outsourced service arrangement (for development and clinical trials).

Is the arrangement the acquisition of a business?

Analysis

No. The acquired group is not a business.

Company A determined there is nominal fair value ascribed to the supply arrangement and outsourced service arrangement because the contracts are short-term and at market rates. Therefore, Company A would conclude that the license agreement is the only identifiable asset acquired with significant value. As a result, the set would meet the screen and would not be a business combination. Even if the set was assessed under the more detailed framework, since no employees were acquired and there is no continuation of revenue, the set does not contain outputs or a substantive process.

EXAMPLE BCG 1-5

Acquisition of a license agreement

Pharma Co. is a clinical-stage biopharmaceutical company that has an advanced drug in Phase 2 of clinical trials. Company A enters into a license agreement with Pharma Co. for the exclusive global license to the drug's intellectual property, including R&D, manufacturing, and commercialization. The drug being licensed is not yet generating revenues. Concurrently, Company A acquires a subsidiary of Pharma Co. that includes experienced management and scientists as well as a corporate headquarters building, including a research lab with equipment necessary to develop the drug. Company A also

enters into two limited-time period arrangements at market rates, including a supply arrangement for product materials and an outsourced service arrangement (for development and clinical trials).

Is the arrangement the acquisition of a business?

Analysis

Yes. The acquired group is a business. The identifiable assets in the set include the license agreement as well as the headquarters building, research lab, and equipment, which Company A determined have an aggregate fair value equal to 30% of the total consideration. As a result, the set does not meet the screen and the framework must be assessed.

Although the set does not have outputs, Company A would likely conclude that the workforce has the necessary skills, knowledge, and experience to continue or expand existing R&D activities. The experienced management and scientists represent an organized workforce that when applied to the acquired inputs (IPR&D) significantly contribute to the ability to create outputs.

EXAMPLE BCG 1-6

Acquisition of office buildings

Company T manages a portfolio of office buildings. Company T has a contract with a property management company. The executives of Company T are responsible for key strategic decisions, including identifying new properties to acquire. The property managers perform the primary duties related to tenant and lease management and property-level accounting. Company T has 25 domestic properties across five different states and each office building is diversified in terms of design construction.

Company A acquires Company T. At closing, the former executives of Company T become senior executives of Company A. None of the other employees of Company T join Company A. Additionally, Company A does not acquire the contract with the property management company.

Has Company A acquired a business?

Analysis

Yes. The acquired group is a business. The office buildings are not considered similar as the risks are significantly different (e.g., different geography, design) and may produce different cash flows throughout the period. As a result, the set does not meet the screen and the framework would need to be assessed.

Employees that form an organized workforce for property management services were not obtained since the property management contract was not acquired. However, the former executives are critical employees (due to the executive nature of their positions), which together with the continuation of revenue, indicates that the set includes a substantive process and is a business.

1.2.3 *The presence of goodwill in an acquisition*

ASC 805-10-55-9 addresses the presence of goodwill and whether a business exists when it is present.

Excerpt from ASC 805-10-55-9

...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.

A business may exist when goodwill is present in the acquired group. Evidence to the contrary would need to be considered. Therefore, the presence of goodwill in the acquired group could imply that the acquired group is a business, and any inputs or processes that may be missing are unlikely to prevent the acquired group from providing a return to its investors. An acquirer should consider whether all of the tangible and intangible assets in the acquired group have been specifically identified, recognized, and correctly valued before determining whether goodwill is present.

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

1.3 *Identifying a business combination*

A business combination is defined as an entity obtaining control of one or more businesses. The most common business combination is a purchase transaction in which the acquirer purchases the net assets or equity interests of a business for some combination of cash or shares. An entity may also obtain control of a business (1) through the execution of a contract, (2) due to an action by the acquiree, (3) without the exchange of consideration, or (4) through transactions that combine multiple companies to form a single company. The acquisition method, which is discussed in BCG 2, should be applied to all business combinations within the scope of ASC 805. ASC 805-10-55-2 provides examples of how an acquirer may obtain control of an acquiree in a business combination.

ASC 805-10-55-2

Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. In a business combination, an acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

- a. By transferring cash, cash equivalents, or other assets (including net assets that constitute a business)
- b. By incurring liabilities
- c. By issuing equity interests
- d. By providing more than one type of consideration
- e. Without transferring consideration including by contract alone (see paragraph 805-10-25-11).

ASC 805-10-55-3

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

- a. One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.
- b. One combining entity transfers its net assets or its owners transfer their equity interests to another combining entity or its owners.
- c. All of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity (sometimes referred to as a roll-up or put-together transaction).
- d. A group of former owners of one of the combining entities obtains control of the combined entity.

The initial consolidation of a VIE that is a business is also a business combination and should be accounted for under the acquisition method by the acquirer (i.e., the primary beneficiary). See BCG 2.11 for additional information.

Example BCG 1-7, Example BCG 1-8, and Example BCG 1-9 illustrate transactions (other than purchase transactions) that are considered business combinations.

EXAMPLE BCG 1-7**Share repurchase by investee**

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

Is this transaction a business combination?

Analysis

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

EXAMPLE BCG 1-8**Change in the rights of noncontrolling interest holders**

Company A owns a majority share of its investee's voting equity interests. The investee meets the definition of a business. Company A is precluded from exercising control of the investee due to contractual rights held by the noncontrolling interest holders in the investee (e.g., veto rights, board membership rights, other substantive participation rights). The contractual rights expire, and Company A obtains control over the investee.

Is this transaction a business combination?

Analysis

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

EXAMPLE BCG 1-9**Contracts or other arrangements**

Company A and Company T enter into a contractual arrangement to combine their businesses and both meet the definition of a business. Company A will control the operations of both Company A and Company T.

Is this transaction a business combination?

Analysis

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

1.3.1 Stapling transactions and dual-listed companies

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

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

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

1.3.2 Merger of equals, mutual enterprises, and roll-ups/put-togethers

A merger of equals, in which two entities of approximately equal size combine and share control over the combined entity, is considered a business combination that falls within the scope of ASC 805. As described in FAS 141(R).B35, the FASB concluded it was not feasible to develop a separate accounting framework for these transactions due to the difficulty in distinguishing between a merger of equals and other business combinations. Accordingly, in a merger of equals, the entity deemed to be the acquirer (see BCG 2.3) should account for the transaction using the acquisition method.

Combinations of mutual enterprises are also within the scope of ASC 805. The FASB acknowledged some differences between mutual enterprises and corporate business enterprises but determined that such differences were not substantial enough to warrant separate accounting. Accordingly, in a combination of mutual enterprises, the entity deemed to be the acquirer (see BCG 2.3) should account for the transaction using the acquisition method.

“Roll-up” or “put-together” transactions typically result when several unrelated companies in the same market or in similar markets combine to form a larger company. The FASB concluded that, although these transactions might not cause a single entity to obtain control of the combined entity, they are similar to other types of business combinations and the acquirer (see BCG 2.3) should account for the transaction using the acquisition method.

1.3.3 Exchanges of assets between companies

Companies that exchange assets other than cash (i.e., nonmonetary assets) should apply the acquisition method if the result is the acquisition of a business. For example, assume Company A transfers a radio broadcast license to Company B in exchange for a radio station. If Company A determines that the radio station it receives is a business, Company A would account for the acquired radio station as a business combination by applying the acquisition method. If Company B determines that the radio broadcast license it receives is an asset, Company B would account for the radio broadcast license as an asset acquisition under the applicable US GAAP. See PPE 2 for additional information on the accounting for asset acquisitions.

1.3.4 Multiple transactions that result in a business combination

Legal, tax, or regulatory considerations frequently affect the structure of a business combination. A series of transactions might be used to combine two businesses in the most economically advantageous way. An arrangement to acquire a business through a series of transactions that are linked is a business combination and should be accounted for using the acquisition method. Determining whether a series of transactions is linked and whether they should be combined and viewed as a single arrangement is a matter of judgment and should be based on specific facts and circumstances. See BCG 5.3.7 and BCG 5.5.4 for additional guidance on factors to consider when determining whether to account for a series of transactions as a single business combination.

Example BCG 1-10 provides a scenario in which a reporting entity considers whether a series of transactions constitutes a single business combination.

EXAMPLE BCG 1-10

Determining whether a series of transactions is a single business combination

Company A (an international media group) has agreed to acquire Company T’s television broadcast and production operations. For tax reasons, Company A will not acquire Company T’s shares, but the program rights will be purchased by a subsidiary of Company A. The production facilities and workforce that are located in the various countries will be acquired by separate operating subsidiaries of Company A in those locations. None of the transactions will be completed unless all of the other transactions are also completed.

Is the series of transactions to acquire the program rights, production facilities and workforces considered a single business combination?

Analysis

Yes. The separation of the acquisition of Company T's television broadcast and production operations into several transactions does not affect the substance of the arrangement. The arrangements to acquire the program rights, production facilities, and workforce are entered into in contemplation of one another, are designed to achieve an overall commercial effect (i.e., acquiring Company T's broadcast and production operations), and are mutually dependent on each other. Therefore, Company A should account for the series of transactions as a single business combination.

1.3.5 Business combinations when control is temporary

ASC 805 does not have a concept of "temporary" control. Generally, any transaction in which an entity obtains control of one or more businesses qualifies as a business combination. However, there is one industry scope exception in ASC 810-10-15-10(a)(2) for a transaction in which control is only temporarily obtained. A parent entity that is a broker-dealer within the scope of ASC 940, *Financial Services—Broker and Dealers*, is not required to consolidate a majority-owned subsidiary in which the parent entity has a controlling financial interest and control is likely to be temporary. Otherwise, there are no scope exceptions for a transaction in which control is only temporarily obtained.

When a reporting entity obtains control of a business, the transaction is a business combination and the acquirer must follow the acquisition method. This is the case even when control is expected to be transferred in the future or maintained for a short period of time. For example, assume Company A has a signed purchase agreement with Company T (third party) to acquire multiple entities that each individually meet the definition of a business, including Business X. Company A has also negotiated a contract with Company C (separate third party) to sell Business X three months from the date on which Business X is acquired from Company T. Therefore, Company A determines the business being acquired meets the criteria in ASC 205-20-45-1E to be classified as held for sale (and therefore also should be presented as discontinued operations per ASC 205-20-45-1D). Based on ASC 805-20-30-22, Company A would measure the acquired disposal group (Business X) on the acquisition date at fair value less cost to sell (in accordance with ASC 360-10-35-38 and ASC 360-10-35-43).

Chapter 2:
Acquisition method—updated
May 2022

2.1 Overview: acquisition method

Business combinations are recorded using the acquisition method. This chapter outlines the steps in applying the acquisition method, including the accounting for assets acquired and liabilities assumed, and the recognition of gains and losses in a business combination (e.g., bargain purchases, step acquisitions). With limited exceptions, assets and liabilities acquired are measured at fair value. The FASB has established a single source of guidance on fair value measurements and definition of fair value. See FV 7 for more information on the fair value standards.

2.2 The acquisition method

ASC 805-10-25-1 requires use of the acquisition method while ASC 805-10-05-04 summarizes the steps in that method.

Excerpt from ASC 805-10-25-1

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

Excerpt from ASC 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.

Specific issues surrounding the application of the acquisition method for partial and step acquisitions and the recognition and measurement of noncontrolling interest are discussed in BCG 5 and BCG 6, respectively.

2.3 Identifying the acquirer

ASC 805-10-25-4 provides the principle with regard to identifying the acquirer.

ASC 805-10-25-4

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

Application of the above principle requires one of the parties in a business combination to be identified as the acquirer for accounting purposes. The process of identifying the acquirer begins with the determination of the party that obtains control based on the guidance in the consolidation standard (ASC 810-10).

The general rule is the party that directly or indirectly holds greater than 50% of the voting shares has control. If a variable interest entity (VIE) that is a business is consolidated using the VIE subsections of ASC 810-10, the party that consolidates the VIE (i.e., primary beneficiary) is identified as the acquirer. See BCG 2.11 for further information.

If the accounting acquirer is not apparent when considering the guidance in ASC 810-10, the guidance in ASC 805-10-55-11 and ASC 805-10-55-12 can assist in the identification of the acquirer.

ASC 805-10-55-11

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

Excerpt from ASC 805-10-55-12

In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests.

It is sometimes not clear which party is the acquirer if a business combination is effected through the exchange of equity interests. The acquirer for accounting purposes may not be the legal acquirer (i.e., the entity that issues its equity interest to effect the business combination). Business combinations in which the legal acquirer is not the accounting acquirer are commonly referred to as “reverse acquisitions.” See BCG 2.10 for further information. All pertinent facts and circumstances should be considered in determining the acquirer in a business combination that primarily involves the exchange of equity interests. ASC 805-10-55-12 provides additional factors that should be considered when determining the acquirer in a business combination effected through the exchange of equity interests.

Excerpt from ASC 805-10-55-12

- a. The relative voting rights in the combined entity after the business combination. The acquirer usually is the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.
- b. The existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest. The acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.
- c. The composition of the governing body of the combined entity. The acquirer usually is the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
- d. The composition of the senior management of the combined entity. The acquirer usually is the combining entity whose former management dominates the management of the combined entity.

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

The weight of relative voting rights in the combined entity after the business combination generally increases as the portion of the voting rights held by the majority becomes more significant (e.g., a split of 75% and 25% may be more determinative than a split of 51% and 49%). See below for additional information on the consideration of options, warrants, and convertible instruments when evaluating relative voting rights.

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

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

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

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

Other factors to consider in determining the acquirer include:

- If one of the combining entities is significantly larger than the other combining entity or entities, it would typically be considered the accounting acquirer. When assessing relative size, a reporting entity may consider the combining entities' assets, revenues, cash flows, or earnings measures that are most relevant, which may vary based on sector. Differences in accounting policies, entity capitalization, and the occurrence of nonrecurring items should also be considered when comparing the relative size of the combining entities.
- When identifying the acquirer, a reporting entity should consider which of the combining entities initiated the business combination.

- The combined entity's name, location of its headquarters, and ticker symbol may also be considered.
- A newly formed entity (NewCo) that issues equity to effect the combination/merger of two or more existing businesses would generally not be the accounting acquirer (see Example BCG 2-3). One of the existing combining entities should be determined to be the acquirer utilizing the criteria described in ASC 805-10-55-12. However, a NewCo that transfers cash or other assets or that incurs liabilities as consideration may be deemed to be the accounting acquirer. See BCG 2.3.1 for further guidance on NewCos.

In addition to these factors, certain circumstances can complicate the identification of the acquirer, including the following:

- *Acquisitions involving companies with overlapping shareholders.* The effect of common ownership (but not common control) among the shareholders of the combining entities should be considered in the identification of the accounting acquirer. The analysis of the relative voting rights in a business combination involving entities with common shareholders should consider the former shareholder groups of the combining entities and not the individual owners that are common to the combining entities. The former shareholder group that retains or receives the largest portion of the voting rights in the combined entity would be the accounting acquirer, absent the consideration of any of the other factors provided in ASC 805.
- *Options, warrants, and convertible instruments.* Options, warrants, and convertible instruments assumed or exchanged in a business combination are considered in the determination of the accounting acquirer if the holders of these instruments are viewed to be essentially the same as common shareholders. Options, warrants, and convertible instruments that are in the money and are vested, exercisable, or convertible may be included in the determination of the relative voting rights in the combined entity. Options, warrants, and convertible instruments that are not vested, exercisable, or convertible until after the acquisition date generally should not be included in the assessment of relative voting rights. However, if the instruments become vested, exercisable, or convertible shortly after the acquisition date and it can be reasonable to assume those instruments will be converted, then the instruments should be included in the analysis.
- *Debt holders that receive common shares.* Debt holders that receive common shares in a business combination should be considered in the determination of the accounting acquirer if the debt holders are viewed to have attributes similar to common shareholders prior to the acquisition. The holders of debt that is exchanged for shares in a business combination may be included in the determination of the relative voting rights in the combined entity if the debt is convertible and in the money prior to the acquisition.

Example BCG 2-1 and Example BCG 2-2 illustrate the impact on the determination of relative voting rights in the combined entity if debt holders receive common shares in a business combination.

EXAMPLE BCG 2-1

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

Company A acquires Company B in a business combination by exchanging equity interests. Company B has nonconvertible debt that Company A does not wish to assume in the acquisition. Company A

reaches an agreement with Company B's nonconvertible debt holders to extinguish the debt for Company A's common shares. The nonconvertible debt holders hold no other financial interests in Company B.

How do the shares issued to the nonconvertible debt holders impact the determination of relative voting rights?

Analysis

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

EXAMPLE BCG 2-2

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

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

How do the shares issued to the convertible debt holders impact the determination of relative voting rights?

Analysis

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

2.3.1 New entity created to facilitate a business combination

It is not uncommon to use one or more newly formed legal entities (NewCos) in a business combination or other common corporate transactions, such as legal reorganizations or recapitalizations. There may be various legal, tax, or other business purposes for the creation of a NewCo in such transactions.

NewCos may also be created to facilitate combinations between entities that are under common control or under a high degree of common ownership. Common control transactions are excluded

from the scope of the business combinations guidance in ASC 805. See BCG 7.1.1 for further detail on common control transactions and BCG 7.1.1.3 for further detail on transactions involving entities with a high degree of common ownership.

If a NewCo is created to facilitate a business combination, an analysis needs to be performed to determine whether the NewCo is the accounting acquirer or whether it should be disregarded for accounting purposes. The determination of whether a NewCo is the accounting acquirer begins with assessing whether or not the NewCo is substantive. This assessment should be based on the specific facts and circumstances surrounding the transaction, which may include the following:

- Will the NewCo survive the transaction or is it transitory in nature?
- Does the NewCo issue shares or pay cash to acquire the shares of a business?
- Does the NewCo have any ownership interest in the acquiree?
- Are there significant precombination activities at the NewCo (e.g., raising debt, negotiating transactions, identifying businesses for acquisitions)?

It generally should not matter which entity formed the NewCo (i.e., the buyer or the seller) in the analysis of whether or not NewCo is substantive. A NewCo's formation, ownership, and activities prior to the business combination should be considered and may provide evidence as to whether a NewCo is substantive. These factors are particularly relevant in the case of a NewCo that does not survive the transaction, as frequently a NewCo that survives the transaction is considered substantive. For example, a transitory NewCo that has assets, liabilities, or operating activities may be determined to be substantive. Alternatively, the following indicators may indicate that a transitory NewCo lacks substance and therefore is not an accounting acquirer:

- NewCo was created solely as a means for a new investor to acquire the shares in the acquired business.
- NewCo is newly formed for the transaction and has no other operations or activities that would lead to a conclusion that NewCo is a substantive entity.
- Any debt used in the transaction is not raised or incurred by the NewCo.

The determination of whether a NewCo is the accounting acquirer is judgmental and requires an understanding of the substance and legal form of the transaction. If the NewCo is the acquirer, acquisition accounting (rather than pushdown accounting), would be applied in the NewCo's financial statements. See BCG 10.1 for further information on pushdown accounting.

Special purpose acquisition company (SPAC)

A SPAC, also known as a blank-check company, is a publicly-traded company that completes an IPO with the intent of using the funds to acquire an existing company within a fixed period of time, often two years. If an acquisition is not identified and consummated within the specified time period, the funds raised in the SPAC's IPO are returned to its investors.

In the merger transaction between the SPAC and the target operating company, an important accounting judgment is the determination of which entity is the accounting acquirer. The accounting

acquirer is the entity that obtains control of the merged entity and may be different from the legal acquirer. If the SPAC merger is effectuated primarily by transferring cash or other assets or by incurring liabilities, the SPAC is usually the accounting acquirer. If the target operating company is a variable interest entity (VIE), the entity that is the primary beneficiary and consolidates the VIE is the accounting acquirer (i.e., if the SPAC becomes the primary beneficiary as a result of the merger, the SPAC would be the accounting acquirer). See CG 3 for guidance on VIE analysis and CG 7.1.1 for consolidation considerations when assessing limited liability companies and other similar entities.

If the voting interest model applies and the SPAC merger consideration is equity or a combination of cash and equity, the determination of the accounting acquirer requires further evaluation based on the facts and circumstances of the SPAC merger. The guidance in ASC 805-10-55-11 through ASC 805-10-55-15 includes factors that may indicate which party is the accounting acquirer (see BCG 2.3). In the common case of the SPAC merger consideration being in the form of equity, the target operating company may often be determined to be the accounting acquirer based on the relative voting rights of the historical stockholder groups in the merged entity and the composition of the governing body and senior management team of the merged entity. If the target operating company is the accounting acquirer, the transaction is considered a reverse merger. A reverse merger with a SPAC is typically accounted for as a reverse recapitalization because often the SPAC's only pre-merger asset is cash received from investors and the SPAC generally does not meet the definition of a business. Instead, the substance of these types of reverse mergers is a capital transaction of the legal acquiree, which is equivalent to the issuance of shares by the target operating company for the net monetary assets of the SPAC accompanied by a recapitalization.

A SPAC is not a shell company. A shell company is a dormant, non-operating entity. For merger transactions with a shell company, refer to BCG 2.10.1.

2.3.1.1 *NewCo issues shares to effect a merger*

A NewCo that is established solely to issue equity interests to effect a business combination between two pre-existing businesses generally will not be substantive and should be “looked through” to determine the acquirer. Therefore, when a NewCo issues equity interests to effect a business combination, one of the existing entities or businesses would be identified as the acquirer in accordance with ASC 805-10-55-15.

Example BCG 2-3 illustrates circumstances in which a NewCo is established solely to issue equity interests to effect a business combination between two pre-existing businesses.

EXAMPLE BCG 2-3

Determining the acquirer: NewCo issues shares to facilitate a merger of two pre-existing businesses

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

Is NewCo the accounting acquirer?

Analysis

No. NewCo is not considered substantive and would be disregarded for accounting purposes. The transaction is, in substance, no different than a transaction in which one of the combining entities directly acquires the other. In accordance with ASC 805-10-55-15, NewCo would not be identified as the accounting acquirer; rather, one of the combining entities would be. Identification of the acquirer would be based on the guidance in ASC 805-10-55-12 through ASC 805-10-55-14.

2.3.1.2 *Transitory NewCo may be substantive*

A NewCo may be used to acquire control of a business by merging with and into the acquired business. A NewCo that does not survive the transaction (i.e., the acquired business is the surviving entity) is referred to as a transitory NewCo. The use of a transitory NewCo (sometimes referred to as a merger sub) may be driven by legal considerations, such as a means to limit liability, or may be driven by state merger laws when the acquiree is publicly traded or has numerous shareholders. A transitory NewCo formed solely for the merger transaction that has no other operations or activities would indicate that NewCo is not a substantive entity and therefore not the accounting acquirer. However, as illustrated in Example BCG 2-4, a transitory NewCo may be determined to be the acquirer if the NewCo is considered to be substantive.

EXAMPLE BCG 2-4**Determining the acquirer: transitory NewCo raises debt to fund the acquisition**

A transitory NewCo is formed by a private equity firm to effect an acquisition. NewCo negotiates with lenders and raises debt to fund the acquisition of Target T. NewCo acquires and merges with Target T, with Target T being the surviving entity.

Is NewCo the accounting acquirer?

Analysis

Yes. NewCo is considered to have substantive precombination activities as a result of raising debt to fund the acquisition and would be identified as the accounting acquirer.

2.3.1.3 *NewCo acquires a business and is the reporting entity*

There are acquisitions in which a NewCo may acquire a business and survive the transaction. The NewCo may be determined to be the acquirer if the NewCo is considered to be substantive.

Example BCG 2-5 illustrates an acquisition in which a NewCo issues equity for cash to purchase 100% of the equity of a company and survives the transaction.

EXAMPLE BCG 2-5**Determining the acquirer: surviving NewCo**

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

Is NewCo the accounting acquirer?

Analysis

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

Example BCG 2-6 illustrates an acquisition in which a selling shareholder contributes a business to a NewCo, which concurrently issues shares to an unrelated investor for cash.

EXAMPLE BCG 2-6

Determining the acquirer: selling shareholder contributes a business to a NewCo, which concurrently issues shares to an unrelated investor for cash

As part of an integrated transaction, a seller contributes a business to NewCo in exchange for shares of NewCo. NewCo concurrently issues 60% of its common shares to an unrelated investor for cash. NewCo survives the transaction.

Is NewCo the accounting acquirer?

Analysis

Yes. NewCo would be identified as the accounting acquirer. ASC 805-10-20 defines a business combination as a "transaction or other event in which an acquirer obtains control of one or more businesses." In this instance, the surviving NewCo is considered the accounting acquirer as an unrelated investor has obtained control over it and the contributed business. The accounting for this transaction is the same as if the new investor had infused cash into a NewCo, which then issued equity securities to the seller in return for the net assets of the contributed business, resulting in a business combination.

2.4 Determining the acquisition date

ASC 805-10-25-6 to ASC 805-10-25-7 provide the principle with regard to determining the acquisition date.

ASC 805-10-25-6

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

ASC 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.

The acquisition date is the date on which the acquirer obtains control of the acquiree, which is generally the closing date. However, if control of the acquiree transfers to the acquirer through a written agreement, the acquisition date can be before or after the closing date. In accordance with ASC 805-10-25-7, all pertinent facts and circumstances surrounding a business combination should be considered in assessing when the acquirer has obtained control of the acquiree. The date on which control passes is a matter of fact, and it cannot be backdated or artificially altered.

As described in paragraph B110 in the basis for conclusions of FAS 141(R), in certain situations reporting entities may wish to designate a “convenience date” (i.e., a date other than the actual acquisition date) as a practical matter when recognizing a business combination. Use of a convenience date will eliminate the need to perform the financial reporting process twice within the same month. The convenience date should be no more than a few days after control has transferred and should be in the same reporting period as the acquisition date. Further, the use of a convenience date should not have a material effect on the financial statements (e.g., no material transaction should have occurred between the acquisition date and convenience date). When considering materiality, a reporting entity should ensure it is assessing quantitative metrics, such as net income, revenues, and expenses, and qualitative factors, such as debt covenant compliance and the impact on employee compensation arrangements. A materiality assessment should consider the impact of using a convenience date together with the effect of other errors in the financial statements.

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

2.5 Recognition and measurement on the acquisition date—updated May 2024

ASC 805-20-25-1 provides the recognition principle for assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree.

Excerpt from ASC 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 paragraphs 805-20-25-2 through 25-3.

An acquirer should recognize the identifiable assets acquired and the liabilities assumed that exist on the acquisition date. For example, costs that an acquirer expects to incur but is not obligated to incur at the acquisition date (e.g., restructuring costs) are not liabilities assumed under ASC 805-20-25-2. An acquirer may also recognize assets and liabilities that are not recognized by the acquiree in its financial statements prior to the acquisition date, due to differences between the recognition principles in a business combination and other US GAAP. This can result in the recognition of intangible assets in a business combination, such as a brand name or customer relationship, which the acquiree would not recognize in its financial statements because these intangible assets were internally generated.

Certain assets acquired and liabilities assumed in connection with a business combination may not be considered part of the assets and liabilities exchanged in the business combination and will be recognized as separate transactions in accordance with other US GAAP, as described in BCG 2.7.

ASC 805-20-30-1 provides the principle with regard to the measurement of assets acquired and liabilities assumed and any noncontrolling interest in the acquiree.

Excerpt from ASC 805-20-30-1

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

The measurement of the identifiable assets acquired and liabilities assumed is at fair value, with limited exceptions as provided for in ASC 805. Fair value is based on the definition in ASC 820-10-20 as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. See FV 7 for a discussion of the valuation techniques and issues related to the fair value measurement of the identifiable assets acquired and liabilities assumed.

The recognition and measurement of particular assets acquired and liabilities assumed are discussed in BCG 2.5.1 through BCG 2.5.19. The following table provides a summary of the exceptions to the recognition and fair value measurement principles in ASC 805, along with references to where these exceptions are discussed.

Summary of exceptions to the recognition and fair value measurement principles

Measurement principle	<ul style="list-style-type: none"> □ Reacquired rights (BCG 2.5.6) □ Assets held for sale (BCG 2.5.8) □ Share-based payment awards (BCG 2.6.3.1) □ Purchased financial assets with credit deterioration (BCG 2.5.2)
Recognition and measurement principles	<ul style="list-style-type: none"> □ Income taxes (BCG 2.5.9) □ Employee benefits (BCG 2.5.10) □ Contingencies (BCG 2.5.13) □ Indemnification assets (BCG 2.5.14) □ Leases (BCG 4.3.3.7) □ Contract assets and contract liabilities

(subsequent to adoption of ASU 2021-08)
(BCG 2.5.16)

In some instances, the SEC has expressed the view that significant differences between the acquired entity's historical carrying value and the acquiring entity's estimated fair value could call into question whether the fair value determined by the acquiring entity and/or the carrying value reported by the acquired entity before the acquisition is appropriate. If it is determined that the pre-acquisition carrying value was not accurate in the acquired entity's financial statements, the pre-acquisition financial statements may require adjustment.

2.5.1 *Assets that the acquirer does not intend to use*

An acquirer, for competitive or other reasons, may intend to use the asset in a way that is not its highest and best use (i.e., different from the way other market participants would use the asset). Additionally, a company may acquire intangible assets in a business combination that it has no intention to actively use, but rather intends to hold them (lock them up) to prevent others from obtaining access to them (defensive intangible assets). ASC 805 specifies that the intended use of an asset by the acquirer does not affect its fair value. See BCG 4.5 for further information on the accounting and subsequent measurement of assets that the acquirer does not intend to use.

2.5.2 *Valuation allowances (business combinations)*

As described in ASC 805-20-30-4, separate valuation allowances are not recognized for acquired non-financial assets that are measured at fair value, as any uncertainties about future cash flows are included in their fair value measurement. The use of a separate valuation allowance is permitted, however, for assets that are not measured at fair value on the acquisition date (e.g., certain indemnification assets). Consequently, a valuation allowance for deferred income tax assets is allowed.

The accounting for acquired financial assets within the scope of ASC 326 will depend on whether the financial assets are considered purchased with credit deterioration. Purchased financial assets without credit deterioration will be recorded at their acquisition date fair value. The fair value of short-term trade receivables generally incorporates only the time value of money and the customers' credit risk. In certain situations, the fair value of acquired short-term trade receivables may approximate their carrying value if the receivables are short term in nature and customer credit risk is not significant in the context of their short-term nature. Additionally, consistent with ASC 805-20-30-4A, an allowance is recorded with a corresponding charge to credit loss expense in the reporting period in which the acquisition occurs for financial assets in the scope of ASC 326-20, such as receivables, net investments in leases, and held-to-maturity debt securities. Purchased financial assets in the scope of ASC 326 with credit deterioration are not recognized at fair value. They are an exception to the measurement principle in ASC 805. Instead, as described in ASC 805-20-30-4B, the acquirer will first determine the fair value of the financial asset as of the acquisition date and then will recognize an allowance calculated in accordance with ASC 326 with a corresponding increase to the cost basis of the financial asset as of the acquisition date.

Excerpt from ASC Master Glossary

Purchased financial assets with credit deterioration: Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have

experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.

See LI 9 for additional information on purchased financial assets with credit deterioration.

Contract assets

In the Basis for conclusions of ASU 2021-08, the FASB clarified that this ASU did not address the application of the credit loss guidance. ASC 606-10-45-3 requires contract assets to be evaluated for credit losses under ASC 326-20. ASC 326-20-45-1 and the definition of “amortized cost basis” in ASC 326-20-20 states that the credit loss allowance is separate from its related gross asset balance (i.e., an asset subject to a credit loss allowance does not have a cost basis net of the allowance). Accordingly, we believe an acquirer should record any contract assets of the acquiree at the acquisition date (see BCG 2.5.16.1) in accordance with ASU 2021-08 at its cost basis (which does not include an allowance for credit losses), and then should record an allowance on those contract assets with a corresponding charge to credit loss expense (consistent with ASC 805-20-30-4A) in the reporting period in which the acquisition occurs. Additionally, as contract assets do not meet the definition of “financial assets” and will not be recorded at fair value under the new guidance, we believe the guidance related to purchased financial assets with credit deterioration described in ASC 326-20 (including the related acquisition accounting guidance in ASC 805-20-30-4B) does not apply to contract assets.

Note about ongoing standard setting

The FASB has an active project related to acquired financial assets. Specifically, the FASB is considering changing the term “purchased with credit deterioration (PCD)” in ASC 326 to “purchased financial assets (PFA)” and expanding the scope of the PFA model to include financial assets acquired in a business combination as well as “seasoned” financial assets acquired via either an asset acquisition or consolidation of a variable interest entity that is not a business. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the accounting implications.

2.5.3 *Inventory acquired in a business combination*

Acquired inventory can be in the form of finished goods, work in process (WIP), and/or raw materials. ASC 805 requires inventory acquired in a business combination to be measured at its fair value on the acquisition date in accordance with ASC 820. Ordinarily, the amount recognized for inventory at fair value by the acquirer will be higher than the amount recognized by the acquiree before the business combination. See FV 7.3.3.1 for further information.

2.5.4 *Contracts acquired in a business combination*

Contracts (e.g., sales contracts, supply contracts) assumed in a business combination may give rise to assets or liabilities. An intangible asset or liability may be recognized for contract terms that are favorable or unfavorable compared to current market transactions or related to identifiable economic benefits for contract terms that are at market. See BCG 4 for further discussion of the accounting for contract-related intangible assets. Also see BCG 2.5.16 for further discussion of acquired revenue contracts.

2.5.5 *Intangible assets acquired in a business combination*

All identifiable intangible assets that are acquired in a business combination should be recognized at fair value on the acquisition date. Identifiable intangible assets are recognized separately if they arise from contractual or other legal rights or if they are separable (i.e., capable of being sold, transferred, licensed, rented, or exchanged separately from the entity). This includes research and development acquired in a business combination, which is recognized at fair value and capitalized as an indefinite-lived intangible asset. Digital assets acquired in a business combination that meet the definition of an intangible asset should also be recognized at fair value on the acquisition date (for further guidance on the subsequent accounting, refer to PwC's *Crypto assets* guide). See BCG 4 for guidance on the recognition and measurement of intangible assets.

2.5.6 *Reacquired rights in a business combination*

An acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. Such reacquired rights generally are identifiable intangible assets that the acquirer separately recognizes from goodwill in accordance with ASC 805-20-25-14. The reacquisition must be evaluated separately to determine if a gain or loss on the settlement should be recognized. See BCG 2.7.2.1 for further information.

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

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

Contracts giving rise to reacquired rights that include a royalty or other type of payment provision should be assessed for contract terms that are favorable or unfavorable when compared to pricing for current market transactions. A settlement gain or loss should be recognized and measured at the acquisition date for any favorable or unfavorable contract terms identified. A settlement gain or loss related to a reacquired right should be measured consistently with the guidance for the settlement of preexisting relationships. See BCG 2.7.2.1 for further information. The amount of any settlement gain

or loss should not impact the measurement of the fair value of any intangible asset related to the reacquired right.

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

2.5.6.1 *Determining value and useful life of reacquired rights*

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

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

The FASB concluded that a right reacquired from an acquiree in substance has a finite life (i.e., the contract term); a renewal of the contractual term after the business combination is not part of what was acquired in the business combination.

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

In some cases, the reacquired right may not have any contractual renewals and the remaining contractual life may not be clear, such as with a perpetual franchise right. An assessment should be made as to whether the reacquired right is an indefinite-lived intangible asset that would not be amortized, but subject to periodic impairment testing. A conclusion that the useful life is indefinite requires careful consideration and is expected to be infrequent. If it is determined that the reacquired right, such as a perpetual franchise right, is not an indefinite-lived intangible asset, then the reacquired right should be amortized over its economic useful life. See PPE 4.2.1 for guidance on identifying the useful life of an intangible asset.

Example BCG 2-7 illustrates the recognition and measurement of a reacquired right in a business combination.

EXAMPLE BCG 2-7

Recognition and measurement of a reacquired right

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

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

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

What should Company A consider when recognizing the reacquired right?

Analysis

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

2.5.7 Property, plant, and equipment acquired in a business combination

Property, plant, and equipment acquired in a business combination intended to be held and used should be recognized and measured at fair value. Accumulated depreciation of the acquiree is not carried forward in a business combination. See FV 7.3.3.2 for further information on the measurement of property, plant, and equipment. See BCG 4.3.3.7 for the recognition and measurement of right-of-use assets and lease liabilities of an acquiree in a business combination. Also, see BCG 2.5.8 for the recognition and measurement of long-lived assets acquired in a business combination classified by the acquirer as held for sale.

2.5.7.1 Government grants acquired in a business combination

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

2.5.7.2 AROs in a business combination

An acquirer may obtain long-lived assets, such as property, plant, and equipment, that upon retirement require the acquirer to dismantle or remove the assets and restore the site on which it is located (i.e., asset retirement obligations (AROs)). If an ARO exists at the acquisition date, it must be recognized at fair value (using market-participant assumptions), which may be different than the amount previously recognized by the acquiree. Long-lived assets and any associated AROs acquired in a business combination should be recorded on a gross basis. In other words, the acquired long-lived assets should be recorded at fair value, unencumbered by future cash flows associated with the settlement of the asset retirement obligation. Separately, an ARO should be recorded at fair value on the acquisition date. The long-lived asset and ARO are separate units of account.

For example, a nuclear power plant is acquired in a business combination. The acquirer determines that an ARO of \$100 million (fair value) associated with the power plant exists at the acquisition date. The appraiser has included the expected cash outflows of the ARO in the cash flow model, establishing the value of the plant at \$500 million (i.e., the appraised value of the power plant would be \$100 million higher if the ARO were disregarded). The acquirer would record the power plant and the ARO as two separate units of account. The acquirer would record the power plant at its fair value of \$600 million (i.e., on an unencumbered basis) and an ARO of \$100 million.

2.5.8 Acquired assets held for sale in a business combination

Assets held for sale are an exception to the fair value measurement principle because they are measured at fair value less costs to sell. A long-lived asset or group of assets (disposal group) may be classified and measured as assets held for sale at the acquisition date if, from the acquirer's perspective, the classification criteria in ASC 360-10, *Property, Plant, and Equipment*, are met.

ASC 360-10-45-12 provides specific criteria which, if met, would require the acquirer to present newly-acquired assets as assets held for sale. The criteria require a plan to dispose of the assets within a year and that it be probable that the acquirer will meet the other held for sale criteria within a short period of time after the acquisition date (generally within three months). The other criteria in ASC 360-10-45-9 include (1) management having the authority to approve an action commits to sell the assets; (2) assets are available for immediate sale in their present condition, subject only to sales terms that are usual and customary; (3) an active program to locate a buyer and actions to complete the sale are initiated; (4) assets are being actively marketed; and (5) it is unlikely there will be significant changes to, or withdrawal from, the plan to sell the assets. If the criteria are not met, those assets should not be classified as assets held for sale until all applicable criteria have been met. See PPE 5.3 for further information on accounting for assets held for sale under US GAAP.

If the acquired disposal group is a business that upon acquisition meets the held for sale criteria, it must be presented as a discontinued operation. See FSP 27.3.1.1 for further information on this requirement.

2.5.9 *Income taxes related to business combinations—updated June 2023*

Income taxes are identified as an exception to the recognition and fair value measurement principles. The acquirer should record all deferred tax assets, liabilities, and valuation allowances of the acquiree that are related to any temporary differences, tax carryforwards, and uncertain tax positions in accordance with ASC 740, *Income Taxes*.

Deferred tax liabilities are not recognized for goodwill that is not tax-deductible. However, see TX 10.8 for discussion of the treatment of tax-deductible goodwill. Additionally, deferred tax liabilities should be recognized for differences between the book and tax basis of indefinite-lived intangible assets.

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

Adjustments or changes to the acquirer's deferred tax assets or liabilities as a result of a business combination should be reflected in earnings or, if specifically permitted, charged to equity in the period subsequent to the acquisition. See TX 10 for further information on the recognition of income taxes and other tax issues related to a business combination. Alternatively, if the tax change is not a part of the business combination, it should be accounted for as a separate transaction.

2.5.10 *Employee benefit plans acquired in a business combination*

Employee benefit plans are an exception to the recognition and fair value measurement principles. In accordance with ASC 805-20-25-23, employee benefit plan obligations are recognized and measured in accordance with the guidance in applicable US GAAP, rather than at fair value. Applicable guidance under US GAAP includes:

- ASC 420, *Exit or Disposal Cost Obligations*
- ASC 710, *Compensation—General*
- ASC 712, *Compensation—Nonretirement Postemployment Benefits*
- ASC 715, *Compensation—Retirement Benefits*

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

ASC 805 requires recognition of a pension asset or liability of a single-employer defined benefit pension plan in connection with recording assets and liabilities of a business combination. A pension liability is recorded for the excess of the projected benefit obligation over the fair value of the plan assets. A pension asset is recorded if the fair value of the plan assets exceeds the projected benefit

obligation. The projected benefit obligation and the fair value of plan assets should be measured at the acquisition date using current discount rates and assumptions established by the acquirer. Unlike annual and interim remeasurements, there is no practical expedient to measure the plan assets and obligations as of the closest calendar month-end date in a business combination.

The amount recorded for the pension asset or liability in an acquisition essentially represents a "fresh start" approach; there are no amounts recorded in accumulated other comprehensive income that are carried over from the acquired company. Accordingly, subsequent net periodic pension cost should not include amortization of the acquired company's prior service cost/credit, net gain or loss, or transition amount. If a calculated "market-related value" is used, it is also appropriate to restart the calculation for the plan assets (i.e., use fair value at the acquisition date and phase into a new computed market-related value prospectively) at acquisition. Consistent with ASC 715-30-55-37, the methodology used to compute market-related value of the acquired plan should generally be consistent with the acquiring company's methodology.

When determining the funded status of the plan at the acquisition date, the acquiring entity should exclude the effects of expected plan amendments, terminations, or curtailments that it has no obligation to make at the acquisition date.

If the acquirer is not obligated to amend the plan in connection with the business combination, a post-acquisition amendment to the plan that gives rise to prior service cost or credit would be accounted for by the acquirer in the post-acquisition period. As a result, the impact of such an amendment would be recognized in the income statement of the acquirer in future periods. On the other hand, if the acquirer is obligated to make the amendment (e.g., for legal or regulatory requirements), the impact of a plan amendment would generally be incorporated into the initial measurement of the plan in acquisition accounting.

ASC 805-20-55-50 and ASC 805-20-55-51 state that a liability for contractual termination benefits and for curtailment losses under employee benefit plans that will be triggered by consummation of a business combination should be recognized when the combination is consummated, even if consummation (and therefore the liabilities) is probable at an earlier date.

If the business combination is consummated, but the pension assets are to be transferred from the seller's pension trust at a later date (i.e., based on a final valuation as of the merger date), the acquirer should estimate the amount to be received and record this as part of acquisition accounting, similar to a working capital adjustment. The acquirer then must determine if this receivable meets the definition of plan assets. If the pension assets will be transferred from the seller's pension trust directly to the acquirer's pension trust, we believe that this receivable would be a plan asset and result in a net presentation within the opening net pension asset or liability. If the pension assets will be transferred to the acquirer (rather than directly to the acquirer's pension trust), they would not meet the definition of plan assets and the acquirer would record a receivable separate from the opening net pension liability, resulting in gross presentation. Companies should consider disclosing both situations if material.

In some transactions, the seller agrees to reimburse the buyer for payments made under the plan to retired participants of the plan at the date of the business combination. If the payment is made directly to the acquirer (and not the acquirer's pension trust), this reimbursement should be presented gross, with the recognition of a receivable and a pension liability. The receivable would be based on the corresponding actuarially determined pension liability. The receivable should also reflect the credit risk of the seller.

If enhanced pension benefits are offered as part of a voluntary termination program that is not contingent upon the acquisition, ASC 715 should take precedence over ASC 805. Therefore, the effects should only be included in the determination of the pension liability (asset) at the acquisition date to the extent the voluntary termination offer is accepted before that date.

For a multiemployer plan in which the acquired company's employees participate, an obligation to the plan for a portion of its unfunded benefit obligations should not be established at the acquisition date unless withdrawal from the multiemployer plan is probable. The FASB acknowledged in B298 in the basis for conclusions of FAS 141(R) that the provisions for single-employer and multiemployer plans are not necessarily consistent.

Question BCG 2-1

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

PwC response

Generally, no. ASC 805 generally requires employee compensation costs for future services, including pension costs, to be recognized in earnings in the postcombination period. Modifications to defined benefit pension plans are usually done for the benefit of the acquirer. A transaction that primarily benefits the acquirer is likely to be a separate transaction. Additionally, modifications to a defined benefit pension plan would typically relate to future services of the employees. It is not appropriate to analogize this situation to the exception in ASC 805 dealing with share-based compensation arrangements. That exception allows the acquirer to include a portion of the fair value based measure of replacement share-based payment awards as consideration in acquisition accounting through an obligation created by a provision written into the acquisition agreement. Such an exception should not be applied to modifications to defined benefit pension plans under the scenario described.

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

2.5.11 Payables and debt assumed in a business combination

An acquiree's payables and debt assumed by the acquirer are recognized at fair value in a business combination. Short-term payables are generally recorded based on their settlement amounts since the settlement amounts would be expected to approximate fair value. However, the measurement of debt at fair value may result in an amount different from what was recognized by the acquiree before the business combination. See FV 7.3.3.5 for further discussion of the measurement of debt at fair value. Unamortized revolving line of credit debt issuance costs of the acquiree do not meet the conceptual definition of an asset and, therefore, would not be recognized by the acquirer in a business combination.

An acquirer may settle (i.e., pay-off) some or all of the outstanding debt of the acquiree on, or in close proximity to, the date of the business combination. In these situations, it is important to determine whether the cash paid to settle the acquiree's debt should be recognized (1) as a component of

consideration transferred or (2) as the acquirer's settlement of an assumed liability of the acquiree post-acquisition.

Cash paid by the acquirer to settle the acquiree's outstanding debt on, or in close proximity to, the date of the business combination is generally recognized as a component of consideration transferred if the acquirer does not legally assume the outstanding debt. In this scenario, an assumed liability for the outstanding debt of the acquiree would not be recognized in acquisition accounting. However, if the acquirer legally assumes the acquiree's outstanding debt through the business combination, an assumed liability should be recognized at fair value on the acquisition date. Any subsequent repayment of the debt is a separate transaction from the business combination and would not be a component of consideration transferred. See FSP 6.8.20 for discussion of the impact on the statement of cash flows.

In other situations, an acquirer may incur new debt with a third party to fund a business combination. The new debt incurred by the acquirer to fund the business combination is not an assumed liability.

2.5.12 Guarantees assumed in a business combination

All guarantees made by the acquiree and assumed by the acquirer in a business combination are recognized at fair value on the acquisition date. An assumed guarantee would be accounted for under ASC 460, *Guarantees*, and the acquirer should relieve the guarantee liability through earnings using a systematic and rational manner as it is released from risk.

2.5.13 Contingencies: recognition and measurement

ASC 805-20-20 defines contingencies as existing conditions, situations, or sets of circumstances resulting in uncertainty about a possible gain or loss that will be resolved if one or more future events occur or fail to occur. ASC 805-20-25-18A through ASC 805-20-25-20A include a framework that acquirers should follow in recognizing preacquisition contingencies.

An acquirer should first determine whether the acquisition-date fair value of the asset or liability arising from the preacquisition contingency can be determined as of the acquisition date or during the measurement period. If the acquisition-date fair value of the contingency can be determined, the corresponding asset or liability should be recognized at fair value as part of acquisition accounting. For example, an acquirer will often have sufficient information to determine the fair value of warranty obligations assumed in a business combination. Generally, an acquirer also has sufficient information to determine the fair value of other contractual contingencies assumed in a business combination, such as penalty provisions in a supply agreement. In contrast, the fair value of legal contingencies assumed in a business combination may not be determinable.

If the acquisition-date fair value of assets or liabilities arising from the preacquisition contingency cannot be determined as of the acquisition date or during the measurement period, the acquirer should recognize the estimated amount of the asset or liability as part of the acquisition accounting if both of the following criteria are met:

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

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

The above recognition criteria should be applied using the guidance provided in ASC 450 (i.e., application of similar criteria in ASC 450-20-25-2). In a business combination, this guidance applies to both assets and liabilities arising from preacquisition contingencies.

Contingencies identified during the measurement period that existed as of the acquisition date qualify for recognition as part of acquisition accounting. However, if the above criteria are not met based on information that is available as of the acquisition date or during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer should not recognize an asset or liability as part of acquisition accounting. In periods after the measurement period, the acquirer should account for such assets or liabilities in accordance with other GAAP, including ASC 450, as appropriate.

Example BCG 2-8, Example BCG 2-9, and Example BCG 2-10 illustrate the initial recognition and measurement of acquired contingencies.

EXAMPLE BCG 2-8

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

On June 30, 20X1, Company A purchases all of Company B's outstanding equity shares for cash. Company B's products include a standard three-year warranty. An active market does not exist for the transfer of the warranty obligation or similar warranty obligations. Company A expects that the majority of the warranty expenditures associated with products sold in the last three years will be incurred in the remainder of 20X1 and in 20X2 and that all will be incurred by the end of 20X3. Based on Company B's historical experience with the products in question and Company A's own experience with similar products, Company A estimates the potential undiscounted amount of all future payments that it could be required to make under the warranty arrangements.

Should Company A recognize a warranty obligation as of the acquisition date?

Analysis

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

EXAMPLE BCG 2-9

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

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

Should Company C recognize a contingent liability for the employee litigation?

Analysis

No. A contingent liability for the employee litigation is not recognized at fair value on the acquisition date. Company C would not record a liability by analogy to ASC 450-20-25-2, because it has determined that an unfavorable outcome is reasonably possible, but not probable. Therefore, Company C would recognize a liability in the postcombination period when the recognition and measurement criteria in ASC 450 are met.

EXAMPLE BCG 2-10

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

In a business combination, Company C assumes a contingency of Company D related to employee litigation. Based upon discovery proceedings to date and advice from its legal counsel, Company C believes that it is reasonably possible that Company D is legally responsible and will be required to pay damages. Neither Company C nor Company D have had previous experience in dealing with this type of employee litigation, and Company C's attorney has advised that results in this type of case can vary significantly depending on the specific facts and circumstances of the case. An active market does not exist to transfer the potential liability arising from this type of lawsuit to a third party. Company C has decided to pay \$1 million to settle the liability on the acquisition date to avoid damage to its brand or further costs associated with the allocation of resources and time to defend the case in the future.

Should Company C recognize a contingent liability for the employee litigation?

Analysis

Yes. Company C would record the liability to settle the litigation on the acquisition date applying the guidance of ASC 805-20-25-20 (i.e., by analogy to ASC 450-20-25-2). Company C's decision to pay a settlement amount indicates that it is probable that Company C has incurred a liability as of the acquisition date and that the amount of the liability can be reasonably estimated.

Question BCG 2-2

Should an accounting acquirer that has an accounting policy to expense legal fees as incurred accrue future costs to defend litigation assumed in a business combination as of the acquisition date if the fair value of the litigation contingency cannot be determined?

PwC response

No. Given that the accounting acquirer has historically elected an accounting policy to expense legal fees as incurred, it would not be appropriate to accrue future legal costs as of the acquisition date, even though the related litigation existed as of the acquisition date. Instead, such future legal costs should be expensed as incurred consistent with the acquirer's policy.

However, if the litigation contingency was recognized at fair value on the acquisition date (i.e., if the fair value was determinable at the acquisition date), future legal fees would be included in the fair value measurement.

2.5.13.1 Contingencies: subsequent measurement

The acquirer should develop a systematic and rational approach for subsequently measuring and accounting for assets and liabilities arising from contingencies that were recognized at fair value on the date of acquisition (e.g., self-insured workers' compensation liability). The approach should be consistent with the nature of the asset or liability. Although ASC 805 does not provide guidance on subsequent accounting for contingencies, we believe the acquirer should consider the initial recognition and measurement of the contingency when developing the systematic and rational basis. For example, the method developed for the subsequent accounting for warranty obligations may be similar to methods that have been used in practice to subsequently account for guarantees that are initially recognized at fair value under ASC 460-10-35-2. For other contingencies initially recognized at fair value, we believe that a systematic and rational approach may consider accretion of the liability as well as changes in estimates of the cash flows (e.g., an accounting model similar to asset retirement obligations under ASC 410-20 may be an acceptable method). Judgment is required to determine the method for subsequently accounting for assets and liabilities arising from contingencies.

It would not be appropriate to recognize an acquired contingency at fair value on the acquisition date and then in the immediate subsequent period value the acquired contingency in accordance with ASC 450, with a resulting gain or loss for the difference. In addition, subsequently measuring an acquired asset or liability at fair value is not considered to be a systematic or rational approach, unless required by other GAAP.

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

If the acquirer recognized an asset or liability under ASC 450 on the acquisition date, the acquirer should continue to follow the guidance in ASC 450 in periods after the acquisition date.

If the acquirer did not recognize an asset or liability at the acquisition date because none of the recognition criteria are met, the acquirer should account for such assets or liabilities in the periods after the acquisition date in accordance with other GAAP, including ASC 450, as appropriate.

2.5.14 *Indemnification assets (business combinations)*

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

The recognition and measurement of an indemnification asset is based on the related indemnified item. That is, the acquirer should 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 collectibility or contractual limitations on the indemnified amount. Indemnification assets recognized on the acquisition date (or at the same time as the indemnified item) continue to be measured on the same basis as the related indemnified item subject to collectibility and contractual limitations on the indemnified amount until they are collected, sold, cancelled, or expire in the postcombination period.

Question BCG 2-3

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

PwC response

ASC 805 states that an indemnification asset should be recognized at the same time as the indemnified item. Therefore, if the indemnified item has not met the recognition criteria as of the acquisition date, an indemnification asset should not be recognized. If the indemnified item is recognized subsequent to the acquisition, the indemnification asset would then also be recognized on the same basis as the indemnified item subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount. This accounting would be applicable even if the indemnified item is recognized outside of the measurement period.

Question BCG 2-4

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

PwC response

No. Indemnification accounting can still apply even if the indemnification arrangement is the subject of a separate agreement. Indemnification accounting applies as long as the arrangement is entered into on the acquisition date, is an agreement reached between the acquirer and seller, and relates to a specific contingency or uncertainty of the acquired business, or is in connection with the business combination.

Question BCG 2-5

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

PwC response

General representations and warranties would not typically relate to any contingency or uncertainty related to a specific asset or liability of the acquired business. Therefore, in most cases, the amounts held in escrow for the seller's satisfaction of general representations and warranties would not be accounted for as an indemnification asset. See BCG 2.6.3.3 for further information on consideration held in escrow for general representation and warranty provisions.

Example BCG 2-11 provides an example of the recognition and measurement of an indemnification asset.

EXAMPLE BCG 2-11

Recognition and measurement of an indemnification asset

As part of an acquisition, the seller provides an indemnification to the acquirer for potential losses from an environmental matter related to the acquiree. The contractual terms of the seller indemnification provide for the reimbursement of any losses greater than \$100 million. There are no issues surrounding the collectibility of the arrangement from the seller. A contingent liability of \$110 million is recognized by the acquirer on the acquisition date using similar criteria to ASC 450-20-25-2 because the fair value of the contingent liability could not be determined during the measurement period. At the next reporting period, the amount recognized for the environmental liability is increased to \$115 million based on new information.

How should the seller indemnification be recognized and measured?

Analysis

The seller indemnification should be considered an indemnification asset and should be recognized and measured on a similar basis as the related environmental contingency. On the acquisition date, an indemnification asset of \$10 million (\$110 million less \$100 million), is recognized. At the next reporting period after the acquisition date, the indemnification asset is increased to \$15 million (\$115 million less \$100 million), with the \$5 million adjustment offsetting the earnings impact of the \$5 million increase in the contingent liability.

2.5.15 Liabilities related to restructurings or exit activities

Liabilities related to restructurings or exit activities of the acquiree should only be recognized at the acquisition date if they are preexisting liabilities of the acquiree and were not incurred for the benefit of the acquirer. Including a plan for restructuring or exit activities in the purchase agreement does not in itself create an obligation for accounting purposes to be assumed by the acquirer at the acquisition date. Liabilities and the related expense for restructurings or exit activities that are not preexisting liabilities of the acquiree should be recognized through earnings in the postcombination period when all applicable criteria of ASC 420 have been met. Liabilities related to restructuring or exit activities

that were recorded by the acquiree after negotiations to sell the company began should be assessed to determine whether such restructurings or exit activities were done in contemplation of the acquisition for the benefit of the acquirer. If the restructuring activities were done for the benefit of the acquirer, the acquirer should account for the restructuring activities as a separate transaction. Refer to ASC 805-10-55-18 for more guidance on separate transactions.

Example BCG 2-12 and Example BCG 2-13 illustrate the recognition and measurement of liabilities related to restructuring or exit activities.

EXAMPLE BCG 2-12

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

An acquiree has an existing liability/obligation related to a restructuring that was initiated one year before the business combination was contemplated. In addition, during negotiations and at the instruction of the acquirer, the acquiree closed a manufacturing plant and incurred a related liability prior to the business combination. Further, in connection with the acquisition, the acquirer identified several operating locations to close and selected employees of the acquiree to terminate to realize synergies in the postcombination period. Six months after the acquisition date, the recognition criteria under ASC 420 for this restructuring are met and a liability recorded.

How should the acquirer account for each of these restructurings?

Analysis

The acquirer would account for the restructurings as follows:

- Restructuring initiated by the acquiree: The acquirer would recognize the previously recorded restructuring liability at fair value as part of the business combination, since it is an obligation of the acquiree at the acquisition date.
- Acquiree restructuring initiated based on the acquirer's instruction prior to the acquisition date: The guidance in ASC 805-10-55-18 should be considered to determine if the restructuring benefits the acquirer. In this case, the restructuring was requested by the acquirer, was initiated as a result of negotiations between the acquirer and acquiree and is presumed to be for the benefit of the combined entity. Accordingly, the combined entity would account for the restructuring activities as a separate transaction. It is not a liability the acquirer will assume in the business combination.
- Restructuring initiated by the acquirer subsequent to the acquisition date: The acquirer would recognize the effect of the restructuring in earnings in the postcombination period, rather than as part of the business combination. Since the restructuring is not an obligation at the acquisition date, the restructuring does not meet the conceptual definition of a liability and is not a liability assumed in the business combination.

EXAMPLE BCG 2-13

Seller's reimbursement of acquirer's postcombination restructuring costs

The sale and purchase agreement for a business combination contains a provision for the seller to reimburse the acquirer for certain qualifying costs of restructuring the acquiree during the postcombination period. Although it is probable that qualifying restructuring costs will be incurred by

the acquirer, there is no liability for restructuring that meets the recognition criteria at the combination date.

How should the reimbursement right be recorded?

Analysis

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

2.5.16 *Acquired revenue contracts with customers (after adoption of ASU 2021-08)*

New guidance

ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*, affects all entities that enter into a business combination within the scope of ASC 805-10. ASU 2021-08 is effective for public business entities. For all other entities, it is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Entities should apply the guidance in ASU 2021-08 on a prospective basis to all business combinations with an acquisition date on or after the effective date.

Early adoption is permitted, including in an interim period, for any period for which financial statements have not yet been issued. However, adoption in an interim period other than the first fiscal quarter requires an entity to apply the new guidance to all prior business combinations that have occurred since the beginning of the annual period in which the new guidance is adopted.

No adjustment can be made to acquisitions that occurred in previous fiscal years, even if the “measurement period” described in ASC 805-10-25-14 is still open for such acquisition. See BCG 2.5.16A for applicable guidance before adoption of ASU 2021-08.

Summary

The acquiree in a business combination may have revenue contracts with customers for which it had recognized contract assets and/or contract liabilities in its precombination financial statements. In accordance with ASC 805-20-30-28, the acquirer should determine what contract assets and/or contract liabilities it would have recorded under ASC 606 (the revenue guidance) as of the acquisition date, as if the acquirer had entered into the original contract at the same date and on the same terms as the acquiree.

ASC 606 provides guidance on when certain assessments and estimates should be made (i.e., at contract inception or on a recurring basis). ASC 805-20-30-28 states that the acquirer should make those assessments as of the dates required by ASC 606. Accordingly, the acquirer should evaluate the performance obligations, transaction price (e.g., significant financing considerations), and relative standalone selling price at the original contract inception date or subsequent modification dates

(unless certain practical expedients are applied—see BCG 2.5.16.6). The acquirer should then assess the measure of progress (for performance obligations satisfied over time) or timing of control transfer (for performance obligations satisfied at a point in time) compared to the amount of consideration received (or receivable) to determine the amount of contract asset or contract liability as of the acquisition date. The acquirer should also determine its estimate of variable consideration (subject to the constraint described in ASC 606-10-32-11 through ASC 606-10-32-13, or the exception for sales- or usage-based royalties described in ASC 606-10-55-65) as of the acquisition date. As noted in FSP 33.3.4, while the amounts are calculated based on individual performance obligations, a single net contract asset or contract liability should be determined for each acquired revenue contract. See PwC’s guide to *Revenue from contracts with customers* for further guidance on these calculations and estimates.

While the unit of account for the recognition and measurement of contract assets and liabilities in a business combination should be the customer contract, there may be acquired intangible assets or liabilities associated with customer contracts that meet the contractual-legal or the separability criterion for which separate recognition of these intangible assets would be required. For example, acquired contract-related intangible assets such as off-market contracts, customer relationships, or contract backlogs may require separate recognition. See BCG 4.3.5 and BCG 4.3.3.5 for further discussion of the accounting for customer contract-related intangible assets.

The recognition and measurement of contract assets and contract liabilities will likely be comparable to what the acquiree has recorded on its books under ASC 606 as of the acquisition date. However, the FASB noted in paragraph BC33 in the basis for conclusions of ASU 2021-08 that the accounting is not simply a “carryover” basis of the acquiree’s books and records. For example, the acquirer has to consider the reasonableness of the application of ASC 606 by the acquiree. Further, if the acquirer’s accounting policies differ from those of the acquiree (e.g., applying the practical expedient for a significant financing component when the time between performance and payment is less than one year), the acquirer’s policies are required to be applied.

Generally, the amount of revenue recognized by the acquirer subsequent to the acquisition date will be the same as the amount that would have been recognized by the acquiree absent the business combination, or that would be recognized for identical contracts entered into by the acquirer. However, as the FASB noted in paragraphs BC33 and BC43 in the basis for conclusions of ASU 2021-08, there may be differences due to the recording of off-market contract assets or liabilities (see discussion on off-market contracts in BCG 4.3.3.5) as well as differences arising from:

- Situations when the acquiree has not applied ASC 606 (e.g., prepared financial statements under IFRS, statutory reporting requirements, or other financial reporting frameworks)
- Differences in the acquirer’s and acquiree’s revenue recognition accounting policies
- Differences in estimates between the acquirer and acquiree (e.g., estimates of variable consideration or measure of progress)
- Errors in the ASC 606 accounting of the acquiree prior to the business combination

ASC 805-20-30-28 states the acquirer should measure the contract assets and contract liabilities of the acquired contract as if the acquirer originated the contract and then subsequently followed the guidance in ASC 606. Therefore, estimates (e.g., measurement of progress to completion) should be determined from the perspective of the acquirer, which may differ from the amounts recorded on the

acquiree's books immediately prior to the business combination (for example, due to a different cost structure of the acquirer or expected synergies arising from the acquisition).

Example BCG 2-14 illustrates the accounting by an acquirer in a business combination in which the acquiree entered into a long-term construction contract with a customer prior to the acquisition date, including how progress should be measured for that acquired in-progress performance obligation.

EXAMPLE BCG 2-14

Long-term construction contract

Company A enters into an arrangement with Company B on January 1, 20X1 to construct a new office building for total consideration of \$40 million, which is paid in various installments as certain defined milestones are met over the construction period. The construction of the facility is considered a single performance obligation under ASC 606 that is satisfied over time and is expected to take approximately two years to complete. Company A concludes that the contract does not include a significant financing component and determines that the most appropriate measure of progress is an input method based on costs incurred as compared to total anticipated costs to complete the building.

On January 1, 20X2, Company C acquires Company A in a business combination. Based on the measure of progress, Company A estimated the contract to be 50% complete immediately before the acquisition and had recognized \$20 million in revenue (50% x total consideration of \$40 million) and received \$18 million in payments from Company B through that date. Therefore, as of the acquisition date, Company A would have recognized a contract asset of \$2 million under ASC 606 since payment of this amount is conditioned on something other than the passage of time.

However, on the acquisition date, Company C estimates that the performance obligation is 55% complete based on its assessment of the cost of the remaining post-acquisition performance obligation and Company C's cost structure (which differs from the cost structure of Company A due to Company C's greater purchasing power).

How should Company C account for this arrangement in acquisition accounting?

Analysis

The measure of progress for a performance obligation satisfied over time should reflect the reporting entity's performance in transferring control of goods or services. In a business combination, the acquirer should assess the measure of progress for a performance obligation satisfied over time (multiplied by the total consideration for the contract) compared to the amount of consideration received as of the acquisition date to determine the amount of contract asset or liability to record in acquisition accounting. Such calculations should reflect the acquirer's estimates associated with the acquired contract.

Company C would record a contract asset or contract liability in acquisition accounting based on what it would have recorded if Company C had entered into the original contract with Company B at the same date and on the same terms. Based on its measure of progress toward completion (55%) at the acquisition date, multiplied by the total contract consideration of \$40 million, less the \$18 million of payments received from Company B to date, Company C would record a contract asset of \$4 million. Note that this differs from the \$2 million contract asset that Company A would have recorded as of that date, due to differences in estimates between the companies.

Scope

In accordance with ASC 805-20-25-28C(b), the guidance in ASU 2021-08 also applies to other contracts that apply the provisions of ASC 606, including contract liabilities from the sale of nonfinancial assets within the scope of ASC 610-20, *Other Income--Gains and Losses from the Derecognition of Nonfinancial Assets*. Additionally, the guidance could apply to other arrangements that apply the provisions of ASC 606 either directly or by analogy, such as those accounted for under ASC 808, *Collaborative Arrangements*.

2.5.16.1 **Acquired customer contract assets (after adoption of ASU 2021-08)**

ASC 606 distinguishes between a contract asset and a receivable based on whether receipt of the consideration is conditional on something other than the passage of time.

Definition from ASC Master Glossary

Contract asset: 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).

Excerpt from ASC 606-10-45-4

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due...An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20.

In a business combination, the acquirer will recognize a contract asset if the acquiree has already transferred goods or services to a customer but has not yet received (or is not yet due) payment as of the acquisition date and the right to consideration is conditioned on something other than the passage of time. A contract asset differs from a receivable because the right to consideration is conditioned on something other than the passage of time (e.g., the transfer of additional goods or services). See BCG 2.5.2 for consideration of the credit loss allowance for contract assets acquired in a business combination.

ASC 606-10-55-65 includes an exception for the recognition of revenue relating to licenses of intellectual property with sales- or usage-based royalties. Under this exception, royalty revenue is not recorded until the subsequent sale or usage occurs, or the performance obligation has been satisfied, whichever is later. For example, when the contract is a license of functional intellectual property in exchange for sales-based royalties, no amount of the future variable consideration can be recognized as a contract asset under ASC 606-10-55-65 until the underlying sales occur.

No contract asset would be recognized at the acquisition date for variable consideration that cannot be recognized under ASC 606 at that time, and any subsequent consideration received (or recognizable under ASC 606) would be recognized as revenue in the post-acquisition period. The FASB indicated that the estimated cash flows subject to the variable consideration constraint or the exclusion of sales- or usage-based royalties could still be included in the valuation of the customer-related intangible assets associated with the contract in acquisition accounting (see BCG 4.3.5.1).

Example BCG 2-15 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed functional intellectual property to a customer in exchange for royalties.

EXAMPLE BCG 2-15

Pharmaceutical drug license

Company A is a pharmaceutical company. Company A acquires Company B in a business combination on January 1, 20X2. Company B, also a pharmaceutical company, previously licensed its approved oncology drug to Company Z on January 1, 20X1. The drug license arrangement has a term of five years with a 6% sales-based royalty paid by Company Z to Company B based upon Company Z's sales of the drug to third parties. Company B previously delivered the oncology drug intellectual property at the contract inception date and has no remaining performance obligations.

How should Company A account for the functional intellectual property drug license arrangement with Company Z in acquisition accounting?

Analysis

ASC 606-10-55-65 includes an exception for the recognition of revenue relating to licenses of intellectual property with sales- or usage-based royalties. Under this exception, royalty revenue is not recorded until the subsequent sale or usage occurs, or the performance obligation has been satisfied, whichever is later.

Company A would not record a contract asset in acquisition accounting related to this arrangement. Company A would record revenue subsequent to the acquisition date as the royalties are generated by Company Z. On the acquisition date, Company A would record a customer-related intangible asset at fair value (which likely contemplates anticipated future royalties that will be generated for Company A from Company Z) and reflect amortization of that intangible asset as an expense ratably over the useful life of the asset.

2.5.16.2 **Acquired customer contract liabilities (after adoption of ASU 2021-08)**

Under ASC 606, an entity should recognize a contract liability if the customer's payment of consideration precedes the entity's performance (e.g., an upfront payment or a non-refundable deposit) or when an entity has an unconditional right to consideration in advance of performance. Contract liabilities may also be referred to as deferred or unearned revenue.

ASC 606-10-45-2

If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

In a business combination, the acquirer should apply the definition of a performance obligation in ASC 606 to determine whether to recognize a contract liability. As described in ASC 606-10-25-16, a performance obligation includes not only legal and explicitly stated obligations in a contract, but also those that may be implied by an entity's customary business practices, published policies, or specific statements. See RR 3.2.2 for further discussion.

The acquirer will recognize a contract liability if the customer has provided consideration to the acquiree (or the acquiree has a receivable from the customer), but the acquiree has not yet fully transferred the related goods or services to the customer (i.e., the acquiree has an unsatisfied performance obligation). The acquirer will also apply the provisions of ASC 606 to calculate the amount of such contract liability. Subsequent to the acquisition date, the acquirer should derecognize the contract liability and recognize revenue when or as the performance obligations are satisfied.

Example BCG 2-16 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed functional intellectual property and provides distinct services to a customer.

EXAMPLE BCG 2-16

Software license with post-contract customer support

Company A provides a three-year, fixed-term software license to Company B on January 1, 20X1. Company B also receives post-contract customer support (PCS), which entitles Company B to “when and if available upgrades” that are developed by Company A. The total cash consideration paid at contract inception is \$75 million. Company A determines the software license and PCS are separate performance obligations and allocates \$60 million of the transaction price to the software license and \$15 million to the PCS. Company A recognizes revenue allocated to the software license when the license term commences and recognizes the revenue allocated to PCS ratably over the three-year term.

Company C acquires Company A on January 1, 20X3. For the purpose of this example, any effects of significant financing are ignored, and the price associated with PCS in the contract is still considered market pricing at the acquisition date.

How should Company C account for the software license and PCS arrangements with Company B in acquisition accounting?

Analysis

Company C would not record a contract asset or contract liability related to the software license, as the acquiree already received the cash and delivered the software. Company C would recognize a \$5 million contract liability for the unsatisfied portion of the performance obligation for the PCS arrangement (\$15 million less \$10 million recognized for the first two years, as performance is two-thirds complete as of the acquisition date of January 1, 20X3). This amount is based upon the original terms of the contract, the determination of the performance obligations and relative standalone selling prices of the performance obligation at contract inception, and the progress to completion through the acquisition date. This amount would be recognized as revenue over the next year post-acquisition as the remaining PCS service is provided to Company B.

Example BCG 2-17 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed symbolic intellectual property to a customer and had received an upfront payment from that customer prior to the acquisition date.

EXAMPLE BCG 2-17

License of character images

Company A creates and produces early childhood educational programs, including a new animated

television show. Company A grants a four-year exclusive license to Company B on January 1, 20X1 to use the images of the characters from the television show in exchange for an upfront payment of \$80 million.

The intellectual property (IP) underlying the license is symbolic IP because the character images do not have significant standalone functionality. The license is therefore a right to access IP and Company A recognizes revenue over time under ASC 606.

On January 1, 20X4, Company C acquires Company A in a business combination. There is one year remaining on the symbolic IP license arrangement between Company A and Company B, and to date Company A has recognized \$60 million in revenue. For the purpose of this example, any effects of significant financing are ignored, and the fee associated with the IP license is still considered market pricing at the acquisition date.

How should Company C account for this arrangement in acquisition accounting?

Analysis

Company C would record a contract liability in acquisition accounting based on what it would have recorded if Company C had entered into the original contract with Company B at the same date and on the same terms. As the license fee would be recognized over the four-year term of the license under ASC 606, Company C would record a contract liability in acquisition accounting for the remaining one-fourth of the license period that remains at the acquisition date of January 1, 20X4, or \$20 million. This amount would be recognized as revenue by Company C in the one-year period subsequent to the acquisition.

The fair value of the intangible asset for the symbolic IP should consider that there will be no future cash flows associated with the licensed character images from Company B for the remaining term of the license arrangement, even though there will be future revenue recognized under this contract under the new guidance. Additionally, we believe that there is no customer relationship intangible asset to record in this situation, as there are no further cash flows to be received from the customer under the license arrangement subsequent to the acquisition date.

2.5.16.3 *Costs to obtain/fulfill customer contract (after adoption of ASU 2021-08)*

Costs to obtain or fulfill contracts with customers may be recognized as assets in the acquirer's precombination financial statements under ASC 340-40. Similar to other types of deferred costs (e.g., debt issuance costs), unamortized contract acquisition and fulfillment costs of the acquirer do not meet the conceptual definition of an asset to the acquirer and therefore would not be recognized by the acquirer in a business combination. However, the fair value of these costs may be measured in the value of certain customer-related intangible assets recognized in acquisition accounting. See BCG 4.3.5.1 for further information on recognizing and measuring intangible assets relating to customer contracts and relationships.

2.5.16.4 *Loss contracts acquired in a business combination (after adoption of ASU 2021-08)*

A loss contract occurs if the unavoidable costs of meeting the obligations under a contract with a customer exceed the expected future consideration to be received. However, unprofitable operations of an acquired business do not necessarily indicate that the contracts of the acquired business are loss

contracts. Additionally, outside of acquisition accounting, only certain types of contracts are eligible for recognition of losses in advance of costs actually being incurred. See further discussion in RR 11.5.1.

In limited circumstances, the acquirer may acquire contracts for which the acquiree had determined that the total costs to complete the contract exceed the total consideration to be received from the customer (i.e., loss contracts), and for which the acquiree recorded a loss accrual. A question arises as to how loss contracts should be recorded in acquisition accounting.

The scope of ASU 2021-08 only addresses contract assets and contract liabilities under ASC 606. Loss contracts are addressed under other US GAAP, such as ASC 605-35 for construction-type contracts or ASC 605-20 for separately priced extended warranty contracts. Therefore, we do not believe that loss contracts are subject to ASU 2021-08. A loss contract should be recognized as a liability at fair value in acquisition accounting if the contract is a loss contract to the acquiree at the acquisition date, which may be different from any loss accrual that the acquiree had previously recognized. This amount should be calculated using market participant assumptions about the prevailing market terms for such goods or services, rather than simply using the acquiree's cost estimates. An acquirer should have support for certain key assumptions, such as market price and the unavoidable costs to fulfil the contract (e.g., manufacturing costs, service costs), if a liability for a loss contract is recognized. For example, Company A acquires Company B in a business combination. Company B is contractually obligated to fulfill a previous fixed-price contract to produce a fixed number of components for one of its customers. However, Company B's unavoidable costs to manufacture the component exceed the sales price in the contract. As a result, Company B has incurred losses on the sale of this product and the combined entity is expected to continue to do so in the future. Company B's contract is considered a loss contract that is assumed by Company A in the acquisition. Therefore, Company A would record a liability for the loss contract assumed in the business combination.

When measuring a loss contract, an acquirer should first consider whether the amount to be recognized should be adjusted for any intangible assets or liabilities recognized for contract terms that are favorable or unfavorable compared to current market terms (i.e., there should not be double-counting). A contract assumed in a business combination that becomes a loss contract subsequent to the acquisition should be recognized through earnings in the postcombination period based on the applicable framework in US GAAP.

2.5.16.5 *Upfront payments made by the acquiree to its customer (after adoption of ASU 2021-08)*

An entity may make an upfront payment to a customer to incentivize the customer to sign a contract. Under ASC 606, payments to a customer are recorded as a reduction of revenue, unless they reflect payment for a distinct good or service. If paid upfront, depending on assessments of recoverability, such amount may be deferred and recognized against subsequent revenue generated from that customer (see further discussion in RR 4.6.4).

Such deferred assets do not reflect separate assets to be recognized in acquisition accounting. The impact of an upfront payment made by an acquiree to its customer is generally included by the acquirer as part of the valuation of the customer relationship intangible asset in acquisition accounting. In essence, the upfront payment helped to obtain the future cash flows associated with the customer contract. The acquirer generally records the amortization of this intangible asset as an expense.

However, if the acquirer negotiated and/or directed the acquiree to make the upfront payment to a new customer in contemplation of the business combination, the payment should be viewed to be for the benefit of the acquirer/combined entity post-acquisition, and the subsequent amortization should be recorded as a reduction of revenue. This is consistent with the guidance issued in EITF 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*. While this guidance was not codified in ASC 805, we believe it is consistent with the guidance in ASC 805-10-55-18 related to transactions that should be accounted for separate from the business combination, and the guidance in ASC 606 related to payments to customers.

2.5.16.6 *Acquired revenue contracts: practical expedients (after adoption of ASU 2021-08)*

The acquirer may elect to apply certain practical expedients when measuring contract assets and/or contract liabilities in a business combination, as described in ASC 805-20-30-29.

ASC 805-20-30-29

An acquirer may use one or more of the following practical expedients when applying paragraphs 805-20-30-27 through 30-28 at the acquisition date:

- a. For contracts that were modified before the acquisition date, an acquirer may reflect the aggregate effect of all modifications that occur before the acquisition date when:
 1. Identifying the satisfied and unsatisfied performance obligations
 2. Determining the transaction price
 3. Allocating the transaction price to the satisfied and unsatisfied performance obligations.
- b. For all contracts, for purposes of allocating the transaction price, an acquirer may determine the standalone selling price at the acquisition date (instead of the contract inception date) of each performance obligation in the contract.

These practical expedients are designed to provide relief for circumstances when the acquirer is unable to assess or rely on the acquiree's accounting under ASC 606. In this case, the FASB observed that the acquirer would effectively have to adopt ASC 606 for the acquiree's revenue contracts.

The first practical expedient in ASC 805-20-30-29(a) is similar to one applicable to the initial adoption of ASC 606 and permits an acquirer to utilize the terms that exist as of the latest modification of a contract to determine the performance obligations and transaction price.

The second practical expedient in ASC 805-20-30-29(b) relates to the timing of determining the standalone selling prices in order to allocate the transaction price to the performance obligations in the contract. This practical expedient permits an acquirer to determine the standalone selling prices at the acquisition date, rather than at the contract inception date as otherwise required by ASC 606. The FASB indicated that the purpose of this practical expedient is to alleviate circumstances in which it would be onerous for the acquirer to go back to the contract inception date if the acquiree lacks sufficient information or did not previously prepare financial statements in accordance with US GAAP.

An acquirer can elect to apply either or both of these practical expedients on an acquisition-by-acquisition basis. If practical expedients are elected for a particular acquisition, they should be applied to all revenue contracts associated with that acquisition. However, different elections can be made for different acquisitions.

If an entity elects to apply any of these practical expedients, the disclosures discussed in FSP 17.4.7 are required.

2.5.16A Acquired revenue contracts with customers (prior to adoption of ASU 2021-08)

The acquiree in a business combination may have revenue contracts with customers for which it had recognized contract assets and liabilities in its precombination financial statements. Contract assets and liabilities acquired in a business combination should be recognized and measured by the acquirer at their acquisition date fair values, which may be different from the amounts that the acquiree had previously recognized under ASC 606.

The unit of account for the recognition and measurement of contract assets and liabilities in a business combination should be the customer contract. However, there may be acquired intangible assets or liabilities associated with customer contracts that meet the contractual-legal or the separability criterion, in which case separate recognition of these intangible assets would be required. For example, acquired contract-related intangible assets such as off-market contracts, customer relationships, or contract backlogs may require separate recognition. See BCG 4.3.5 and BCG 4.3.3.5 for further discussion of the accounting for customer contract-related intangible assets.

The fair value of acquired customer contracts is not impacted by the acquiree's method of accounting for the contracts before the acquisition or the acquirer's planned accounting methodology in the postcombination period (i.e., the fair value is determined using market-participant assumptions).

For performance obligations satisfied over time, the acquirer will need to determine the measure of progress to recognize revenue during the post-acquisition period. The measure of progress should be based on the acquirer's estimate of the remaining post-acquisition performance and should be determined in accordance with ASC 606. For example, if the "cost-to-cost" (i.e., input) method is used, the acquirer should measure progress based on the estimated cost to complete the contract as of the acquisition date as opposed to the estimated cost to complete the contract from inception. In other words, the acquired contract is effectively viewed as a new performance obligation that is 0% complete as of the acquisition date.

New guidance

In October 2021, the FASB issued ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*. This guidance requires contract assets and contract liabilities (i.e., deferred revenue) acquired in a business combination to be recognized and measured by the acquirer on the acquisition date in accordance with ASC 606, *Revenue from Contracts with Customers*. See BCG 2.5.16 for additional information on ASU 2021-08, including effective dates, transition requirements, and post-adoption guidance.

2.5.16.1A Acquired customer contract assets (prior to adoption of ASU 2021-08)

ASC 606 distinguishes between a contract asset and a receivable based on whether receipt of the consideration is conditional on something other than the passage of time.

Definition from ASC Master Glossary

Contract asset: 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).

Excerpt from ASC 606-10-45-4

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due...An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20.

An acquiree's contract assets and receivables are recognized and measured by the acquirer at their acquisition date fair values. Although contract assets and receivables are similar in nature in that both represent the right to consideration from a customer, the measurement of each at fair value may be different. Since contract assets are conditioned on something other than the passage of time, such as the performance of future performance obligations, the fair value of these assets may need to incorporate assumptions regarding other factors, such as the satisfaction of future performance obligations. The fair value of receivables, however, generally incorporates only the time value of money and the customers' credit risk. In certain situations, the fair value of acquired receivables may approximate their carrying value if the receivables are short term in nature and customer credit risk is not material. See BCG 2.5.2 and BCG 2.5.2A for information on recognizing asset valuation allowances for receivables. Additionally, see FSP 33.3.1 for information on distinguishing between contract assets and receivables, including the separate presentation of these assets in the financial statements.

2.5.16.2A Acquired customer contract liabilities (prior to adoption of ASU 2021-08)

Under ASC 606, an entity should recognize a contract liability if the customer's payment of consideration precedes the entity's performance (e.g., an upfront payment or a deposit) or when an entity has an unconditional right to consideration in advance of performance. Contract liabilities may also be referred to as deferred or unearned revenue.

ASC 606-10-45-2

If a customer pays consideration or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

The acquirer in a business combination recognizes an assumed contract liability at the acquisition date fair value when the contract liability represents a legal obligation assumed by the acquirer. The fair value of a contract liability recognized by the acquirer in acquisition accounting may be different from the contract liability recognized in the acquiree's precombination financial statements. See FV 7.3.3.6A for further information on measuring deferred or unearned revenue (i.e., contract liabilities) at fair value.

Subsequent to the acquisition date, the acquirer should derecognize the contract liability and recognize revenue when or as the performance obligations are satisfied.

2.5.16.3A *Costs to obtain/fulfill customer contract (business combinations) (prior to adoption of ASU 2021-08)*

Costs to obtain or fulfill contracts with customers may be recognized as assets in the acquiree's precombination financial statements under ASC 340-40. Similar to other types of deferred costs (e.g., debt issuance costs), unamortized contract acquisition and fulfillment costs of the acquiree do not meet the conceptual definition of an asset to the acquirer and therefore would not be recognized by the acquirer in a business combination. However, the fair value of these costs may be measured in the value of certain customer-related intangible assets recognized in acquisition accounting. See BCG 4.3.5.1 for further information on recognizing and measuring intangible assets relating to customer contracts and relationships.

2.5.16.4A *Loss contracts acquired in a business combination (prior to adoption of ASU 2021-08)*

A loss contract occurs if the unavoidable costs of meeting the obligations under a contract with a customer exceed the expected future consideration to be received. However, unprofitable operations of an acquired business do not necessarily indicate that the contracts of the acquired business are loss contracts. Additionally, outside of acquisition accounting, only certain types of contracts are eligible for recognition of losses in advance of costs actually being incurred. See further discussion in RR 11.5.1.

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

When measuring a loss contract, an acquirer should first consider whether the amount to be recognized should be adjusted for any intangible assets or liabilities recognized for contract terms that are favorable or unfavorable compared to current market terms (i.e., there should not be double-counting). A contract assumed in a business combination that becomes a loss contract subsequent to the acquisition should be recognized through earnings in the postcombination period based on the applicable framework in US GAAP.

2.5.17 *Deferred charges arising from leases (acquiree is a lessor)*

The balance sheet of an acquiree that is a lessor before the acquisition date may include deferred rent related to an operating lease, resulting from the accounting guidance in ASC 842 to generally recognize operating lease income on a straight-line basis if lease terms include decreasing or escalating lease payments. The acquirer should not recognize the acquiree's deferred rent using the acquisition

method because it does not meet the conceptual definition of an asset or liability. The acquirer may record deferred rent starting from the acquisition date in the postcombination period based on the terms of the assumed lease.

Although deferred rent of the acquiree is not recognized in a business combination, the acquirer may recognize an intangible asset or liability related to the lease, depending on its nature or terms. See BCG 4.3.3.7 for additional guidance on the accounting for leases in a business combination.

Example BCG 2-18 illustrates the recognition of deferred rent in a business combination.

EXAMPLE BCG 2-18

Recognition of deferred rent when the acquiree is a lessor

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

- Four-year lease term
- Lease payments are:
 - Year 1: \$400
 - Year 2: \$300
 - Year 3: \$200
 - Year 4: \$100

On the acquisition date, the lease had a remaining contractual life of two years, and the acquiree had recognized a \$200¹ liability for deferred rent. For the purpose of this example, other identifiable intangible assets and liabilities related to the operating lease are ignored.

How should Company A account for the deferred rent?

Analysis

Company A does not recognize any amounts related to the acquiree's deferred rent liability on the acquisition date. However, the terms of the acquiree's lease will give rise to deferred rent in the postcombination period. Company A will record a deferred rent liability of \$50² at the end of the first year after the acquisition.

¹ *Deferred rent of the acquiree: straight-line income of \$500 $(\frac{(\$400 + \$300 + \$200 + \$100)}{4} \times 2 \text{ years})$ less cash receipts of \$700 $(\$400 + \$300)$.*

² *Deferred rent of the acquirer: straight-line income of \$150 $(\frac{(\$200 + \$100)}{2} \times 1 \text{ year})$ less cash receipts of \$200 (year 3 of lease).*

2.5.18 Classifying or designating identifiable assets and liabilities—updated June 2023

ASC 805-20-25-6 provides the principle with regard to classifying or designating the identifiable net assets acquired.

ASC 805-20-25-6

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

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

- Classifying assets as held for sale: As discussed in BCG 2.5.8, the classification of assets held for sale is based on whether the acquirer has met, or will meet, all of the necessary criteria.
- Classifying investments in debt securities: Debt securities are classified based on the acquirer's investment strategies and intent in accordance with ASC 320, *Investments—Debt Securities*.
- Re-evaluation of the acquiree's contracts: The identification of embedded derivatives and the determination of whether they should be recognized separately from the contract is based on the facts and circumstances existing on the acquisition date.
- Designation and redesignation of the acquiree's precombination hedging relationships: The decision to apply hedge accounting is based on the acquirer's intent and the terms and value of the derivative instruments to be used as hedges on the acquisition date.

See BCG 2.5.19 for further information on the classification or designation of derivatives on the acquisition date.

ASC 805-20-25-8 provides two exceptions to the classification or designation principle:

- Classification of a lease of an acquiree in accordance with ASC 842-10-55-11
 - See BCG 4.3.3.7 for further information.
- Classification of contracts as an insurance or reinsurance contract or a deposit contract within the scope of ASC 944, *Financial Services—Insurance*
 - The classification of these contracts is based on either the contractual terms and other factors at contract inception or the date (which could be the acquisition date) that a modification of these contracts triggered a change in their classification in accordance with the applicable US GAAP. See IG 12.1.3 for further information.

2.5.19 Classification or designation of financial instruments and hedges

An acquiree may have a variety of financial instruments that meet the definition of a derivative instrument. The type and purpose of these instruments will typically depend on the nature of the acquiree's business activities and risk management practices. These financial instruments may have

been (1) scoped out of ASC 815, *Derivatives and Hedging*, (2) used in hedging relationships, (3) used in an “economic hedging relationship,” or (4) used in trading operations. Generally, the precombination accounting for the acquiree’s financial instruments is not relevant to the postcombination accounting by the acquirer. Several issues could arise with respect to an acquiree’s financial instruments and hedging relationships and the subsequent accounting by the acquiring entity. The key issues are summarized below:

- Re-evaluation of the acquiree’s contracts: All contracts and arrangements of the acquiree need to be re-evaluated at the acquisition date to determine if any contracts are derivatives or contain embedded derivatives that need to be separated and accounted for as financial instruments. This includes reviewing contracts that qualify for the normal purchases and sales exception and documenting the basis for making such an election. The determination is made based on the facts and circumstances at the date of the acquisition.
- Designation and redesignation of the acquiree’s precombination hedging relationships: To obtain hedge accounting for the acquiree’s precombination hedging relationships, the acquirer will need to designate hedging relationships anew and prepare new contemporaneous documentation for each. The derivative instrument may not match the newly designated hedged item as closely as it does the acquiree’s item.
- Potential inability to apply the short-cut method: Previous hedging relationships may not be eligible for the short-cut method because, upon redesignation of the hedging relationship, the derivative instrument will likely have a fair value other than zero (positive or negative) on the acquisition date, which will prevent the hedge from qualifying for the short-cut method.

2.5.20 Equity method investments acquired in a business combination

The acquiree may have an investment in another entity accounted for under the equity method. As part of the purchase price allocation, the acquirer should recognize and measure the equity method investment at its acquisition-date fair value in accordance with ASC 820. The acquirer should also determine any basis differences between that acquisition-date fair value and the acquirer’s share of the investee’s net assets following the guidance described in EM 3.3.1.

2.6 Goodwill, bargain purchase gains, and consideration transferred

In accordance with ASC 805-20-25-1, the acquirer in a business combination recognizes the assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree as of the acquisition date. The acquirer often recognizes goodwill on the acquisition date (see BCG 2.6.1). Less frequently, an acquirer may recognize a bargain purchase gain on the acquisition date (see BCG 2.6.2). The amount of goodwill or a bargain purchase gain recognized by the acquirer is determined based on the consideration transferred (see BCG 2.6.3 through BCG 2.6.8).

2.6.1 Goodwill

Goodwill is an asset representing the acquired future economic benefits such as synergies that are not individually identified and separately recognized (i.e., it is measured as a residual). The amount of goodwill recognized is also impacted by measurement differences resulting from certain assets and liabilities not being recorded at fair value (e.g., income taxes, employee benefits).

ASC 805-30-30-1 provides guidance for measuring goodwill.

ASC 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 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.

Goodwill acquired in a business combination is recognized as an asset and is not amortized (except for private companies or not-for-profit entities electing the goodwill alternative – see BCG 9.11). Instead, goodwill is subject to annual impairment tests, or more frequently if there is an indication of impairment, based on the guidance in ASC 350, *Intangibles—Goodwill and Other*. See BCG 9 for a discussion of goodwill impairment testing.

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

2.6.2 Bargain purchase

Bargain purchases occur if the acquisition date amounts of the identifiable net assets acquired, excluding goodwill, exceed the sum of (1) the value of consideration transferred, (2) the value of any noncontrolling interest in the acquiree, and (3) the fair value of any previously held equity interest in the acquiree. ASC 805 requires the recognition of a gain for a bargain purchase. The FASB believes that a bargain purchase represents an economic gain, which should be immediately recognized by the acquirer in earnings. When a bargain purchase gain is recognized in a business combination, no goodwill is recognized.

Although a bargain purchase gain is not expected to be recognized frequently, examples in which a bargain purchase may occur include transactions without a competitive bidding process or when there is a forced or distressed sale. A gain from a bargain purchase may also occur if the acquirer and acquiree enter into an agreement prior to the closing date in which the purchase price is fixed and the fair value of the net identifiable assets increases during the period prior to the closing date.

If a bargain purchase is initially identified, the acquirer should reassess whether all of the assets acquired and liabilities assumed have been identified and recognized, including any additional assets and liabilities not previously identified or recognized in the acquisition accounting in accordance with ASC 805-30-25-4. Once completed, the acquirer should review the procedures used to measure the following items in accordance with ASC 805-30-30-5:

- Identifiable assets acquired and liabilities assumed

- Noncontrolling interest in the acquiree, if any
- Acquirer's previously held equity interest in the acquiree, if any
- Consideration transferred

The objective of reviewing the above items is to ensure that the measurements used to determine a bargain purchase gain reflect all available information as of the acquisition date. The acquirer should also consider whether there are any preexisting relationships that were settled as part of the business combination. If after this review a bargain purchase is still indicated, it should be recognized in earnings and attributed to the acquirer in accordance with ASC 805-30-25-2. ASC 805 requires disclosure of (1) the amount of the gain, (2) the line item where the gain is recognized, and (3) a description of the reasons why the transaction resulted in a bargain purchase gain.

Example BCG 2-19 illustrates a bargain purchase gain recorded in acquisition accounting.

EXAMPLE BCG 2-19

Bargain purchase gain

Company A acquires 100% of Company B for \$150 million in cash. The preliminary fair value of the identifiable net assets acquired is \$160 million. After assessing whether all the identifiable net assets have been identified and recognized and reviewing the measurement of (1) those identifiable net assets, and (2) the consideration transferred, Company A adjusted the value of the identifiable net assets acquired to \$155 million.

How should Company A record the transaction in acquisition accounting?

Analysis

Company A, as part of the acquisition accounting, should recognize a \$5 million bargain purchase gain (\$155 million - \$150 million), which is the amount that the acquisition date fair value of the identifiable net assets acquired exceeds the consideration transferred.

When a bargain purchase gain is recognized in a business combination in which the acquirer obtains less than a 100% controlling interest in the acquiree, we believe that no portion of the bargain purchase gain should be allocated to the noncontrolling interest. This is consistent with ASC 805-20-30-7, which requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value on the acquisition date. See BCG 6 for further information on measurement of a noncontrolling interest.

2.6.3 Measuring and recognizing consideration transferred—updated May 2024

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

The fair value of equity securities issued by the acquirer should be determined in accordance with ASC 820 and should consider all relevant rights and restrictions associated with those securities. The impact of a restriction on fair value depends on whether the restriction is a characteristic of the security itself or a characteristic of the holder of the security, which, in turn, depends on the source of the restriction and its connection to the underlying security. See FV 4.8 and FV 4.8A for additional information.

There may be circumstances where the consideration exchanged in a business combination is only equity interests and the value of the acquiree's equity interests are more reliably measurable than the value of the acquirer's equity interest. This may occur when a private company acquires a public company with a quoted and reliable market price. If so, the acquirer should 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.

In a business combination that does not involve the transfer of consideration, the fair value of the acquirer's interest in the acquiree (determined by using valuation techniques) should be used in the measurement of goodwill. See FV 7.3 for a discussion of valuation techniques.

Additionally, the acquirer must determine whether any portion of the consideration transferred is not part of the acquisition accounting, but instead relates to a transaction separate from the business combination. If a transaction is entered into by the acquirer and is primarily for the benefit of the acquirer or the combined entity, the transaction should likely be recognized and accounted for separately from the business combination. See BCG 2.7 for additional information.

2.6.3.1 *Share-based payment awards*

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. All or a portion of the value of the share-based payment awards may be included in the measurement of consideration transferred, depending upon the various terms and provisions of the awards. Share-based payment awards are identified as a measurement exception because these awards are measured in accordance with ASC 718, *Compensation—Stock Compensation*. The recognition and measurement of share-based payments in a business combination are discussed further in BCG 3.

2.6.3.2 *Consideration transferred includes other assets of the acquirer*

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

2.6.3.3 *Consideration held in escrow*

Acquisition agreements may require that a portion of the consideration transferred to the seller be held in escrow, often for the settlement of general representation and warranty provisions. These

provisions typically lapse within a short period of time after the acquisition date. Absent evidence to the contrary, general representations and warranties are assumed to be valid as of the acquisition date and release of the escrowed funds is considered likely to occur. Therefore, amounts held in escrow for general representations and warranties should generally be included in acquisition accounting as part of the consideration transferred by the acquirer as of the acquisition date. For escrow arrangements relating to specific indemnifications or contingencies, see BCG 2.5.14.

An acquirer should carefully evaluate the legal terms of the business combination and the escrow arrangement to determine if it should present the amounts held in escrow as an asset on its balance sheet. For example, if cash held in the escrow account is legally owned by the acquirer, the acquirer should consider whether an escrow asset and corresponding liability to the seller should be recognized.

Contingent consideration is defined in ASC 805-10-20 as an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. Amounts held in escrow for general representations and warranties would generally not meet the definition of contingent consideration as these amounts relate to conditions existing as of the acquisition date and are not contingent upon the occurrence of a future event. However, if the release amounts held in escrow are dependent upon the occurrence of a future event (e.g., achieving post-acquisition earnings targets), the acquirer should consider whether such amounts represent contingent consideration. See BCG 2.6.4 for information on evaluating contingent consideration arrangements.

2.6.3.4 Working capital adjustments

A working capital adjustment is typically included in a purchase and sale agreement as a means of agreeing on the amount of working capital that existed, and was thus acquired, as of the acquisition date. Examples of working capital adjustments may include adjustments to allowances for returns and rebates and inventory valuation allowances. Similar to general representation and warranty provisions, the subsequent determination of working capital that existed as of the acquisition date does not relate to future events or conditions (i.e., events occurring or conditions being met after the acquisition date) and therefore does not give rise to contingent consideration. Accordingly, payments or receipts for changes in provisional amounts for working capital would be recognized as an adjustment of consideration transferred by the acquirer in its acquisition accounting if the changes occur during the measurement period. Payments or receipts for changes in provisional amounts for working capital that occur outside of the measurement period should be recognized in current period earnings.

2.6.3.5 Deferred consideration (business combinations)

In a business combination transaction, an acquirer may be required to transfer a specified amount of consideration to the seller after the acquisition date. If the amount of consideration is contractually specified in the purchase agreement and is not contingent on a future event or condition being met (i.e., the payment is based solely on the passage of time), the obligation is not accounted for as contingent consideration as discussed in BCG 2.6.4. Rather, the acquirer should measure the deferred payment obligation at fair value on the acquisition date and include this amount as part of the consideration transferred. Subsequent accounting for the obligation should follow other applicable US GAAP (e.g., ASC 835, *Interest*).

Example BCG 2-20 illustrates the accounting for deferred consideration that is not contingent on a future event or condition being met.

EXAMPLE BCG 2-20

Deferred payment of consideration

Company A acquires 100% of Target B in a business combination. The acquisition agreement requires Company A to make a \$100 million cash payment to the shareholders of Target B on the acquisition date and an additional \$30 million cash payment two years after the acquisition date.

How should Company A account for the deferred payment of \$30 million?

Analysis

As the \$30 million cash consideration is not dependent upon the occurrence of a future event or condition, the deferred payment is considered seller financing, not contingent consideration. The deferred payment should be recognized at fair value on the acquisition date and included in the consideration transferred. Subsequent accounting for the deferred consideration should follow ASC 835, *Interest*, for the seller financing obligation.

2.6.4 **Contingent consideration**

Contingent consideration generally represents an obligation of the acquirer to transfer additional assets or equity interests to the selling shareholders if future events occur or conditions are met. Contingent consideration can also take the form of a right of the acquirer to the return of previously transferred assets or equity interests from the sellers of the acquired business. It is often used to enable the buyer and seller to agree on the terms of a business combination, even though the ultimate value of the business has not been determined. Any payments made or shares transferred to the sellers of the acquired business should be evaluated to determine whether they should be accounted for separately from the business combination. Contingent consideration that is paid to sellers that remain employed and linked to future services is generally considered compensation cost and recorded in the postcombination period. See BCG 2.6.5.1 and BCG 3 for further information on compensation arrangements.

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

An acquirer's obligation to pay contingent consideration should be classified as a liability or in shareholders' equity in accordance with ASC 480, *Distinguishing Liabilities from Equity*, ASC 815, *Derivatives and Hedging*, or other applicable US GAAP. A contingent consideration arrangement may be a freestanding instrument or an embedded feature within another arrangement.

The accounting for contingent consideration in the postcombination period is impacted by its classification as an asset, liability, or equity, which is determined based on the nature of the instrument. Accounting for contingent consideration in the postcombination period is as follows:

- Contingent consideration classified as an asset or liability: Contingent consideration classified as either an asset or liability is measured initially and subsequently at each reporting date at fair value. Generally, we would expect a reporting entity to record the entire change as a component of operating income until the contingent consideration arrangement is resolved. Also, see FSP 6.8.20

for discussion of the treatment of contingent consideration classified as an asset or liability in the statement of cash flows.

- Contingent consideration classified as equity: Equity-classified contingent consideration is measured initially at fair value on the acquisition date and is not remeasured subsequent to initial recognition. Settlement of the equity-classified contingent consideration is accounted for within equity. In other words, the initial value recognized for an equity-classified contingent consideration arrangement on the acquisition date is not adjusted, even if the fair value of the arrangement on the settlement date is different. There may be situations when contingent consideration is settled by issuing an entity's own equity securities, but the arrangement is accounted for as a liability. See BCG 2.6.4.2 for further information regarding the classification of contingent consideration. See FV 7.3.3.5 for further information regarding the measurement of share-settled contingent consideration.

2.6.4.1 Contingent consideration related to a partially-owned subsidiary

A contingent consideration arrangement may be entered into as part of the acquisition of a partially-owned subsidiary. Similar to a contingent arrangement in the acquisition of a 100% interest, when acquiring less than 100%, the economics of the arrangement will determine whether the changes in the fair value of the arrangement represents an expense of the acquiree or acquirer. However, if acquiring less than 100%, the determination of which entity the expense belongs to will impact the amount allocated to the noncontrolling interest.

Example BCG 2-21 provides an example of contingent consideration related to a partially-owned subsidiary.

EXAMPLE BCG 2-21

Contingent consideration related to a partially-owned subsidiary

Target is owned 60% by Shareholder 1 and 40% by Shareholder 2. On January 1, Company A purchases the 60% interest in Target from Shareholder 1 for \$200 plus contingent consideration. The contingent consideration arrangement specifies that Company A (not Target) will make future cash payments to Shareholder 1 based on Target achieving certain earnings levels in the two-year period following the acquisition. The acquisition-date fair value of the contingent consideration arrangement, which is classified as a liability in Company A's balance sheet, is \$50.

How should changes in the fair value of a contingent consideration liability be treated when the arrangement relates to a partially-owned subsidiary?

Analysis

The contingent consideration arrangement is between Company A and Shareholder 1 and does not impact the earnings of Target after the acquisition. In this case, none of the expense associated with the increase in the contingent consideration liability would be recognized by Target and therefore none would be attributed to the noncontrolling interest in Company A's consolidated financial statements.

2.6.4.2 **Determining classification of contingent consideration**

A contingent consideration arrangement that is required to be settled in cash or other assets should be classified as a liability. A contingent consideration arrangement that is indexed to the entity's own stock and required to be (or at the issuer's option can be) settled in shares is classified as a liability or as equity. Determining the liability or equity classification of a contingent consideration arrangement that is indexed to and can be settled in an entity's own shares can be complex and will require analysis of the facts and circumstances of each transaction. A company should determine the appropriate classification of a contingent consideration arrangement only after it has evaluated the criteria in ASC 480, ASC 815-40, and any other appropriate authoritative guidance. FG 5 provides guidance on the application of the equity-linked instruments model, including the application of ASC 480 (FG 5.5) and ASC 815-40 after the adoption of ASU 2020-06 (FG 5.6) and prior to the adoption of ASU 2020-06 (FG 5.6A).

The guidance in ASC 480 applies to freestanding equity and equity-linked financial instruments and requires a reporting entity to classify certain financial instruments as liabilities. Financial instruments in the scope of ASC 480 are:

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

Often, a contingent consideration arrangement includes an obligation to issue a variable number of shares if certain targets are met (e.g., revenues, EBITDA). ASC 480-10-25-14 provides additional guidance on financial instruments that an issuer must or may settle by issuing a variable number of shares.

ASC 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 shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

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

See paragraph 480-10-55-21 for related implementation guidance.

The determination of whether the monetary value of an obligation is based solely or predominantly on the factors in ASC 480-10-25-14 can be complex. See FG 5.5.1.1 for additional guidance on the meaning of “predominantly.”

If the contingent consideration arrangement is required to be classified as a liability under ASC 480, the arrangement will be initially measured at fair value in accordance with ASC 805-30-30-7 and subsequently measured at fair value with changes in fair value recorded in earnings pursuant to ASC 805-30-35-1(b). If a reporting entity has determined that the contingent consideration is not required to be reported as a liability under ASC 480, additional analysis under ASC 815 and ASC 815-40 is required to determine whether the instrument should be accounted for as an equity instrument or a liability. See DH 2.3 for additional information on the definition of a derivative under ASC 815.

ASC 815-40-15 provides guidance for determining whether an instrument (or embedded feature) is indexed to an entity’s own stock. ASC 815-40-25 provides guidance for determining whether the instrument (or embedded feature), if indexed to an entity’s own stock, meets the requirements to be classified in shareholders’ equity. If a contingent consideration arrangement is (1) indexed to an entity’s own stock and (2) classified in shareholders’ equity, the arrangement would not be classified as a liability. It is important to note that the guidance in ASC 815-40 must be applied even if the instrument does not meet the definition of a derivative under ASC 815. See FG 5.6 (for companies that have adopted ASU 2020-06) or FG 5.6A (for companies that have not adopted ASU 2020-06) for additional information on this guidance.

2.6.4.3 *Determining whether instrument is indexed to entity’s own stock*

In determining whether the instrument (or embedded feature) is indexed to an entity’s own stock, ASC 815-40-15 requires an entity to apply a two-step approach – first evaluating an instrument’s contingent exercise provisions and then the instrument’s settlement provisions.

The first step relates to the evaluation of the arrangement’s contingent exercise provisions. An exercise contingency is a provision that entitles an entity (or counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in the underlying, including the occurrence (or nonoccurrence) of an event. Any contingent provision that affects the holder’s ability to exercise the instrument (or embedded component) must be evaluated. For example, holders may have a contingent exercise right or may have their right to exercise accelerated, extended, or eliminated upon satisfaction of a contingency.

Under the first step of ASC 815-40-15, if the exercise contingency is based on (a) an observable market, other than the market for the issuer’s own stock, or (b) an observable index, other than one measured solely by reference to the entity’s own operations (e.g., revenue, EBITDA), then the presence of the exercise contingency precludes an instrument (or embedded feature) from being considered indexed to an entity’s own stock. See FG 5.6.2.1 (for companies that have adopted ASU 2020-06) or FG 5.6A.2.1 (for companies that have not adopted ASU 2020-06) for additional guidance on the evaluation of exercise contingencies, including an example when the exercise contingency is based on a change in the S&P 500 (which would not be considered indexed to the entity’s own stock).

The second step relates to the evaluation of the arrangement’s settlement provisions. Under the second step of ASC 815-40-15, if the settlement amount equals the difference between the fair value of a fixed number of the entity’s equity shares and a fixed monetary amount (or a fixed amount of a debt instrument issued by the entity), then the instrument (or embedded feature) would be considered indexed to an entity’s own stock. The settlement amount is not fixed if the terms of the instrument (or

embedded feature) allow for any potential adjustments, regardless of the probability of the adjustment being made or whether the entity can control the adjustments. ASC 815-40-15-7E discusses an exception to the “fixed for fixed” rule. The exception allows the instrument (or embedded feature) to still be considered indexed to an entity’s own stock if the only variables that could affect the settlement amount are variables that are typically used to determine the fair value of a fixed-for-fixed forward or option on equity shares. See FG 5.6.2.2 (for companies that have adopted ASU 2020-06) or FG 5.6A.2.2 (for companies that have not adopted ASU 2020-06) for additional guidance on the evaluation of settlement provisions.

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

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

2.6.4.4 *Equity classification for instrument indexed to entity’s stock—after adoption of ASU 2020-06*

In August 2020, the FASB issued ASU 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40)*. As part of this guidance, the FASB amended the derivative guidance for the “own stock” scope exception and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity’s most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

This section discusses the guidance in ASC 815-40-25 after the adoption of ASU 2020-06. BCG 2.6.4.4A discusses the guidance in ASC 815-40-25 prior to the adoption of ASU 2020-06.

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

All of the criteria that are relevant to the instrument must be met before the arrangement could meet the criteria to be classified in shareholders' equity. See FG 5.6.3 (for companies that have adopted ASU 2020-06) for guidance on the evaluation of whether the instrument meets the equity classification requirements. A contingent consideration arrangement that meets the criteria in ASC 815-40-15 and ASC 815-40-25 would be classified as equity at the acquisition date (provided it is not in the scope of ASC 480 and the mezzanine equity guidance in ASC 480-10-S99 for companies subject to that guidance). In addition, the arrangement must be continually assessed to determine whether equity classification remains appropriate. If the arrangement no longer meets the criteria for equity classification, it would be reclassified to a liability at its then current fair value (see FG 5.6.3.1).

In practice, equity classification is sometimes precluded because an entity does not have a sufficient number of authorized and unissued shares available to settle its potentially dilutive instruments. In a situation in which the issuance of a contingent consideration arrangement in the current business combination results in an insufficient number of authorized shares to settle all of the potentially dilutive instruments, the contingent consideration arrangements and/or the other dilutive instruments will require liability classification, depending on the company's policy for allocating authorized shares to the dilutive instruments. See FG 5.6.3.1 for additional information on sequencing of instruments.

2.6.4.4A *Equity classification for instrument indexed to entity's stock—before adoption of ASU 2020-06*

This section discusses the guidance in ASC 815-40-25 prior to the adoption of ASU 2020-06. BCG 2.6.4.4 discusses the guidance in ASC 815-40-25 subsequent to the adoption of ASU 2020-06.

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

All of the criteria that are relevant to the instrument must be met before the arrangement could meet the criteria to be classified in shareholders' equity. See FG 5.6A.3 (for companies that have not adopted ASU 2020-06) for additional guidance on the evaluation of whether the instrument meets the equity classification requirements.

A contingent consideration arrangement that meets the criteria in ASC 815-40-15 and ASC 815-40-25 would be classified as equity at the acquisition date (provided it is not in the scope of ASC 480). In addition, the arrangement must be continually assessed to determine whether equity classification remains appropriate. If the arrangement no longer meets the criteria for equity classification, it would be reclassified to a liability at its then current fair value (see FG 5.6A.3.1).

In practice, equity classification is sometimes precluded because an entity does not have a sufficient number of authorized and unissued shares available to settle its potentially dilutive instruments. In a situation in which the issuance of a contingent consideration arrangement in the current business

combination results in an insufficient number of authorized shares to settle all of the potentially dilutive instruments, the contingent consideration arrangements and/or the other dilutive instruments will require liability classification, depending on the company's policy for allocating authorized shares to the dilutive instruments. See FG 5.6A.3.1 for additional information on sequencing of instruments.

2.6.5 ***Classification of contingent consideration: examples***

The examples consider various contingent consideration arrangements and provide analysis for determining the classification of contingent consideration arrangements as a liability or as equity. The examples assume Company A is a public company and would issue the same class of shares as its publicly traded shares if the contingent performance measures are achieved. The analyses below for nonpublic entities would generally be the same, except that most nonpublic companies would not have a means to net cash settle the arrangement outside the contract since their shares are not readily convertible to cash. However, our experience is that most contingent consideration arrangements involving nonpublic companies include net settlement provisions within the contract. Without net settlement, the arrangement would not be considered a derivative within the scope of ASC 815. If an arrangement was not considered a derivative due to physical settlement terms or for any other reason, it would still need to meet the conditions of ASC 815-40 to be classified as equity. If the contingent consideration is not classified in equity, it is required to be reported at fair value with changes in fair value reflected in earnings in accordance with ASC 805-30-35-1(b).

The examples provided in this section assume common shares are non-redeemable.

- Example BCG 2-22 illustrates a contingent consideration arrangement when a fixed number of shares is issued based on an entity's performance.
- Example BCG 2-23 illustrates a contingent consideration arrangement when a variable number of shares is issued based on an entity's performance and there is only one discrete performance period.
- Example BCG 2-24 illustrates a contingent consideration arrangement that is linked to the acquisition-date fair value.
- Example BCG 2-25 provides an example of a contingent consideration arrangement when a fixed number of shares is issued based on another entity's operations.
- Example BCG 2-26 illustrates a contingent consideration arrangement when a variable number of shares is issued based on an entity's performance and there are multiple performance periods.

EXAMPLE BCG 2-22

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

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 additional common shares to the former shareholders of Company B if Company B's revenues (as a wholly owned subsidiary of Company A) exceed \$200 million during the one-year period following the acquisition.

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

How should the issuance of a fixed number of shares based on Company B's performance be recognized?

Analysis

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

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

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

Based on the analysis performed, the contingent consideration arrangement would be classified as equity if all of the other criteria in ASC 815-40 for equity classification have been satisfied and classification as mezzanine equity is not required under ASC 480-10-S99.

EXAMPLE BCG 2-23

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

Company A, a publicly traded company, purchases Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 additional common shares to the former shareholders of Company B if Company B's revenues (as a wholly owned subsidiary of Company A) equal or exceed \$200 million during the one-year period

following the acquisition. In addition, if Company's B's revenues exceed \$200 million, Company A will issue an additional 1,000 shares for each \$2 million increase in revenues in excess of \$200 million, not to exceed 100,000 additional shares (i.e., 200,000 total shares for revenues of \$400 million or more).

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

How should the issuance of a variable number of shares based on Company B's performance be recognized?

Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since the number of Company A shares that could be issued under the arrangement is variable and relates to the same risk exposure (i.e., the number of shares to be delivered will vary depending on which performance target is achieved in the one-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement. The arrangement may be within the scope of ASC 480 since it is an obligation to issue a variable number of shares and it varies based on something other than the fair value of the issuer's equity shares (in this case, based on Company B's revenues). A determination would need to be made as to whether the arrangement's monetary value at inception is based solely or predominantly on Company B's revenues (versus Company A's share price), which, if so, would require liability classification. This determination would be based on facts and circumstances, but generally the more substantive (i.e., difficult to achieve) the revenue target, the more likely the arrangement is based predominantly on the revenue target. If the arrangement is determined to be predominantly based on revenues, it would be considered a liability under ASC 480.

For the purpose of this example, assume that Company A determines the arrangement is not based solely or predominantly on Company B's revenues. Although the contingent consideration arrangement is not required to be classified as a liability under ASC 480, liability classification would still be required because the arrangement would also not meet the second step of ASC 815-40-15 for equity classification. The settlement amount of the contingent consideration arrangement incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares (i.e., one of the key variables to determine fair value for this contingent consideration arrangement is Company B's revenues). In other words, the amount of revenues not only determines whether the exercise contingency is achieved, but also adjusts the settlement amount after the exercise contingency is met. Therefore, the contingent consideration arrangement would not be considered indexed to Company A's shares because the settlement provisions are affected by the amount of revenues which is not an input in valuing a fixed-for-fixed equity award. Therefore, the contingent consideration arrangement would be recorded as a liability at its fair value following the guidance in ASC 805-30-25-6. Further, changes in the liability will be recognized in Company A's earnings until the arrangement is resolved in accordance with ASC 805-30-35-1(b).

EXAMPLE BCG 2-24

Contingent consideration arrangement linked to the acquisition-date fair value

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. At the acquisition date, Company A's share price is \$40 per share. Company A also provides Company B's former shareholders contingent consideration whereby if the common shares of Company A are trading below \$40 per share one year after the acquisition date, Company A will issue additional common shares to the former shareholders of Company B sufficient to make the current value of the acquisition date consideration equal to \$40 million (i.e., the acquisition-date fair value of the consideration transferred). However, the number of shares that can be issued under the arrangement cannot exceed 2 million shares.

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

How should the contingent consideration agreement linked to the acquisition-date fair value be recognized?

Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The security price guarantee feature of the contingent consideration arrangement should be assessed to determine whether it is a freestanding feature or whether it is embedded within the shares issued in the business combination. In this instance, the guarantee is a freestanding financial instrument that was entered into in conjunction with the purchase agreement and is legally detachable and separately exercisable. The guarantee arrangement is within the scope of ASC 480 (ASC 480-10-25-14(c)) since, at inception, the guarantee arrangement creates an obligation that Company A would be required to settle with a variable number of Company A's equity shares, the amount of which varies inversely to changes in the fair value of Company A's equity shares. For example, if Company A's share price decreases from \$40 per share to \$35 per share one year after the acquisition date, the amount of the obligation would be \$5 million. Therefore, the freestanding guarantee would be recorded as a liability at its fair value following the guidance in ASC 805-30-25-6. Further, changes in the liability will be recognized in Company A's earnings until the arrangement is resolved in accordance with ASC 805-30-35-1(b).

EXAMPLE BCG 2-25

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

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

Company A has sufficient authorized and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in

unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification. Company A has concluded that there is one unit of account since there is only one performance target.

How should the issuance of a fixed number of shares based on another entity's operations be recognized?

Analysis

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

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

In determining whether the derivative instrument is in the scope of ASC 815, the instrument must be evaluated to determine if it is subject to the exception in ASC 815-10-15-74(a) (i.e., the arrangement is indexed to an entity's own stock and classified in shareholders' equity). In making the determination of whether the arrangement is considered indexed to Company A's own stock, the first step would be to determine whether there are exercise contingencies and, if so, if they are based on an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated solely by reference to the issuer's operations. The exercise contingency requires Company B's operating revenues to exceed Company X's (largest third-party competitor) operating revenues by \$1 million at the end of the one-year period following the acquisition and, therefore, is based on an index that is not calculated solely by reference to the issuer's operations (i.e., the index is a comparison to Company X's revenues). This precludes the arrangement from being considered indexed to Company A's own stock. Therefore, it is not necessary to perform the second step of ASC 815-40-15.

Since the arrangement is not considered indexed to Company A's own stock under ASC 815-40-15, the arrangement is a liability and should be subsequently measured at fair value with changes in fair value recorded in earnings in accordance with ASC 805-30-35-1(b).

EXAMPLE BCG 2-26

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

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 common shares to the former shareholders of Company B if Company B's revenues (as a wholly-owned subsidiary of Company A) equal or exceed \$200 million during the one-year period following the acquisition. Furthermore, Company A agrees to issue an additional 50,000 common shares to the former shareholders of Company B if Company B's revenues (as a wholly-owned subsidiary of Company A) equal or exceed \$300 million during the second one-year period following

the acquisition. The achievement of the earnouts is independent of each other (i.e., outcomes could be zero, 50,000, 100,000 or 150,000 additional shares issued).

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

How should the issuance of a variable number of shares based on Company B's performance be recognized?

Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since this is a contingent consideration arrangement subject to ASC 805, and the year one and year two outcomes are independent and do not relate to the same risk exposures (i.e., the number of shares to be delivered will vary depending on performance targets achieved in independent one-year periods following the acquisition), the arrangement would be treated as two separate contracts that would each result in the delivery of a fixed number of shares, and not as a single contract that would result in the delivery of a variable number of shares. As a result, the arrangement is not within the scope of ASC 480. That is, at inception, the separate arrangements will not result in the issuance of a variable number of shares and do not obligate Company A to transfer cash or other assets to settle the arrangement.

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

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

Based on the analysis performed, assuming the other requirements in ASC 815-40 are met and classification as mezzanine equity is not required under ASC 480-10-S99, each independent contract within the contingent consideration arrangement would be classified as equity.

For contingent consideration arrangements in a business combination, judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement. For instance, an arrangement to issue 100,000 shares if revenues equal or exceed \$200 million in the one-year period following the acquisition or 110,000 shares if revenues equal or exceed \$220 million in the one-year and one-month period following the acquisition would likely be considered a single overall contract with multiple performance targets. That is, the performance targets for both the one-year and the one-year and one-month periods are largely dependent on achieving the revenue targets in the first year given the short duration of time (i.e., one month) that elapses between the end of the first period and the end of the second period. If the arrangement (or multiple performance targets) relates to the same risk exposure, the unit of account would be the overall contract rather than two separate, independent contracts.

2.6.5.1 Contingent consideration requiring continued employment

Certain contingent consideration arrangements may be tied to continued employment of the acquiree's employees or the selling shareholders. These arrangements are recognized as compensation expense in the postcombination period. An acquirer should consider the specific facts and circumstances of contingent consideration arrangements with selling shareholders that have no requirement for continuing employment in determining whether the payments represent part of the purchase price or are separate transactions to be recognized as compensation expense in the postcombination period. See BCG 3.3 for additional discussion of compensation arrangements, including the determination of whether contingent payments to selling shareholders should be included as part of consideration transferred, compensation, or a combination of both.

In addition to arrangements directly between the acquirer and selling shareholders, it is also important for the acquirer to understand whether any other arrangements exist (e.g., side arrangements) that could affect the analysis of whether a contingent consideration provision is compensatory. Example BCG 2-27 provides guidance on consideration of side arrangements in a business combination.

EXAMPLE BCG 2-27

Consideration of side arrangements in a business combination

Company B is made up of two business units, BU1 and BU2. The company is owned 5% by the former CEO and current board member, 1% by each of two management employees (together the "owner-employees") and 93% by the majority owner.

Company B is selling BU1 to Company A in exchange for a \$10 million upfront payment with additional consideration up to \$4 million based on BU1 meeting certain EBITDA targets over a two-year period. The three owner employees will remain employed by BU1. Company A became aware of a side arrangement between Company B and the former CEO whereby the additional consideration would be paid to the former CEO and divided among the three owner employees at his discretion. Company A did not initiate and was not involved in the side arrangement.

Should the additional consideration be accounted for as contingent consideration or compensation?

Analysis

If the side arrangement did not exist, the additional consideration would likely be considered contingent consideration. However, in this example, there is a side arrangement, and as such it must be evaluated. The side arrangement results in the additional consideration being directed to the three owner employees, providing these individuals with contingent consideration that is not consistent with the majority shareholder on a per-share basis. As a result, this is an indicator that the arrangement is compensation and not contingent consideration.

2.6.5.2 *Contingent consideration of an acquiree*

A preexisting contingent consideration arrangement of the acquiree assumed by the acquirer in a business combination should be initially recognized and measured at fair value in accordance with ASC 805-20-25-15A and ASC 805-20-30-9A. The fair value of a contingent consideration arrangement of an acquiree should be determinable because (1) the existing contingent consideration arrangement is inherently part of the economic consideration in the negotiations between the buyer and the seller and (2) most contingent consideration obligations are financial instruments for which fair value can be determined using current valuation techniques.

After initial recognition of the contingent consideration, it is subsequently accounted for and measured by the acquirer in accordance with ASC 805-30-35-1A. However, rather than being accounted for as part of the consideration transferred (as would be the case, for example, in a contingent consideration arrangement agreed upon between the acquirer and acquiree), diversity in practice exists as some believe the assumed contingent consideration should be treated as an assumed liability. A preexisting contingent consideration arrangement of the acquiree may be considered an assumed liability because it is payable to a third party rather than the seller in the business combination. See BCG 2.6.4 for further information on the accounting for contingent consideration in a business combination.

2.6.5.3 *Effect of contingently issuable shares on earnings per share*

When contingent consideration arrangements are in the form of common shares (or may be settled in common shares at the election of one or both parties), the shares are considered contingently issuable shares and may need to be included in the computation of basic and diluted earnings per share (EPS) of the combined entity. The EPS guidance for contingently issuable shares is included in ASC 260, *Earnings per Share*, paragraphs ASC 260-10-45-13 and ASC 260-10-45-48 through ASC 260-10-45-57. Refer to FSP 7.4.3.1 and FSP 7.5.3 for additional information related to basic EPS and diluted EPS, respectively.

2.6.5.4 *Contingent consideration: seller accounting*

Reporting entities may sell a business in a transaction that includes a contingent consideration arrangement. The seller should determine whether the arrangement meets the definition of a derivative in accordance with ASC 815-10-15-83. See DH 2.3 for additional information on the definition of a derivative under ASC 815.

If the arrangement meets the definition of a derivative and does not qualify for a scope exception in ASC 815-10-15, it should be recorded at fair value on the acquisition date and subsequently adjusted to fair value each reporting period. In paragraph B349 in the basis for conclusions of FAS 141(R) the

FASB acknowledged that most contingent consideration arrangements are financial instruments and that many meet the definition of a derivative. However, in practice, contingent consideration arrangements when the underlying is revenue, net income, cash flow from operations, or EBITDA qualify for the scope exception in ASC 815-10-15-59 (unless the income measure is due predominantly to the movement of the fair value of a portfolio of assets) and would therefore not be accounted for as derivatives.

If the arrangement meets the definition of a derivative but qualifies for a scope exception in ASC 815-10-15 or does not meet the definition of a derivative, the seller should make an accounting policy election to either record the contingent consideration portion of the arrangement at fair value at the transaction date or record the contingent consideration portion of the arrangement when the consideration is determined to be realizable. If the seller elects to record the contingent consideration portion of the arrangement at fair value at the transaction date, the seller must also make an election with respect to the subsequent accounting. The Emerging Issues Task Force discussed the accounting for contingent consideration by the seller in EITF Issue No. 09-4, *Seller Accounting for Contingent Consideration* (EITF 09-4), but did not reach a consensus. In the absence of definitive guidance issued by the FASB, we believe it is helpful to consider the alternatives evaluated during the EITF's deliberations, which included allowing the seller to elect to subsequently account for the contingent consideration using the fair value option or in accordance with ASC 450. Other approaches may be acceptable based on facts and circumstances.

Example BCG 2-28 provides an example of how to account for a contingent consideration arrangement from a seller's perspective.

EXAMPLE BCG 2-28

Contingent consideration: seller accounting

Company A sells its entire controlling stake in wholly-owned Subsidiary B. The proceeds of the sale include \$150 million in cash paid up front plus contingent payments of 5% of revenue for the next 3 years. Net assets of Subsidiary B were \$100 million. Company A has accounted for the contingent consideration arrangement based on the following information:

- The contingent consideration arrangement does not meet the criteria to be accounted for as a derivative under ASC 815.
- The seller can make an accounting policy election to either record the contingent consideration portion of the arrangement at fair value at the transaction date or when the consideration is determined to be realizable. In this example, Company A will account for the contingent consideration arrangement at fair value at the transaction date.
- The fair value of the contingent consideration proceeds as of the disposal date is \$10 million (assessed based on expected sales over the next 3 years of \$70 million in year 1 with a 15% annual growth rate for years 2 and 3 and using a 10% discount rate that does not change over the period of the arrangement). See FV 7.3.3.5 for further detail on recognizing contingent consideration at fair value.
- At the end of year one, while revenue was equal to the projections for the year, it was determined that the years two and three revenue growth rate would increase to 30%.

- For illustrative purposes, tax effects have been excluded from the transaction.

How should Company A recognize the disposal transaction?

Analysis

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

Dr. Cash	\$150	
Dr. Contingent consideration—asset	\$10	
Cr. Net assets		\$100
Cr. Gain on sale		\$60

Company A would need to make an election for the subsequent accounting of the contingent consideration (e.g., fair value option or in accordance with ASC 450).

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

2.6.6 Noncontrolling interest (NCI)

NCI is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. Said differently, it is the ownership interest in a consolidated subsidiary that is held by an owner other than the reporting entity (see ASC 810-10-20 and ASC 810-10-45-15).

Only interests classified as equity for financial reporting purposes may be characterized as an NCI. Interests that are equity in legal form, but for financial reporting purposes are classified as liabilities, would not constitute an NCI. BCG 6.2.1 provides guidance on determining whether interests held by third parties should be classified as equity.

An NCI is recognized and measured at fair value on the acquisition date (see ASC 805-20-30-1). Additional guidance on the initial measurement of an NCI can be found in BCG 6.3.1 and FV 7.3.5.

While interests in a subsidiary classified as a liability would not be characterized as NCI, they would still impact the amount of goodwill recognized, as explained in BCG 2.6.1.

2.6.7 Treatment of previously held equity interest in an acquiree

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

On the acquisition date, the acquirer recognizes a gain or loss, if any, in earnings based on the remeasurement of any previously held equity interest in the acquiree to fair value in accordance with ASC 805-10-25-10.

A remeasurement of a previously held equity interest is more likely to result in the recognition of gains, since companies are required to periodically evaluate their investments for impairment.

See BCG 5.3.2 for additional information on remeasurement of a previously held equity interest in an acquiree.

2.6.8 Business combinations achieved without consideration transferred

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

In a business combination achieved by contract alone, the equity interests in the acquiree held by parties other than the acquirer are the noncontrolling interest in the acquirer's financial statements. This could result in the noncontrolling interest being equal to 100% of the acquiree's equity if the acquirer holds no equity interests in the acquiree after the business combination.

When a business combination is achieved without consideration transferred, the purchase price is based on the acquisition-date fair value of the business obtained. In such situations, a bargain purchase gain is expected to be infrequent. As described in BCG 2.6.2, the acquirer should reassess whether it has correctly identified all of the assets acquired and liabilities assumed before recognizing a gain on a bargain purchase in accordance with ASC 805-30-25-4.

2.7 Assessing what is part of a business combination transaction

ASC 805-10-25-20 provides the principle for determining what is part of a business combination transaction.

ASC 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).

The transfer of consideration may be accompanied by other transactions in a business combination. A transaction is likely to be recognized and accounted for separately from a business combination if it is entered into by or on behalf of the acquirer and is primarily for the benefit of the acquirer or the combined entity rather than that of the acquiree or its former owners.

Identifying those transactions that should be accounted for separately from the acquisition can require significant judgment and analysis. ASC 805-10-55-18 provides three factors to consider that are neither mutually exclusive nor individually conclusive.

Excerpt from ASC 805-10-55-18

- a. The reasons for the transaction. Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.
- b. Who initiated the transaction. Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or combined entity and more likely to be part of the business combination transaction.
- c. The timing of the transaction. The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

In accordance with ASC 805-10-25-21, transactions that are recognized separately from the business combination are accounted for based on the applicable guidance in US GAAP. Specific guidance is provided for the following transactions in connection with a business combination:

- Reimbursement provided to the acquiree or former owners for paying the acquirer's acquisition costs (see BCG 2.7.1.2)
- Settlement of preexisting relationships between the acquirer and acquiree (see BCG 2.7.2)
- Employee compensation arrangements (see BCG 3)

There may also be circumstances in which litigation arises between the acquirer and the former owners of the acquiree related to the business combination. In a speech at the 2003 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member stated that contingencies arising from a business combination are not preacquisition contingencies. Therefore, the settlement of such legal claims should generally be reflected by the acquirer in the income statement in the postcombination financial statements (i.e., accounted for separately from the business combination) unless there is a clear and direct link to the purchase price and the settlement occurs within the measurement period in which case the dispute would be accounted for as part of the consideration transferred. For example, litigation between the acquirer and the acquiree asserting that one party misled the other party as to the value of the acquiree or that a provision of the acquisition agreement is unclear is not the type of litigation that establishes a clear and direct link to the acquisition price, and therefore, its settlement is generally reflected in current earnings. In contrast, litigation initiated by the acquirer seeking the enforcement of escrow or escrow-like arrangements, such as those that specify the requirement of a minimum amount of working capital as of the closing date in an acquired business, may establish a clear and direct link to the acquisition price.

2.7.1 Acquisition-related costs in a business combination

Costs may be incurred by both the acquirer and the acquiree in effecting a business combination. ASC 805-10-25-23 discusses the accounting for acquisition-related costs.

ASC 805-10-25-23

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the period 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.

2.7.1.1 Acquirer's acquisition-related costs in a business combination

An acquirer's acquisition-related costs may include:

- *Direct costs:* third-party costs, including finder's fees, advisory, legal, accounting, valuation, and other professional or consulting fees
- *Indirect costs:* general administrative costs, including the cost of maintaining an internal acquisitions department
- *Financing costs:* costs of issuing debt or equity securities to finance the acquisition

As required by ASC 805-10-25-23, acquisition-related costs are considered separate transactions and should not be included as part of the consideration transferred. These costs are not considered part of the fair value of a business and, by themselves, do not represent an asset. Instead, acquisition-related costs represent services that have been rendered to and consumed by the acquirer. Direct and indirect acquisition-related costs are expensed as incurred when the service is received.

Financing costs relating to the issuance of debt are recorded as a reduction of the debt balance in accordance with ASC 835-30-45-1A. Financing costs relating to the issuance of equity securities reduce the proceeds received from the issuance.

Question BCG 2-6

How should fees paid to an investment banker to provide advisory services and also handle the financing of a business combination be recognized?

PwC response

ASC 340-10-S99-2 indicates that fees paid to an investment banker in connection with a business combination, when the investment banker is also providing interim financing or underwriting services, must be allocated between direct costs of the acquisition and those related to financing or underwriting the securities issued to consummate the business combination.

For example, assume Company A acquired Company B for 70% cash and the balance in preferred shares and debt. Company A hired an investment banker to provide advisory services and also to handle the financing and underwriting of the transaction. The costs paid to the investment banker should be allocated between those that are related to the advisory services and those related to financing or underwriting the business combination on a relative fair value basis.

SAB Topic 5.A states that “specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering.” Accordingly, the equity issuance costs should generally be reflected as a reduction of the gross proceeds of the equity offering (typically, as a reduction to APIC). If debt-issuance costs are incurred to fund the acquisition, those costs should be recognized in the balance sheet as a reduction from the face amount of the debt and amortized as interest expense in accordance with ASC 835-30-45-3. Costs for all other direct and indirect expenses of the transaction should be expensed as incurred.

Question BCG 2-7

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

PwC response

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

2.7.1.2 Reimbursing acquiree for paying acquirer’s acquisition costs

ASC 805-10-25-21 includes “a transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs” as an example of a separate transaction when applying the acquisition method. Under this guidance, acquisition costs embedded in the consideration transferred should be accounted for separately from the business combination. For example, consideration

transferred by the acquirer may include amounts to reimburse the acquiree or its former owners for payments made on behalf of the acquirer for its acquisition-related costs. Such costs should be recognized in the acquirer's financial statements based on the nature of the cost (see BCG 2.7.1.1).

2.7.1.3 Acquiree's acquisition-related costs in a business combination—updated September 2023

Acquirees often incur sell-side acquisition-related costs in a business combination (e.g., entering into contracts directly with and are obligated to pay third parties). Examples of these costs may include sell-side due diligence fees, valuation costs, tax planning fees, investment banking fees, legal fees, and other advisory fees. Acquisition-related costs incurred by the acquiree in a business combination should be expensed as incurred or when the service is received in the acquiree's separate, pre-acquisition financial statements.

Example BCG 2-29 illustrates the accounting for transaction costs incurred by the acquiree in its pre-acquisition financial statements

EXAMPLE BCG 2-29

Accounting for transaction costs in acquiree's pre-acquisition financial statements

PE Firm is selling its portfolio company, Target T. Target T enters into various contracts directly with third-party advisors, law firms, and valuation consultants to receive services related to the transaction and also agrees to pay these costs. These fees are not contingent on the closing of the transaction.

How should Target T account for transaction costs in its pre-acquisition (predecessor) financial statements?

Analysis

As Target T is the legal obligor, Target T should recognize these costs as expenses in its pre-acquisition financial statements.

In other cases, a parent company may incur various sell-side acquisition-related costs in connection with a sale of a subsidiary. Acquisition-related costs incurred by a parent should be recognized as an expense by the parent. In these cases, the subsidiary should consider the guidance in SEC Staff Accounting Bulletin Topic 1.B.1, *Costs Reflected in Historical Financial Statements*, and SEC Staff Accounting Bulletin Topic 5.T, *Accounting for Expenses or Liabilities Paid by Principal Stockholder*, to determine whether these costs were incurred for the benefit of the subsidiary and, accordingly, should be recorded in the subsidiary's financial statements. Generally, we believe that such costs are not incurred on behalf of the subsidiary and therefore should not be reflected in the subsidiary's financial statements.

See BCG 2.7.1.5 for information on acquiree acquisition-related costs that are contingent on the closing of the business combination.

2.7.1.4 Reimbursing acquiree for sell-side acquisition-related costs—updated May 2024

Consideration transferred by the acquirer that includes amounts to reimburse the acquiree for the acquiree's costs incurred to sell the business would generally be accounted for by the acquirer as part

of the consideration transferred, as illustrated in Example BCG 2-30. However, if the acquiree's costs remain unpaid at the acquisition date, such costs would be considered an assumed liability in acquisition accounting and would not be part of the consideration transferred.

In determining whether costs incurred are on behalf of the acquirer or acquiree, the reason for the transaction, who initiated it, and the timing should be considered in accordance with ASC 805-10-55-18.

EXAMPLE BCG 2-30

Accounting for transaction costs incurred by the seller in connection with a business combination

Company A acquired 100% of Company B. In connection with this transaction, Company B incurred costs to sell the business, including legal fees and other consulting fees for services related to valuation. The valuation consulting fees were paid by Company B prior to the acquisition date and expensed in the period incurred; however, Company A agreed to reimburse Company B for those fees on the acquisition date. As of the acquisition date, Company B also had several outstanding invoices to the attorneys and other advisors that assisted with this sale recorded in its acquisition-date balance sheet. The costs incurred by the seller were not for the benefit of the buyer as contemplated in ASC 805-10-25-21.

How should Company A account for the acquiree's sell-side acquisition costs in acquisition accounting?

Analysis

The valuation consulting fees that Company A reimbursed to Company B for its costs incurred to sell the business should be recognized by Company A as part of the consideration transferred for the business. The reimbursement by Company A of Company B's valuation consulting fees is primarily for the benefit of Company B and likely part of the exchange for the acquiree (i.e., Company B's valuation consulting fees were likely considered in agreeing to a sales price for the business and, implicitly, were paid by Company A in the business combination).

The legal costs were incurred by the seller as a result of the sale. Therefore, as long as the outstanding payables do not include any of the acquirer's acquisition-related costs (i.e., Company A and Company B did not negotiate for Company B to pay for Company A's transaction costs), Company A should recognize the outstanding payables as assumed liabilities in acquisition accounting, no different than Company A assuming Company B's other accounts payable balances from normal operating activities.

2.7.1.5 Recognizing certain acquisition-related costs "on the line"

In situations when predecessor and successor financial statements are presented with a "blackline" resulting from the effects of pushdown accounting, a question often arises as to which period acquiree expenses should be recorded in if the amounts are contingent on the closing of a business combination (e.g., acquiree's investment banker "success" fees, acquiree's share-based awards with performance conditions vesting upon a change in control).

One view is that these costs should be recorded in the predecessor period, immediately prior to the closing of the transaction, because all the acquiree's acquisition-related costs should be recognized in the period in which they are incurred. Since the predecessor financial statements present the results of

operations for the acquiree up to the closing of the transaction and at the closing date it is known that the transaction has been consummated, then all expenses would have been incurred and thus should be recognized in the predecessor period.

However, in a speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member stated that when certain expenses are contingent upon a change-in-control event, the SEC staff has not objected to the presentation of such items in neither the predecessor or successor periods (i.e., presented “on the line”), provided that transparent and disaggregated disclosure of the nature and amount of such expenses is made. This view is based on the premise that any expenses contingent on the closing of the business combination are not payable, and thus should not be recognized, until the transaction is consummated. The SEC stated that if such presentation is elected, registrants should ensure that only those amounts fully contingent on the consummation of the change-in-control event be included in the disclosure.

Separately, an acquirer’s costs that are contingent upon the closing of a business combination should be recognized in the acquirer’s financial statements in the period that includes the acquisition.

2.7.2 Settlement of preexisting relationships

A preexisting relationship can be contractual (e.g., vendor and customer, licensor and licensee) or it can be noncontractual (e.g., plaintiff and defendant). The acquirer should identify any preexisting relationships to determine which ones have been effectively settled. Typically, a preexisting relationship will be effectively settled, since such a relationship becomes an “intercompany” relationship upon the acquisition and is eliminated in the postcombination financial statements. Reacquired rights, which also arise from preexisting relationships, are discussed at BCG 2.5.6. The acquirer should recognize a gain or loss if there is an effective settlement of a preexisting relationship in accordance with ASC 805-10-55-21. When there is more than one contract or agreement between the parties with a preexisting relationship or more than one preexisting relationship, the settlement of each contract and each preexisting relationship should be assessed separately.

Example BCG 2-31 illustrates the settlement of a preexisting debtor/creditor relationship between an acquirer and acquiree.

EXAMPLE BCG 2-31

Settlement of a preexisting relationship recorded at current market rates

Company A has accounts payable of \$100,000 to Company B and Company B has accounts receivable of \$100,000 from Company A. Both the recorded payable and corresponding receivable approximate fair value. Company A acquires Company B for \$2 million in a business combination.

How should the settlement of the preexisting relationship be recorded in acquisition accounting?

Analysis

As a result of the business combination, the preexisting relationship between Company A and Company B is effectively settled. No gain or loss was recognized on the settlement as the payable was effectively settled at the recorded amount. Company A should reduce the consideration transferred for the acquisition by \$100,000 to account for the effective settlement of the payable to Company B and would not record Company B’s receivable as an acquired asset in acquisition accounting.

2.7.2.1 *Calculating gain/loss on settlement of preexisting relationships*

The acquirer should recognize a gain or loss for the effective settlement of a preexisting relationship. Settlement gains and losses from noncontractual relationships should be measured at fair value on the acquisition date in accordance with ASC 805-10-55-21.

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

- a. The amount the contract terms are favorable or unfavorable (from the acquirer's perspective) compared to pricing for current market transactions for the same or similar items. If the contract terms are favorable compared to current market transactions, a settlement gain should be recognized. If the contract terms are unfavorable compared to current market transactions, a settlement loss should be recognized.
- b. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. The amount of any stated settlement provision (e.g., voluntary termination) should be used to determine the settlement gain or loss. Provisions that provide a remedy for events not within the control of the counterparty, such as a change in control, bankruptcy, or liquidation, would generally not be considered a settlement provision in determining settlement gains or losses.

If (b) is less than (a), the difference is included as part of the business combination in accordance with ASC 805-10-55-21. If there is no stated settlement provision in the contract, the settlement gain or loss is determined from the acquirer's perspective based on the favorable or unfavorable element of the contract.

If the acquirer has previously recognized an amount in the financial statements related to a preexisting relationship, the settlement gain or loss related to the preexisting relationship should be adjusted (i.e., increasing or decreasing any gain or loss) for the amount previously recognized in accordance with ASC 805-10-55-21. If the preexisting relationship is settled at the amount previously recognized by the acquirer, there is no impact on the acquirer's income statement (i.e., no gain or loss) as a result of the settlement.

Example BCG 2-32 illustrates the accounting for settlement of a noncontractual relationship. Example BCG 2-33 illustrates the accounting for settlement of a contractual relationship that includes a settlement provision. Example BCG 2-34 illustrates the accounting for settlement of a contractual relationship that does not include a settlement provision. Additional examples are provided in ASC 805-10-55-30 through ASC 805-10-55-33.

EXAMPLE BCG 2-32

Settlement loss with a liability previously recorded on a noncontractual relationship

Company A is a defendant in litigation relating to a patent infringement claim brought by Company B. Company A pays \$50 million to acquire Company B and effectively settles the lawsuit. The fair value of the settlement of the lawsuit is estimated to be \$5 million, and Company A had previously recorded a \$3 million litigation liability in its financial statements before the acquisition. The fair value of Company B's net assets is \$45 million, excluding the lawsuit.

How should the settlement loss related to a noncontractual relationship be recorded in acquisition accounting?

Analysis

Company A would record a settlement loss related to the litigation of \$2 million, excluding the effect of income taxes. This represents the \$5 million fair value of the settlement after adjusting for the \$3 million litigation liability previously recorded by Company A. The consideration transferred for the acquisition of Company B and the effective settlement of the litigation are recorded as separate transactions (in millions):

Dr. Litigation liability	\$3	
Dr. Loss on settlement of lawsuit with Company B	\$2	
Dr. Acquired net assets of Company B	\$45	
Cr. Cash		\$50

If, however, Company A had previously recorded a liability greater than \$5 million, then a settlement gain would be recognized for the difference between the liability previously recorded and the fair value of the settlement.

EXAMPLE BCG 2-33

Settlement loss on a contractual relationship

Company C provides services to Company D. Since the inception of the contract, the market price for these services has increased. The terms in the contract are unfavorable compared to current market transactions for Company C in the amount of \$10 million. The contract contains a settlement provision that allows Company C to terminate the contract at any time for \$6 million. Company C acquires Company D for \$100 million.

How should the settlement loss related to a contractual relationship be recorded in acquisition accounting?

Analysis

Company C would recognize a settlement loss of \$6 million, excluding the effect of income taxes.

A settlement loss of \$6 million is recognized because it is the lesser of the fair value of the unfavorable contract terms (\$10 million) and the contractual settlement provision (\$6 million). The \$100 million in cash paid by Company C is attributed as \$6 million to settle the services contract and \$94 million to acquire Company D. The \$4 million difference between the fair value of the unfavorable contract terms and the contractual settlement provision is included as part of consideration transferred for the business combination. The consideration transferred for the acquisition of Company D and the effective settlement of the services contract would be recorded as follows (in millions):

Dr. Loss on settlement of services contract with Company D	\$6	
Dr. Acquired net assets of Company D	\$94	
Cr. Cash		\$100

EXAMPLE BCG 2-34

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

Company E provides services to Company F. Since the inception of the services contract, the market price for these services has increased. The terms in the contract are unfavorable compared to current market transactions for Company E in the amount of \$10 million. The services contract is silent on a settlement provision in the event that either party terminates the contract. Company E acquires Company F for \$100 million.

How should the settlement loss related to a contractual relationship be recorded in acquisition accounting?

Analysis

Company E would recognize a \$10 million settlement loss, excluding the effect of income taxes, for the unfavorable amount of the contract. The \$100 million that Company E pays Company F's shareholders is attributed \$10 million to settle the preexisting relationship and \$90 million to acquire Company F. The consideration transferred for the acquisition of Company F and the effective settlement of the services contract would be recorded by Company E as follows (in millions):

Dr. Loss on settlement of services contract with Company F	\$10	
Dr. Acquired net assets of Company F	\$90	
Cr. Cash		\$100

2.7.3 **Settlement of debt**

If the preexisting relationship effectively settled is a debt financing issued by the acquirer to the acquiree, the guidance in ASC 470, *Debt* should be applied. If debt is settled (extinguished) prior to maturity, the amount paid upon reacquisition of debt may differ from the carrying amount of the debt at that time. An extinguishment gain or loss is recognized in earnings for the difference between the reacquisition price (fair value or stated settlement amount) and the carrying amount of the debt in accordance with ASC 470-50-40-2. For example, if the acquiree has an investment in debt securities of the acquirer with a fair value of \$110 million due to a change in market interest rates since issuance and the carrying amount of the debt payable on the acquirer's books is \$100 million, the acquirer would recognize a settlement loss of \$10 million on the acquisition date (reflecting the notion that the debt was settled at \$110 million). In addition, the consideration transferred by the acquirer would exclude the fair value of the debt (\$110 million), as this would be viewed as being outside of the acquisition.

If the preexisting relationship effectively settled is a debt financing issued by the acquiree to the acquirer, the acquirer effectively is settling a receivable and would apply the guidance for settling a preexisting relationship. See BCG 2.7.2 for further information.

2.7.4 Financial instruments entered into by the acquirer

Financial instruments entered into by the acquirer to hedge certain risks in contemplation of a business combination generally should be accounted for as separate transactions apart from the business combination. These contracts are generally not eligible for hedge accounting, even though these contracts may effectively hedge various economic risks and exposures related to the transaction. Hedge accounting for a firm commitment to acquire a business is prohibited under ASC 815.

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

2.7.5 Transition service agreements

Transition service agreements (TSAs) are often entered into in connection with a business combination. The services are generally provided by the seller to the acquirer for a specified period of time following the acquisition and may be at no cost, at a cost below fair market value of the services, or at fair market value. In such cases, the acquirer should consider whether a portion of the consideration paid should be allocated to the services to be rendered in the future.

Example BCG 2-35 illustrates the accounting for a TSA from the acquirer's perspective. In an acquisition, the seller would account for the services similarly by evaluating whether a portion of the consideration received should be allocated to the services to be rendered in the future. See FSP 27.4.2.3 for guidance on the presentation of revenues and costs associated with TSAs from the seller's perspective.

EXAMPLE BCG 2-35

Transition service agreement

Company A acquires Subsidiary B from Company S for \$100 million in an acquisition accounted for as a business combination. The fair value of the business is \$95 million. Concurrent with the acquisition agreement, Company A and Company S enter into a transition service agreement (TSA), under which Company S agrees to provide certain services to Company A for one year after the acquisition at no cost to Company A. Company A estimates the fair value of the services to be provided under the TSA to be \$5 million.

How should Company A account for the acquisition and services to be provided under the TSA?

Analysis

Although the TSA agreement stipulates that the services will be performed by Company S at no cost to Company A, the substance of the transaction is that a portion of the consideration for the acquisition of the business relates to the transition services that will be provided in the future. Company A should recognize an asset for the prepayment of the services of \$5 million to be expensed as the services are received. The consideration transferred by Company A in the business combination should exclude the \$5 million prepayment of the TSA (\$100 million cash paid - \$5 million TSA = \$95 million consideration transferred).

2.8 Example of applying the acquisition method

Example BCG 2-36 provides an example of the general application of the acquisition method in a business combination.

EXAMPLE BCG 2-36

Applying the acquisition method

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

- Company A pays \$100 million in cash to acquire all outstanding equity of Company B.
- Company A incurs \$15 million of expenses related to the acquisition. The expenses incurred include legal, accounting, and other professional fees.
- Company A agreed to pay \$6 million in cash if the acquiree's first year's postcombination revenues are more than \$200 million. The fair value of this contingent consideration arrangement at the acquisition date is \$2 million.
- The fair value of tangible assets and assumed liabilities on the acquisition date is \$70 million and \$35 million, respectively.
- The fair value of identifiable intangible assets is \$25 million.
- Company A intends to incur \$18 million of restructuring costs by severing employees and closing various facilities of Company B shortly after the acquisition.
- There are no measurement period adjustments.
- Company A obtains control of Company B on the closing date.

How should the acquisition be recorded?

Analysis

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

Identifying the acquirer (BCG 2.3)

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

Determining the acquisition date (BCG 2.4)

The acquisition date is the closing date.

Recognition and measurement on the acquisition date (BCG 2.5)

Company A would recognize and measure all identifiable assets acquired and liabilities assumed at the acquisition date. There is no noncontrolling interest because Company A acquired all of the equity of Company B. Company A would record the acquired net assets of Company B in the amount of \$60 million (\$95 million of assets less \$35 million of liabilities), excluding goodwill, as follows (in millions):

Tangible assets	\$70
(plus) Intangible assets	25
(less) Liabilities	35
Acquired net assets	\$60

Company A would not record any amounts related to its expected restructuring activities as of the acquisition date because Company A did not meet the relevant criteria. The recognition of exit/restructuring costs would be recognized in postcombination periods.

Recognizing and measuring goodwill (BCG 2.6)

Acquisition costs are not part of the business combination and will be expensed as incurred. Company A would make the following entry (in millions):

Dr. Expense - acquisition costs	\$15	
Cr. Cash		\$15

The consideration transferred is \$102 million, which is calculated as follows (in millions):

Cash	\$100
Contingent consideration—liability	2 ¹
Total consideration transferred	\$102

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

The acquisition results in goodwill because the \$102 million consideration transferred is in excess of the \$60 million identifiable net assets acquired, excluding goodwill, of Company B. Goodwill resulting from the acquisition of Company B is \$42 million and is measured as follows (in millions):

Total consideration transferred	\$102
Less: acquired net assets of Company B	(60)
Goodwill to be recognized	<u>\$42</u>

2.9 *Measurement period adjustments—updated May 2024*

ASC 805 requires that an acquirer in a business combination report provisional amounts when measurements are incomplete as of the end of the reporting period covering the business combination.

In accordance with ASC 805-10-25-15, the acquirer has a period of time, referred to as the measurement period, to finalize the accounting for a business combination. The measurement period provides companies with a reasonable period of time to determine the value of:

- The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree
- The consideration transferred for the acquiree or other amount used in measuring goodwill (e.g., a business combination achieved without consideration transferred)
- The equity interest in the acquiree previously held by the acquirer
- The goodwill recognized or a bargain purchase gain

Any adjustments made by the acquirer during the measurement period should only relate to those assets, liabilities, equity interests, or items of consideration for which the initial accounting was incomplete in the reporting period in which the business combination occurred. In accordance with ASC 805-10-25-14, the measurement period ends as soon as the acquirer receives all necessary information about the facts and circumstances that existed as of the acquisition date for the provisional amounts (or otherwise learns that more information is not obtainable). However, the measurement period cannot exceed one year from the acquisition date.

ASC 805-10-25-17 requires that measurement period adjustments be recognized in the reporting period in which the adjustment amount is determined.

ASC 805-10-25-13

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, in accordance with paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed

as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.

Excerpt from ASC 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 provisional amounts are determined. Thus, the acquirer shall adjust its financial statements as needed, including recognizing in its current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, if any, as a result of the change to the provisional amounts calculated as if the accounting had been completed at the acquisition date.

New information that gives rise to a measurement period adjustment should relate to events or circumstances existing at the acquisition date. Factors to consider in determining whether new information obtained gives rise to a measurement period adjustment include the timing of the receipt of new information and whether the acquirer can identify a reason for the measurement period adjustment. Information obtained shortly after the acquisition date is more likely to reflect facts and circumstances existing at the acquisition date, as opposed to information received several months later.

If a measurement period adjustment is identified, the acquirer is required to recognize the adjustment as part of its acquisition accounting. An acquirer increases or decreases the provisional amounts of identifiable assets or liabilities for measurement period adjustments by means of increases or decreases in goodwill. New information obtained during the measurement period may sometimes result in an adjustment to the provisional amounts of more than one asset or liability. In these situations, the adjustment to goodwill may be offset, in whole or part, by another adjustment resulting from a corresponding change to the provisional amount of another asset or liability.

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

On the other hand, information pertaining to events that occur after the acquisition date are not measurement period adjustments. All changes that do not qualify as measurement period adjustments are included in current period earnings. For example, changes in the fair value of contingent consideration resulting from events after the acquisition date, such as changes in the probability of meeting an earnings target or reaching a specified share price, are not measurement period adjustments and should be subsequently accounted for based on the guidance in ASC 805-30-35-1.

Reporting entities should recognize a measurement period adjustment to provisional amounts in the reporting period in which the adjustments are determined in accordance with ASC 805-10-25-17. If a measurement period adjustment is identified in the period after the balance sheet date but before the financial statements are issued or available to be issued, we believe such a measurement period adjustment should be evaluated in accordance with ASC 855, *Subsequent events*, and accounted for as a recognized subsequent event. The Basis for Conclusions of ASU 2015-16 indicates that the "reporting period in which the adjustments are determined" language is meant to distinguish between

recognizing measurement period adjustments prospectively or retrospectively in the period of acquisition and is not meant to change subsequent events guidance.

After the measurement period ends, an acquirer should revise its accounting for the business combination only to correct an error in accordance with ASC 250, *Accounting Changes and Error Corrections*.

ASC 805-10-55-27 through ASC 805-10-55-29 provide an example that illustrates the application of the measurement period guidance where an appraisal is completed after the initial acquisition. Example BCG 2-37 provides an example of the assessment of whether new information gives rise to a measurement period adjustment.

EXAMPLE BCG 2-37

Identifying measurement period adjustments

On January 1, 20X1, Company C acquires Company D. As part of the initial acquisition accounting, Company C recognizes \$50 million of goodwill and a \$5 million intangible asset for the customer relationship related to Company D's largest customer. An appraisal of the customer relationship could not be completed at the time of the acquisition. Thus, Company C recorded the intangible asset at a provisional amount based on historical experience from previous acquisitions and estimates the useful life to be four years. On June 30, 20X1, Company D obtains an independent appraisal of the acquisition-date fair value of the customer relationship intangible asset. Based on the appraisal, the value of the customer relationship of Company D's largest customer is determined to be \$7 million, with a useful life of four years.

How should Company C record the change in fair value of the Company D customer relationship asset?

Analysis

The appraisal obtained by Company C in the postcombination period is new information about facts and circumstances existing at the acquisition date. Company C should recognize any difference between the appraisal and the initial acquisition accounting as a measurement period adjustment. In the June 30, 20X1 financial statements, Company D would make the following measurement period adjustment to the year-to-date financial information, excluding income tax effects (in millions):

Dr. Customer relationship	\$2	
Cr. Goodwill		\$2
To increase the value of the customer relationship		
Dr. Amortization expense	\$0.25 ¹	
Cr. Customer relationship		\$0.25

¹ Amortization expense based on the appraised value, less amortization expense recorded based on initial value: $\$0.875$ (6 months / 48 total months \times \$7) less $\$0.625$ (6 months / 48 total months \times \$5).

To adjust amortization expense to reflect the incremental value assigned to the customer relationship

The entire impact of the measurement period adjustment should be recognized in the reporting period in which the adjustment amount was determined (in this case, the quarter ended June 30, 20X1). Accordingly, the financial statements for the quarter ended March 31, 20X1 would not be restated.

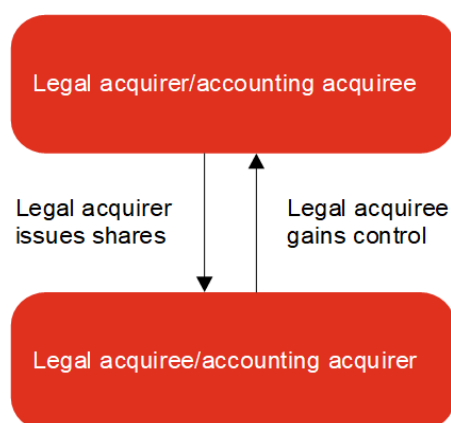
Company C would need to evaluate the reason for the change in the fair value of the customer relationship. If the reason for the difference between the provisionally recognized and the finally determined fair value of the customer relationship had been the result of (1) changes in facts and circumstances or economic conditions that occurred after the acquisition date, or (2) an error in the calculation of the provisionally recognized amount, the difference would not have been a measurement period adjustment.

2.10 Reverse acquisitions

Reverse acquisitions (reverse mergers) present unique accounting and reporting considerations. Depending on the facts and circumstances, these transactions can be asset acquisitions, capital transactions, or business combinations. See BCG 7.1.2 for further information on the accounting for when a new parent is created for an existing entity or group of entities. A reverse acquisition that is a business combination can occur only if the accounting acquiree meets the definition of a business under ASC 805. An entity that is a reporting entity, but not a legal entity, could be considered the accounting acquirer in a reverse acquisition. Like other business combinations, reverse acquisitions must be accounted for using the acquisition method.

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

Figure BCG 2-1
Diagram of a reverse acquisition



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

2.10.1 Reverse acquisition involving a nonoperating public shell

The merger of a private operating entity into a nonoperating public shell corporation with nominal net assets typically results in (1) the owners of the private entity gaining control over the combined entity after the transaction, and (2) the shareholders of the former public shell corporation continuing only as passive investors. This transaction is usually not considered a business combination because the accounting acquiree, the nonoperating public shell corporation, does not meet the definition of a business under ASC 805. Instead, these types of transactions are considered to be capital transactions of the legal acquiree and are equivalent to the issuance of shares by the private entity for the net monetary assets of the public shell corporation accompanied by a recapitalization.

Any excess of the fair value of the shares issued by the private entity over the value of the net monetary assets of the public shell corporation is recognized as a reduction to equity.

2.10.2 Consideration transferred in a reverse acquisition

ASC 805-40-30-2 provides guidance on the consideration transferred in a reverse acquisition.

ASC 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.

In a reverse acquisition involving two public companies, there is a reliably measurable market value for the common stock of both entities. Accordingly, the acquisition-date fair value of the shares of the accounting acquirer should be used to measure the consideration transferred. The consideration transferred is determined based on the number of shares the accounting acquirer would have had to issue to the shareholders of the legal acquirer to achieve the same ownership ratio in the combined entity (i.e., give the shareholders of the legal acquirer the same percentage of equity interests in the combined entity that results from the reverse acquisition).

In a reverse acquisition involving only the exchange of equity, the fair value of the equity of the accounting acquiree may be used to measure consideration transferred if the value of the accounting acquiree's equity interests is more reliably measurable than the value of the accounting acquirer's equity interest. This may occur if a private company arranges to be legally acquired by a public company with a quoted and reliable market price, and the owners of the private company will control the public company such that the private company is identified as the accounting acquirer under ASC

805. If so, the accounting acquirer should determine the amount of goodwill by using the acquisition-date fair value of the accounting acquiree's equity interests in accordance with ASC 805-30-30-2 through ASC 805-30-30-3.

Example BCG 2-38 illustrates the measurement of the consideration transferred in a reverse acquisition.

EXAMPLE BCG 2-38

Valuing consideration transferred in a reverse acquisition (adapted from ASC 805-40-55-8 through ASC 805-40-55-10)

Company B, a private company, is the accounting acquirer of Company A, a public company, in a reverse acquisition. The transaction is a business combination.

Immediately before the acquisition date:

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

On the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares
- The shareholders of Company B own 60% (150/250) of the new combined entity
- The shareholders of Company A own 40% (100/250) of the new combined entity
- Market price of a share of Company A is \$16
- Estimated fair value of a share of Company B is \$40

What is the consideration effectively transferred for the acquisition of Company A by Company B?

Analysis

The fair value of the consideration effectively transferred should be measured based on the most reliable measure. Because Company B is a private company, the fair value of Company A's shares is likely more reliably measurable. Assuming that Company A's fair value is more reliably measurable, the consideration effectively transferred would be measured using the market price of Company A's shares (\$16/share) multiplied by the number of shares owned by Company A shareholders of the newly combined entity (100 shares) or \$1,600.

If the fair value of Company B's shares were more reliably measurable, the fair value of the consideration effectively transferred would be calculated using the amount of Company B's shares that would have been issued to the shareholders of Company A on the acquisition date to give Company A an equivalent ownership interest in Company B as it has in the combined company. Company B would have had to issue 40 shares¹ to Company A shareholders, increasing Company B's outstanding shares to 100 shares. Consideration effectively transferred would be \$1,600 (40 shares times the fair value of Company B's shares of \$40).

¹ The number of shares to be issued that will give owners of accounting acquiree a percentage ownership interest equal to their ownership interest in the combined entity: $(60 \text{ shares} / 60\%) \times 40\% = 40 \text{ shares}$.

2.10.2.1 Employee compensation in a reverse acquisition

An acquirer in a business combination may agree to exchange share-based payment awards held by grantees of the acquiree for replacement share-based payment awards of the acquirer. The accounting acquirer should apply acquisition accounting to the business combination regardless of the legal form of the transaction. In a reverse acquisition, from a legal perspective, outstanding share-based payment awards held by the grantees of the legal acquirer have not changed. However, from an accounting perspective, the awards have been exchanged for share-based payment awards of the accounting acquirer (legal acquiree). Accordingly, the acquisition-date fair value of the legal acquirer's (accounting acquiree's) share-based payment awards need to be evaluated to determine whether the awards should be included as part of the consideration transferred by the accounting acquirer or should be recognized as compensation cost in the accounting acquirer's postcombination financial statements. See BCG 3.2 for detail on determining whether compensation arrangements represent compensation for (1) precombination vesting (i.e., part of the consideration transferred), (2) postcombination vesting (i.e., accounted for separate from the business combination as costs in the postcombination period), or (3) a combination of precombination and postcombination vesting.

For any share-based payment awards held by the grantees of the accounting acquirer (legal acquiree), the legal exchange of the accounting acquirer's awards for legal acquirer's awards is considered to be a modification under ASC 718 of the accounting acquirer's outstanding awards. See SC 4 for further guidance on the accounting for modifications.

2.10.3 Presentation of financial statements (reverse acquisition)

The presentation of the financial statements represents the continuation of the legal acquiree, except for the legal capital structure in a reverse acquisition. Historical shareholders' equity of the accounting acquirer (legal acquiree) prior to the reverse acquisition is retrospectively adjusted (a recapitalization) for the equivalent number of shares received by the accounting acquirer after giving effect to any difference in par value of the issuer's and acquirer's stock with any such difference recognized in equity. Retained earnings (deficiency) of the accounting acquirer are carried forward after the acquisition. Operations prior to the merger are those of the accounting acquirer. Earnings per share for periods prior to the merger are retrospectively adjusted to reflect the number of equivalent shares received by the accounting acquirer.

ASC 805-40-45-2 provides financial statement presentation guidance for reverse acquisitions.

ASC 805-40-45-2

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 the guidance in this Topic 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 this Topic applicable to business combinations. However, the equity structure (that is, the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.
- e. The noncontrolling interest's proportionate share of the legal subsidiary's (accounting acquirer's) precombination carrying amounts of retained earnings and other equity interests as discussed in paragraphs 805-40-25-2 and 805-40-30-3 and illustrated in Example 1, Case B (see paragraph 805-40-55-18).

Example BCG 2-39 and Example BCG 2-40 illustrate the presentation of shareholders' equity following a reverse acquisition.

EXAMPLE BCG 2-39

Presentation of shareholders' equity immediately following a reverse acquisition (adapted from ASC 805-40-55-10 and ASC 805-40-55-13 through ASC 805-40-55-14)

Company B, a private company, is the accounting acquirer of Company A, a public company, in a reverse acquisition.

Shareholders' equity immediately before the acquisition date:

	Company A (accounting acquiree)	Company B (accounting acquirer)
Shareholders' equity		
Retained earnings	\$800	\$1,400
Issued equity		
100 common shares	300	
60 common shares		600
Total shareholders' equity	\$1,100	\$2,000

On the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares. Company A legally owns 100% of Company B.
- The market price of Company A's shares on the acquisition date is \$16/share.
- Fair value of consideration transferred is \$1,600 measured using the market price of Company A's shares (100 shares times \$16)
- The shareholders of Company B own 60% (150/250) of the new combined entity

How should the statement of shareholders' equity be presented following the reverse acquisition?

Analysis

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

Combined company	
Shareholders' equity	
Retained earnings ¹	\$1,400
Issued equity	
250 common shares ²	2,200
Total shareholders' equity	\$3,600

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

²The amount recognized for issued equity (i.e., common shares outstanding) is the sum of the value recognized for issued equity interests of Company B (legal subsidiary) immediately before the acquisition (\$600), plus the fair value of the consideration effectively transferred by Company B (i.e., the group's interest in Company A (legal parent) (100 shares x \$16/share = \$1,600)): \$600 + \$1,600 = \$2,200. 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 (Company A), including the equity interests issued by the legal parent to effect the combination.

EXAMPLE BCG 2-40

Restated presentation of shareholders' equity following a reverse acquisition

Company B, a private company, is the accounting acquirer of Company A, a public company, in a reverse acquisition. The transaction was consummated on 4/1/X2.

Immediately before the acquisition date:

- Company A has 100 shares outstanding (\$1 par)
- Company A has total shareholders' equity of \$125
- Company B has 100 shares outstanding (\$2 par)

- Company B has total shareholders' equity of \$1,850

On the acquisition date:

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

After the acquisition date:

- The recapitalized entity has net income of \$300 for the period 4/1/X2 to 12/31/X2

How should the statement of shareholders' equity of the combined company be presented at 12/31/X2, including the comparative period?

Analysis

Shareholders' equity of Company B (accounting acquirer) immediately before the acquisition date is as follows:

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

Restated shareholders' equity of the combined company at 12/31/X2:

	Shares at par (\$1) ¹	APIC	Retained earnings	Total shareholders' equity
1/1/X1 ¹	240	480	300	1,020
Shares issued 7/1/X1 ¹	80	70		150
Net income ¹			250	250
12/31/X1 ¹	320	550	550	1,420
Shares issued 2/1/X2 ¹	80	150		230
Net income ¹			200	200

	Shares at par (\$1) ¹	APIC	Retained earnings	Total shareholders' equity
3/31/X2 ¹	400	700	750	1,850
Recapitalization 4/1/X2 ²	100 ²	25 ²		125
Net income			300	300
12/31/X2	500	725	1,050	2,275

¹In the prior year, the comparative information presented in the consolidated financial statements should be that of the legal subsidiary (Company B). However, the disclosure of the number and type of equity instruments issued to support that equity value is restated to reflect the capital of the legal parent (Company A) (i.e., shares with a \$1 par). To calculate the shares at par, start with the ratio of Company B's shares at 3/31/X2 (400 shares) to Company A's shares (100 shares), which is a ratio of 4:1, and use that ratio to recast the shares for all periods.

²On the date of the acquisition, the historical APIC account of the legal subsidiary (Company B) reflects the additional fair value of the legal parent (Company A total shareholders' equity of \$125) less the par value of the shares held by the legal parent's precombination shareholders (Company A 100 shares outstanding at \$1 par = \$100). APIC = \$125 - \$100 = \$25.

2.10.4 Noncontrolling interest in a reverse acquisition

Some shareholders of the legal acquiree (accounting acquirer) may not participate in the exchange transaction in a reverse acquisition. These shareholders will continue to hold shares in the legal acquiree and will not exchange their shares for shares in the legal acquirer (accounting acquiree). Because these shareholders hold an interest only in the legal acquiree, they participate in the earnings of only the legal acquiree and not the earnings of the combined entity. The legal acquiree's assets and liabilities are recognized at their precombination carrying values (i.e., not recognized at fair value) on the acquisition date. These shareholders that will now become noncontrolling interest holders were not owners of the accounting acquiree and do not participate in earnings generated in the accounting acquiree. Therefore, in a reverse acquisition, the value of the noncontrolling interest is recognized at its proportionate interest in the precombination carrying amounts of the accounting acquirer in accordance with ASC 805-40-30-3.

Example BCG 2-41 illustrates the measurement of a noncontrolling interest in a reverse acquisition.

EXAMPLE BCG 2-41

Measurement of noncontrolling interest in a reverse acquisition (adapted from ASC 805-40-55-18 through ASC 805-40-55-21)

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

Immediately before the acquisition date:

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

Company B's recognized net assets are \$2,000

On the acquisition date:

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

How should the combined entity recognize the noncontrolling interest?

Analysis

The combined entity would recognize a noncontrolling interest related to the four remaining outstanding shares of Company B. The value of the noncontrolling interest should reflect the noncontrolling interest's proportionate share in the precombination carrying amounts of the net assets of Company B, or \$134. This is based on a 6.7% ownership (4 shares / 60 issued shares) in Company B and Company B's net assets of \$2,000.

2.10.5 Computation of earnings per share in a reverse acquisition

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

ASC 805-40-45-4 and ASC 805-40-45-5 provide guidance on calculating EPS in a reverse acquisition.

ASC 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 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 BCG 2-42 illustrates the computation of EPS in a reverse acquisition.

EXAMPLE BCG 2-42

Computation of EPS in a reverse acquisition (adapted from ASC 805-40-55-16)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition on September 30, 20X1.

Immediately before the acquisition date:

- Company A has 100 shares outstanding
- Company B has 60 shares outstanding
- Company B's outstanding shares (i.e., 60 shares) remained unchanged from January 1, 20X1 through the acquisition date

On September 30, 20X1, the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares. This is an exchange ratio of 2.5 shares of Company A for 1 share of Company B
- Earnings for the consolidated entity for the year ended December 31, 20X1 are \$800

How should earnings per share be computed?

Analysis

EPS for the year ended December 31, 20X1 is computed as follows:

Earnings for the year ended December 31, 20X1	\$800
Number of common shares outstanding of Company B	60
Exchange ratio	2.5
Number of shares outstanding from January 1, 20X1 through September 30, 20X1	150
Number of shares outstanding from acquisition date through December 31, 20X1	250
Weighted-average number of shares outstanding (150 shares × 9 / 12) + (250 shares × 3 / 12)	175
Earnings per share for year ended December 31, 20X1 (\$800 / 175 shares)	\$4.57

2.11 Applying the acquisition method for variable interest entities

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

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

Figure BCG 2-2 provides the applicable guidance for the VIE subsections of ASC 810-10 in connection with a business combination. Although VIEs are accounted for under ASC 810, a model outside of ASC 805, the accounting for common differences between a business combination and an asset acquisition should also be considered in accounting for a VIE.

Figure BCG 2-2

Variable interest entities and business combinations

Scenario	Application of ASC 805
Acquired group is a: Variable interest entity Business	The consolidation of the VIE when control is obtained is considered a business combination. Apply the acquisition method in ASC 805. In this situation, the date the VIE must be consolidated should be used as the acquisition date. The primary beneficiary, the entity that consolidates the VIE, is identified as the acquirer in accordance with ASC 805-10-25-5 through ASC 805-10-25-6.
Acquired group is a: Variable interest entity Not a business	The consolidation of the VIE is considered an asset acquisition. Apply sections ASC 805-20-25, ASC 805-20-30, ASC 805-740-25-2, and ASC 805-740-30-1 to recognize and measure the VIE's assets and liabilities, excluding goodwill, at fair value. The difference between (1) the fair value of any consideration transferred, the fair value of the noncontrolling interest in the VIE, and the reported amount of any previously held equity interests in the VIE (i.e., do not remeasure the previously held equity interests to fair value); and (2) the net amount of the VIE's identifiable assets and liabilities recognized and measured in accordance with ASC 805 will be recognized as a gain or loss. No goodwill is recognized in accordance with ASC 810-10-30-3 through ASC 810-10-30-4.
Acquired group is: Not a variable interest entity	Determine whether the acquired group is a business. If it is a business, apply ASC 805. If it is not a business, apply asset acquisition accounting (see PPE 2 for further information).

2.12 *Conforming acquiree's accounting policies to those of acquirer*

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

Depending on the nature of the assets acquired or liabilities assumed, the acquirer may not have an existing accounting policy. We believe that when the acquirer does not have an existing accounting policy related to the newly acquired assets or liabilities, the acquirer is not required to inherit the accounting policy of the acquiree. That is, the acquirer may select and apply any accounting policy that is acceptable under US GAAP.

In other circumstances, the acquirer may have existing accounting policies and want to change its policies to conform to those of the acquiree. Conforming the acquirer's accounting policies to those of the acquiree is a change in accounting principle and the preferability requirements of ASC 250 must be considered.

***Chapter 3:
Compensation
arrangements—updated
August 2022***

3.1 Overview: compensation arrangements in a business combination

This chapter predominantly focuses on awards issued to employees (for which vesting may be described as providing “service” over a “requisite service period”) although it also applies to nonemployee awards (which may be described as vesting over a “vesting period,” which could reflect delivery of either goods or services). See SC 7 for additional guidance specific to nonemployee awards.

The acquirer in a business combination may agree to assume existing compensation arrangements of the acquiree or may establish new arrangements to compensate for postcombination vesting. The arrangements may involve cash payments or the exchange (or settlement) of share-based payment awards. The replacement share-based payment awards may include the same terms and conditions as the original awards to keep the recipients of the acquiree “whole” (i.e., preserve the value of the original awards). The acquirer may, in other situations, change the terms of the share-based payment awards to provide an incentive for recipients to remain with the combined entity.

Such arrangements should be analyzed to determine whether they represent consideration for (1) precombination vesting, (2) postcombination vesting, or (3) a combination of precombination and postcombination vesting. Amounts attributable to precombination vesting are accounted for as part of the consideration transferred for the acquiree. Amounts attributable to postcombination vesting do not result in recognition at the acquisition date, but rather are accounted for separate from the business combination and are recognized as compensation cost in the postcombination period. In certain cases, the acquirer may recognize compensation cost immediately upon the acquisition date if incremental value is provided to recipients without a further service requirement or awards are accelerated on a discretionary basis (see, for example, BCG 3.4.7). Compensation cost is typically recorded as expense, unless required or permitted to be capitalized by other standards. Under ASC 805-10-25-20, amounts attributable to a combination of precombination and postcombination vesting are allocated between the consideration transferred for the acquiree and the postcombination vesting.

This chapter also addresses the accounting for other compensation arrangements, such as “stay bonuses” and “golden parachute” agreements with employees of the acquiree, as well as assessing contingent consideration arrangements to determine whether they represent additional consideration for the acquired business or compensation for future services.

For guidance on accounting for share-based payment awards, refer to PwC’s *Stock-based compensation* guide. The accounting for pension and other postretirement benefits in a business combination is addressed in BCG 2.

3.2 Assessing consideration transferred in a business combination

In conjunction with accounting for a business combination, an acquirer must assess whether the items exchanged include amounts that are separate from the business combination. As noted in ASC 805-10-25-20, the acquirer should identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination. Separate transactions are accounted for in accordance with other relevant GAAP. See BCG 2.7 for additional information.

A transaction arranged primarily for the economic benefit of the acquirer (or combined entity) is not deemed to be part of the consideration transferred for the acquiree and should be accounted for

separate from the business combination in accordance with ASC 805-10-25-21 through ASC 805-10-25-22. Factors identified in ASC 805-10-55-18 to consider in this analysis include:

- the reasons for the transaction,
- who initiated the transaction, and
- the timing of the transaction.

The basic principle outlined in ASC 805 and the three factors listed above are discussed in more detail in BCG 2. This chapter focuses on compensation arrangements, which require consideration of the basic principle and an assessment of the three factors.

In some cases, instruments issued by the acquirer may have elements of both consideration transferred and compensation. For example, the acquirer may agree to exchange share-based payment awards held by grantees of the acquiree for replacement share-based payment awards of the acquirer. The awards held by the grantees of the acquiree and the replacement awards are measured using the fair-value-based measurement principles of ASC 718 on the acquisition date (share-based payment transactions are excluded from the scope of ASC 820) under ASC 805-30-30-11 and ASC 805-30-55-7. Throughout this chapter, references to fair value of share-based payment awards mean the “fair-value-based measure” that is determined in accordance with ASC 718. The acquirer should then attribute the fair value of the awards to precombination vesting and postcombination vesting. The fair value of the awards attributed to precombination vesting is included as part of the consideration transferred for the acquiree. The fair value of the awards attributed to postcombination vesting is recorded as compensation cost in the postcombination financial statements of the combined entity in accordance with ASC 805-30-55-8 through ASC 805-30-55-10. See further discussion in BCG 3.4. Note that as further described in BCG 3.4.1, the proportions attributed to consideration transferred and compensation cost are based on the portion of the requisite service/vesting period of the original award completed as of the acquisition date, not what portion of the award is legally vested as of that date. Although ASC 805 focuses on the fair value method, it also applies to situations when ASC 718 permits the use of the calculated value method or the intrinsic value method for both the acquiree awards and the replacement awards (refer to ASC 805-30-55-7). See SC 6.2.1.1 and SC 6.2.1.2 for additional information on the use of the calculated value method and the intrinsic value method, respectively.

Consideration transferred in a business combination may be in the form of assets (e.g., cash) or equity interests. Example BCG 3-1 illustrates consideration transferred in the form of both cash and equity interests.

EXAMPLE BCG 3-1

Consideration transferred: Cash and rollover equity

PE, a private equity fund, acquires Company A in a business combination for \$100 million in total consideration. In order to facilitate the acquisition of Company A, PE creates a new wholly-owned subsidiary (“NewCo”). NewCo negotiates with lenders and raises debt to fund the acquisition of Company A (i.e., NewCo has substantive precombination activities). NewCo survives the acquisition and is controlled by PE postcombination. For the purpose of this example, assume NewCo is the accounting acquirer.

The CEO of Company A, who is also a shareholder, will be employed by NewCo after the acquisition. As part of the business combination, NewCo enters into a rollover equity agreement with the CEO of Company A, which provides the CEO with equity interests in NewCo in lieu of receiving cash consideration (i.e., the CEO of Company A will exchange her shares in Company A for shares of NewCo, whereas the other shareholders will receive cash consideration). The fair value of the equity interests in NewCo that the CEO of Company A will receive for her 8% ownership interest in Company A (\$8 million) is commensurate with the fair value of the cash consideration received (\$92 million) by the other shareholders of Company A on a per share basis. The rollover equity agreement does not require the CEO to have any continuing involvement with NewCo to retain her shares.

How should NewCo account for the rollover equity arrangement with the CEO of Company A?

Analysis

As the CEO of Company A is not required to be employed by NewCo after the business combination in order to retain her shares, and is exchanging ownership of her shares in Company A (8%) for shares of NewCo (fair value of \$8 million) that is equal to the cash consideration per share received by other shareholders of Company A, the rollover equity agreement is not considered a compensation arrangement. Therefore, NewCo should include the fair value of the rollover equity issued by NewCo as part of the consideration transferred for the business combination.

3.3 Contingent payments: compensation or consideration transferred

An acquirer may enter into an arrangement to make contingent payments to the selling shareholders of the acquiree. These arrangements need to be analyzed to determine if they should be included in the consideration transferred for the acquiree (i.e., contingent consideration), accounted for as a separate transaction apart from the business combination (generally compensation cost), or a combination of both. In accordance with ASC 805-10-55-24, this assessment requires obtaining an understanding of why the contingent payments are included in the arrangement, which party (the acquiree or the acquirer) initiated the arrangement, and when the parties entered into the arrangement.

If it is not clear whether an arrangement is part of the exchange for the acquiree or is a separate transaction, ASC 805-10-55-25 provides eight indicators that should be considered. While these criteria specifically apply to arrangements for contingent payments, they are also useful in considering other arrangements for payments to employees or selling shareholders, such as when certain selling shareholders (who are also employees) receive a higher price per share than other selling shareholders. Additionally, arrangements between the selling shareholders and the acquiree's employees should be evaluated to determine whether such arrangements were entered into for the benefit of the acquirer and thus represent compensation (e.g., stay bonuses paid by the selling shareholders out of their proceeds).

Excerpts from ASC 805-10-55-25

- a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is

- compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.
- 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.

All of the indicators should be considered when analyzing whether the contingent consideration is for postcombination services. However, ASC 805-10-55-25(a) requires the consideration to be accounted for as postcombination compensation cost if the consideration is automatically forfeited upon termination of employment. Additionally, even if the consideration to be transferred is not required to be forfeited upon termination of employment, we believe that the acquirer should evaluate whether the arrangement contains an in-substance service period, which may indicate that the substance of the arrangement is compensatory. The determination of whether an arrangement contains an in-substance service condition is a matter of judgment based on relevant facts and circumstances. The following factors, which are consistent with the analysis described in ASC 718-20-55-87 through ASC 718-20-55-92, may be considered as part of this determination:

- The acquiree's business is in an industry in which retention of employees is important to preserving the value of its operations.
- The recipient(s) of the contingent payments are critical to the future success of the acquiree's business, which may be due to the size and the nature of the acquiree, the expertise these recipients possess, or the relationships these recipients have with customers of the acquiree.
- The value of the contingent payment that may be received by the selling shareholder(s) is significant in relation to the upfront payment received from the acquirer.
- While the contingent payment is not contingent on future service to the acquirer, the contingent payment will be transferred over a period that aligns with employment agreement(s) entered into by the selling shareholder(s) with the acquirer.
- The selling shareholder(s) have also entered into noncompete agreements which align with the employment agreement(s) entered into by the selling shareholder(s) with the acquirer.

All surrounding circumstances and contracts should be considered in assessing the substance of contingent payment arrangements. There may be situations when there are employment requirements in order to be eligible to receive a contingent payment included in a separate agreement, which the acquirer may not even be a party to. For example, assume an acquiree is structured as a holding company, owned by a group of key employee shareholders, that owns a 100% interest in an operating company. The holding company agrees to sell the operating company to an acquirer in exchange for cash and contingent consideration payable in the future. The selling shareholders will remain employed after the acquisition. Both the initial payment and the contingent consideration are payable to the holding company, which in turn would distribute the proceeds to the employee shareholders. The contingent payments are tied to the acquiree achieving certain revenue and earnings targets, and are not dependent upon the continued employment of any individual. However, the holding company and the employee selling shareholders enter into a separate arrangement that requires the employee shareholders to forfeit their ownership in the holding company if they terminate employment with the acquirer. Because the forfeiture of shares in the holding company results in their inability to share in the contingent payment that will be made to the holding company if the targets are achieved, the

employee selling shareholders' ability to receive contingent payments is substantively dependent upon their continued employment with the acquirer. Therefore, the contingent consideration should be accounted for as postcombination compensation cost.

Example BCG 3-2 and Example BCG 3-3 provide examples of contingent consideration arrangements that are forfeited upon the termination of employment. Example BCG 3-4 provides an example of incremental payments to an employee.

EXAMPLE BCG 3-2

Contingent consideration arrangement – sole shareholder

Company A (the acquiree) is owned by a sole shareholder, Shareholder X, who is also the chief executive officer (CEO) of Company A. Company A is acquired by Company B (the acquirer). Shareholder X will, per the terms of the purchase agreement, receive additional consideration for the acquisition based upon specific earnings before interest, taxes, depreciation, and amortization (EBITDA) levels of Company A over the two-year period following the acquisition. Company B believes that retaining the services of Shareholder X for at least two years is critical to transitioning Company A's ongoing business. The arrangement also stipulates that Shareholder X will forfeit any rights to the additional consideration if Shareholder X is not an employee of Company B at the end of the two-year period.

How should Company B account for the contingent consideration arrangement?

Analysis

Under ASC 805-10-55-25(a), a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is considered compensation for the postcombination services. Accordingly, any payments made to Shareholder X for achievement of the specific EBITDA levels would be accounted for as compensation cost in Company B's postcombination financial statements.

EXAMPLE BCG 3-3

Contingent consideration arrangement – payment contingent on continued employment of a specific employee

Company A (the acquiree) is owned by three shareholders, including Shareholder A, who is also the chief executive officer (CEO) of Company A. Company A is acquired by Company B (the acquirer). Company B believes that retaining the services of Shareholder A for at least two years is critical to transitioning Company A's ongoing business. Accordingly, per the terms of the purchase agreement, the three selling shareholders will receive additional consideration for the acquisition based on Company A achieving specific EBITDA levels over the two-year period following the acquisition only if Shareholder A remains employed by Company B during the two years. The payment, if due, would be divided among the three shareholders on the basis of their relative ownership percentages. Even if the EBITDA targets are met, no contingent payment will be made to any of the three selling shareholders if Shareholder A is not employed by Company B at the end of the two years following the acquisition. The employment requirement is only applicable to Shareholder A; the other two shareholders do not need to remain employed at Company B to receive a payment, if due.

How should Company B account for the contingent consideration arrangement?

Analysis

Under ASC 805-10-55-25(a), a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is considered compensation for postcombination services. Accordingly, we generally believe that Company B should account for any payments made to the three shareholders for the achievement of the specific EBITDA levels as compensation cost in Company B's postcombination financial statements. This is because these payments are contingent on continued employment (even though it is only the continued employment of Shareholder A).

An alternative view is that only the payment to Shareholder A should be compensation cost in Company B's postcombination financial statements. In considering this view, all facts and circumstances should be considered (e.g., the relationship of the employees to each other, the reason for the agreement, etc.). Under this view, the payments to the other selling shareholders should be further evaluated in accordance with the other factors in ASC 805-10-55-25 to determine whether the payments represent compensation cost or consideration transferred in the business combination.

EXAMPLE BCG 3-4**Contingent payment – incremental payment to an employee**

Company B acquires Company A in a transaction accounted for as a business combination. The CEO of Company A, who is also a shareholder, will be employed by Company B after the acquisition. None of the other shareholders are employees. As part of the acquisition agreement, Company B will pay Company A's shareholders \$10/share of stock at the acquisition date. Additionally, Company B will pay the shareholders of Company A a further \$1/share of stock if Company A's net income exceeds \$1 million during the one-year period following the acquisition, except that the CEO of Company A will be entitled to an additional \$2/share of stock (i.e., \$3/share in total) in such case. The CEO's payments are not automatically forfeited if she is no longer employed by Company B.

How should Company B account for this arrangement?

Analysis

As Company B acquired Company A in a business combination accounted for under ASC 805, the \$10/share paid at closing is treated as consideration transferred. Company B would evaluate the factors in ASC 805-10-55-25 to determine whether the contingent payment arrangements should be accounted for as additional consideration transferred for Company A or as compensation. The \$1/share of stock that all selling shareholders of Company A are entitled to receive would likely be accounted for as contingent consideration. As the CEO's additional \$2/share of stock is not automatically forfeited if she is no longer employed, the requirement in ASC 805-10-55-25(a) to account for such arrangements as postcombination compensation cost is not met. However, as the CEO of Company A will receive a higher per-share payment as compared to the other shareholders of Company A and will be employed by Company B after the business combination, the incremental value paid to the CEO of Company A (i.e., the additional \$2/share) should be treated as compensation cost in Company B's postcombination financial statements based on the guidance in ASC 805-10-55-25(d).

See Question BCG 3-7 for a discussion of the accounting for a subsequent modification to an arrangement with contingent payments in a business combination.

3.3.1 *Golden parachute and stay bonuses (business combinations)*

Employment agreements with executives often include arrangements whereby the executive receives a bonus, in cash or shares, when his or her employment is terminated. These arrangements are often triggered by a business combination and are commonly referred to as “golden parachute” arrangements. These arrangements need to be assessed to determine if they represent compensation for precombination or postcombination services. Generally, if the arrangement was included in the employment agreement prior to contemplation of the business combination and there is no postcombination service required, the consideration is associated with a precombination arrangement. The expense is typically recognized in the preacquisition financial statements of the acquiree and would typically be a liability assumed by the buyer that is therefore included in the application of the acquisition method.

Conversely, if the arrangement is newly entered into in conjunction with the business combination, or requires any continued service subsequent to the acquisition date, the consideration would typically be associated with a postcombination arrangement that benefits the acquirer. In this case, compensation cost would be recognized by the acquirer over the relevant service period. See BCG 3.6.2 for a discussion of “dual trigger” arrangements that may be triggered by the acquirer’s actions.

Example BCG 3-5 and Example BCG 3-6 include examples of a golden parachute arrangement and a stay bonus arrangement, respectively.

EXAMPLE BCG 3-5

Golden parachute arrangement

The employment contract for the CEO of Company B provides that if Company B is acquired by another company, the CEO will receive a \$5 million cash payment if the CEO remains employed through the acquisition date (a “golden parachute” arrangement). Several years after the employment contract is signed, Company B is acquired by Company A. The CEO is not obligated to remain employed after the acquisition date.

How should Company A account for the cash payment to the Company B CEO?

Analysis

Company A is required to assess whether the \$5 million cash payment to the CEO is (1) an assumed obligation that should be included in the application of the acquisition method, or (2) a postcombination cost that should be accounted for separately from the business combination. Company A should consider the factors listed in ASC 805-10-55-18:

- The reasons for the transaction: The \$5 million payment was originally included in the CEO’s employment contract by Company B to secure employment of the CEO through the acquisition date in the event that Company B was acquired in the future.
- Who initiated the transaction: The payment was arranged by Company B to benefit Company B through the acquisition date, in the event of an acquisition.
- The timing of the transaction: The employment contract was in existence prior to any discussions regarding the business combination with Company A.

The payment to the CEO is not primarily for the economic benefit of Company A. The CEO is not required to provide continuing services to Company A to receive the payment. Therefore, the payment should be recognized as compensation cost in Company B's precombination financial statements and an assumed obligation included in Company A's application of the acquisition method.

EXAMPLE BCG 3-6

Stay bonus arrangements

Company Z acquires Company Y and agrees to provide each of the key officers of Company Y a cash payment of \$1 million if they remain employed with the combined company for at least one year from the acquisition date. The agreement stipulates that if the key officers resign prior to the first anniversary of the acquisition date, the cash payment of \$1 million will be forfeited. A similar clause was not included in Company Y's key officers' employment agreements prior to the discussions that led to the business combination.

How should Company Z account for the cash payment to each of the key officers?

Analysis

Company Z must assess whether the \$1 million cash payment to each of the key officers is (1) consideration transferred for the acquiree or (2) a postcombination cost that should be accounted for outside of the business combination. Company Z should consider the factors listed in ASC 805-10-55-18:

- The reasons for the transaction: The \$1 million payment was offered to the key officers of Company Y by Company Z to facilitate the transition process following the acquisition and incentivize future service.
- Who initiated the transaction: The payment was arranged by Company Z to benefit Company Z for the first year following the acquisition.
- The timing of the transaction: The arrangement was negotiated in conjunction with the business combination and was not included in the original employment agreements of the key officers.

The payments to the key officers of Company Y appear to be arranged primarily for the economic benefit of Company Z. The key officers will forfeit the payments if they do not provide service to the combined company for at least one year following the acquisition date. Therefore, the payments are not part of the consideration transferred for Company Y and should be recorded as compensation cost in the postcombination financial statements of Company Z.

3.4 Exchange of share-based awards (business combinations)

The acquirer may issue its own share-based payment awards (replacement awards) in exchange for awards held by grantees of the acquiree. Generally, in such a transaction, the acquirer will replace the existing awards (under which the grantees would have received shares of the acquiree) with awards that will be settled in shares of the acquirer. The purpose of this transaction may be to keep the grantees "whole" after the acquisition (i.e., preserve the value of the original awards at the acquisition date) or to provide further incentive for recipients to remain with the combined entity. Therefore,

replacement awards may represent consideration for precombination vesting, postcombination vesting, or a combination of both. Replacement awards may contain the same terms as the original acquiree awards; other times, the acquirer may change the terms of the awards depending on its compensation strategy or other factors.

When the acquirer is obligated to grant replacement awards as part of a business combination, the replacement awards should be considered in the determination of the amount of consideration transferred for the acquiree. An acquirer is obligated to grant replacement awards if the acquiree or the acquiree's grantees can legally require the acquirer to replace the awards. For purposes of applying this requirement, the acquirer is considered obligated to grant replacement awards in a business combination in accordance with ASC 805-30-30-9 if required by one of the following:

- Terms of the acquisition agreement
- Terms of the acquiree's awards
- Applicable laws or regulations

An exchange of share-based payment awards in a business combination is treated as a modification under ASC 718. The replacement awards and the original acquiree awards should both be measured at fair value at the acquisition date and calculated using the fair-value-based measurement principles in ASC 718. The guidance in ASC 805 is also applicable to acquiree and replacement awards valued using the calculated-value method or the intrinsic-value method, where permitted by ASC 718 for the acquirer. For simplicity, this chapter assumes that the share-based payment awards are measured at fair value under ASC 718.

Once the fair value of the awards has been determined, the replacement awards should be analyzed to determine whether the awards relate to precombination or postcombination vesting. To the extent replacement awards are for precombination vesting, the value of the awards should be allocated to consideration transferred to the sellers for the acquiree. To the extent replacement awards are for postcombination vesting, the value of the awards should be excluded from payments for the acquired business and recognized as compensation cost in the postcombination financial statements in accordance with ASC 805-30-30-11 through ASC 805-30-30-13 and ASC 805-30-55-7 through ASC 805-30-55-10. In many cases, awards issued to replace awards of the acquiree that are partially through the vesting period as of the acquisition date will be allocated between precombination and postcombination vesting, as described in BCG 3.4.1. As also noted in BCG 3.4.1, any incremental fair value of the replacement award in excess of the fair value of the original award at the acquisition date will be attributed to postcombination cost.

Acquiree awards may expire as a consequence of a business combination and the acquirer may not be obligated to grant replacement awards. In this situation, any replacement awards granted by the acquirer are considered separate from the business combination. Under ASC 805-30-30-10, the entire fair value of the replacement awards should be recognized as compensation cost in the postcombination financial statements.

Figure BCG 3-1 summarizes the accounting for different arrangements involving the exchange of awards held by the grantees of the acquiree in a business combination.

Figure BCG 3-1

The accounting for different arrangements involving the exchange of awards held by grantees of the acquiree in a business combination

Acquirer's obligation	Scenarios		Accounting
	Replacement of awards	Expiration of acquiree awards	
1. The acquirer is obligated ¹ to issue replacement awards.	The acquirer issues replacement awards.	Not relevant.	The awards are considered in the determination of the amount of consideration transferred for the acquiree or for postcombination vesting.
2. The acquirer is not obligated ¹ to issue replacement awards to the acquiree.	The acquirer issues replacement awards.	The acquiree awards would otherwise expire.	The entire fair value of the replacement awards is recognized as compensation cost in the postcombination period.
3. The acquirer is not obligated ¹ to issue replacement awards to the acquiree.	The acquirer does not issue replacement awards. The acquiree awards remain outstanding postcombination as a noncontrolling interest.	The acquiree awards would not otherwise expire.	The acquirer could account for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above). Alternatively, the acquirer could account for the awards separate from the business combination as new grants and recognize the fair value of the awards as compensation cost in the postcombination period.
4. The acquirer is not obligated ¹ to issue replacement awards to the acquiree.	The acquirer issues replacement awards.	The acquiree awards would not otherwise expire.	Because the awards would not otherwise expire, if the acquirer had not issued replacement awards, the acquiree awards would have remained outstanding postcombination as a noncontrolling interest. The decision to issue replacement awards would then be viewed as an exchange of awards of the subsidiary (acquiree) for awards of the parent (acquirer), which is subject to modification accounting in accordance with ASC 718. Therefore, similar to Scenario 3, the acquirer could account for the awards as if the acquirer was obligated to issue replacement awards. Alternatively, the acquirer could account for the awards

Acquirer's obligation	Scenarios		Accounting
	Replacement of awards	Expiration of acquiree awards	
			separate from the business combination as new grants and recognize the fair value of the awards as compensation cost in the postcombination period.

¹ An acquirer is obligated to issue replacement awards if required by the terms of the acquisition agreement, the terms of the acquiree's awards, or applicable laws or regulations.

3.4.1 *Fair value attributable to pre and postcombination vesting*

For employee awards, the portion of employee replacement awards attributable to precombination vesting is the fair value of the acquiree awards multiplied by the ratio of the precombination employee's requisite service period completed prior to the exchange to the greater of the total requisite service period of the replacement awards or the original requisite service period of the acquiree awards, in accordance with ASC 805-30-55-8 through ASC 805-30-55-9.

The fair value of the employee awards to be attributed to postcombination vesting would then be calculated by subtracting the portion attributable to precombination vesting from the total fair value of the acquirer replacement awards under ASC 805-30-55-10. Excess fair value, which is the incremental amount by which the fair value of the replacement awards exceeds the fair value of the acquiree awards on the acquisition date, should be attributed to postcombination vesting. The fair value attributable to precombination vesting should be reduced to reflect an estimate of future forfeitures, notwithstanding the acquirer's policy for accounting for forfeitures. See ASC 805-30-55-17 through ASC 805-30-55-24 for examples and additional information.

For nonemployee awards, the portion of nonemployee replacement awards 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 the percentage that would have been recognized based on the original vesting requirements of the nonemployee award or the percentage that would have been recognized based on the effective vesting requirements (i.e., goods or services provided before the acquisition date plus any additional postcombination goods or services required by the replacement award) in accordance with ASC 805-30-55-9A. See ASC 805-30-55-25 through ASC 805-30-55-35 for examples and additional information.

Figure BCG 3-2 illustrates how to calculate the amount of fair value attributed to precombination and postcombination vesting for an employee award.

Figure BCG 3-2

Calculation of amount of fair value attributed to precombination and postcombination vesting for an employee award

Precombination vesting		Postcombination vesting
Fair value of the acquiree award	Precombination employee's service period completed prior to the exchange	Total fair value of the acquirer replacement award Less: portion attributable to precombination vesting
	Greater of: total service period of the replacement award OR Original service period of the acquiree award	

The total service period for employee awards includes both the requisite service period of the acquiree's awards completed before the acquisition date and the postcombination requisite service period, if any, of the replacement awards in accordance with ASC 805-30-55-8 through ASC 805-30-55-9.

The amount attributable to precombination vesting should be included in the consideration transferred for the acquiree. The amount attributable to postcombination vesting, however, is not part of the consideration transferred for the acquired business. The amount attributable to postcombination vesting should instead be recognized as compensation cost in the postcombination financial statements over the postcombination requisite vesting period in accordance with ASC 805-30-30-12 through ASC 805-30-30-13 and ASC 805-30-55-10.

The method of attributing the fair value of replacement awards between periods of precombination vesting and postcombination vesting is the same for equity- and liability-classified awards. All changes in the fair-value-based measure of awards classified as liabilities (both the portions attributed to precombination service as well as postcombination service in the initial acquisition accounting) after the acquisition date and the related income tax effects are recognized as an expense in the acquirer's postcombination financial statements in the periods in which the changes occur in accordance with ASC 805-30-55-13.

Question BCG 3-1

How should fair value be attributed to postcombination vesting for employee share options that are deep out of the money at the acquisition date?

PwC response

For employees, deep out of the money options (i.e., the exercise price is significantly higher than the measurement date share price) may have a derived service period if retention of the awards by the employee is contingent upon employment (e.g., the contractual term of the awards will be truncated upon termination). The awards have a derived service period because the employee may effectively be required to provide service for some period of time to obtain any value from the award. Because the awards have a derived service period after the acquisition date, a portion of the replacement awards

would be attributed to postcombination vesting and recognized as compensation cost in the postcombination financial statements in accordance with ASC 805-30-55-8 through ASC 805-30-55-9. See SC 2.6.2 for additional information.

For example, assume that, as of the acquisition date, employees of the acquiree are granted replacement awards with the same terms as their original awards. Under the terms of the awards, one year of service is required after the acquisition date for the awards to fully vest (i.e., the awards have an explicit service period of one year) and vested awards are forfeited upon termination of employment. However, on the acquisition date, the awards are deep out of the money. It is determined through the use of a lattice pricing model that the employee would need to provide three years of service to obtain any value from this award based on an expected increase in the company's share price. This three-year service period is considered a derived service period under ASC 718-10-55-71. The postcombination vesting period should be based on the longer of the explicit service period or the derived service period. Therefore, in this example, the acquirer would use a derived service period of three years as opposed to the explicit service period of one year. The derived service period should generally be determined using a lattice model. Assessing whether an option is deep out of the money will require judgment and may be impacted by whether the derived service period is substantive. The length of the derived service period will be significantly affected by the volatility of the acquirer's shares (i.e., all else equal, a higher volatility means a shorter derived vesting period). Note that this guidance on derived service periods is only applicable to employee awards, not nonemployee awards.

Question BCG 3-2

How should the fair value of the acquirer's unvested replacement awards included in the consideration transferred for the acquiree reflect an estimate of forfeitures?

PwC response

Replacement share-based payment awards should be measured using the fair value-based measurement method in ASC 718. Under ASC 718-10-30-11, no compensation cost is recognized for an award that is not expected to vest. Accordingly, the amount included in consideration transferred for the acquiree related to unvested awards should be reduced to reflect an estimate of future forfeitures. An example is included within ASC 805-30-55-11.

Excerpt ASC 805-30-55-11

...if the fair-value-based measure of the portion of a replacement award attributed to precombination vesting is \$100 and the acquirer expects that the service will be rendered for only 95 percent of the instruments awarded, the amount included in consideration transferred in the business combination is \$95.

The estimate of future forfeitures should be based on the acquirer's estimate of pre-vesting forfeitures, regardless of the acquirer's accounting policy for forfeitures under ASC 718-10-35-3 (see SC 2.7.1). When determining this estimate, the acquirer may need to consider the acquiree's historical employee data as well as the potential impact of the business combination on the employees' future behavior in accordance with ASC 718-10-35-3 and ASC 805-30-55-11 through ASC 805-30-55-12. Any postcombination changes in assumptions should be recognized directly in net income.

Question BCG 3-3

How should the compensation cost recognized in the acquirer's postcombination financial statements be adjusted to reflect estimated forfeitures of unvested awards?

PwC response

Regardless of the accounting policy elected by the acquirer for forfeitures under ASC 718-10-35-3, in the event of an acquisition, an estimate of forfeitures is required under ASC 805-30-55-11. The amount of compensation cost attributed to precombination service (and included in consideration transferred in the acquisition) should be reduced to reflect estimated forfeitures. If an acquirer's accounting policy is to estimate forfeitures, changes in the estimated forfeiture rate postcombination should be accounted for as adjustments to compensation cost in the period in which the change in estimate occurs in accordance with ASC 805-30-55-11. If an acquirer's accounting policy is to account for forfeitures as they occur, the amount excluded from consideration transferred (because the requisite service is not expected to be rendered) should be attributed to the postcombination vesting and recognized in compensation cost over the requisite vesting period, also in accordance with ASC 805-30-55-11.

Example BCG 3-7 illustrates the difference in the postcombination accounting treatment based on the acquirer's accounting policy election for forfeitures.

EXAMPLE BCG 3-7

Accounting treatment based on the acquirer's accounting policy election for forfeitures

As part of Company A's acquisition of Company B in a business combination, Company A is obligated to grant replacement awards to Company B's employees. One year of postcombination service is required by Company B employees for the replacement awards to vest. Prior to the business combination, Company B's employees completed three of the four years of the requisite service period. On the acquisition date, the fair value of the replacement awards is \$100; however, Company A estimates that 20% of the awards will be forfeited before the end of the requisite service period.

How should Company A account for the awards if the company makes an accounting policy election to estimate forfeitures? Alternatively, how should Company A account for the awards if the company's accounting policy election is to account for forfeitures when they occur?

Analysis

Regardless of Company A's accounting policy election for forfeitures, an estimate of forfeitures is required to determine the consideration transferred in acquisition accounting. The amount included in the consideration transferred is calculated as follows: \$100 fair value of Company A's replacement awards multiplied by the percentage of the requisite service period completed (three of the four years = 75%), multiplied by the percentage of awards expected to vest (100% – 20% forfeiture rate = 80%) = \$100 x 75% x 80% = \$60.

Accounting policy election: estimate forfeitures

If Company A has an accounting policy that estimates forfeitures, the postcombination accounting compensation cost would be calculated as follows: \$100 fair value of Company A's replacement awards multiplied by the percentage of awards expected to vest (100% – 20% forfeiture rate = 80%), less the \$60 included in the considered transferred = $\$100 \times 80\% - \$60 = \$20$. This amount would be recorded as postcombination compensation cost and recognized over the one year of postcombination vesting required of Company B employees. Any change in the estimated forfeiture rate would be accounted for as an adjustment to compensation cost in the period in which the change in estimate occurs.

Accounting policy election: account for forfeitures when they occur

If Company A's accounting policy is not to estimate forfeitures, it will account for them in the postcombination period as they occur as follows: \$100 fair value of Company A's replacement awards less the \$60 included in the consideration transferred = $\$100 - \$60 = \$40$. This amount would be recorded as postcombination compensation cost and recognized over the one year of postcombination vesting required of Company B employees. As forfeitures occur, compensation cost would be reduced.

Note: Under both of these elections, the guidance is not specific as to the subsequent treatment of Company A's actual forfeitures (e.g., an increase in forfeitures resulting in a decrease in the number of awards expected to vest/awards that actually vest) that are reflected in the company's postcombination compensation cost. Accordingly, we believe Company A should make one of the following accounting policy elections and apply it consistently: (1) reverse only compensation cost that was attributed to postcombination vesting and actually recognized as compensation cost by the acquirer; or (2) reverse all compensation cost for awards that do not actually vest, regardless of whether that measure was attributed to precombination or postcombination vesting as of the acquisition date. This amount may exceed the amounts previously recognized as compensation cost in the acquirer's postcombination financial statements.

3.4.1.1 Awards with graded vesting features (business combinations)

Awards with graded vesting features vest in stages (tranches) over an award's contractual term, as opposed to vesting on a specific date. An example of an award with graded-vesting features is an award that vests 25% each year over a four-year period. The portion of the award that vests each year is often referred to as a "vesting tranche." See further discussion of the accounting for such awards in SC 2.8.

ASC 805-30-55-12 requires the attribution of compensation cost for the acquirer's replacement awards in the postcombination financial statements to be based on the acquirer's attribution policy (i.e., straight-line approach or graded-vesting approach for awards subject only to a service condition; the graded-vesting approach is required for awards that include performance or market conditions). The acquiree's historical attribution policy is not relevant to the acquirer's accounting. If the acquirer has a different accounting policy for the treatment of service-based awards with graded vesting features than the acquiree, this may result in amounts of compensation cost not being recognized either by the acquirer in the postcombination financial statements or the acquiree in its precombination financial statements. Alternatively, this may result in amounts of compensation expense being recognized by both the acquirer and acquiree in the postcombination and precombination financial statements, respectively.

The acquirer's attribution policy should be applied consistently for all awards with similar features in accordance with ASC 805-30-55-12. If the acquirer does not have an existing policy for awards with graded vesting features, the acquirer should elect its own attribution policy (i.e., the acquirer is not required to adopt the accounting policy used by the acquiree).

Under the straight-line approach, a company recognizes compensation cost on a straight-line basis over the total service period for the entire award (i.e., over the service period of the last separately vesting tranche of the award), as long as the cumulative amount of compensation cost that is recognized on any date is at least equal to the grant-date fair value of the vested portion of the award on that date. Under the graded-vesting approach, a company recognizes compensation cost over the service period for each separately vesting tranche of the award as though the award is, in substance, multiple awards in accordance with ASC 718-10-35-8 and ASC 718-20-55-25 through ASC 718-20-55-34.

Question BCG 3-4

How does an acquirer's attribution policy impact the amount attributable to precombination vesting for awards with graded-vesting features?

PwC response

For awards with graded-vesting features, the amount of fair value of the replacement award attributable to precombination vesting should be determined based on the acquirer's attribution policy for any of its existing awards in accordance with ASC 718-10-35-8. For example, assume an acquirer exchanges replacement awards with a fair value of \$100 for the acquiree's awards with a fair value of \$100 (measured at the acquisition date) and there are no estimated forfeitures. Under their original terms, the replacement awards vest 25% each year over four years, based on continued service. At the acquisition date, one year of service has been rendered. The replacement awards have the same vesting period as the original acquiree awards; therefore, three additional years of service are required after the acquisition date for all of the awards to vest. The fair value attributable to precombination vesting will depend on the acquirer's attribution policy as follows:

- Straight-line attribution approach: If the acquirer's attribution policy is the straight-line approach, the amount attributable to precombination vesting is \$25 ($\$100 \times 1/4$ years).
- Graded-vesting attribution approach: If the acquirer's attribution policy is the graded-vesting approach, the amount attributable to precombination vesting is \$52. The calculation of this amount (assuming the fair value of the award was estimated for the entire grant) is illustrated below:

	Total fair value	% Vesting in year 1	Graded-vesting attributed in year 1
Tranche 1	\$25	100%	\$25.00
Tranche 2	25	50%	12.50
Tranche 3	25	33%	8.33
Tranche 4	25	25%	6.25
Total	\$100		\$52.08

Accordingly, if the acquirer's attribution policy is the straight-line approach, \$25 should be included in consideration transferred for the acquiree, and \$75 (\$100 less \$25) should be recognized in the postcombination financial statements. If the acquirer's attribution policy is the graded-vesting approach, \$52 should be included in consideration transferred for the acquiree, and \$48 (\$100 less \$52) should be recognized in the postcombination financial statements.

When acquiree share-based awards with graded-vesting features are granted prior to a business combination, some of the original awards may have vested and been exercised prior to the acquisition. Share-based payment awards of the acquiree that have already been exercised will be included in the consideration transferred for the acquiree's outstanding shares. For replacement awards related to awards still outstanding at the time of the business combination, the acquirer must determine the portion of the entire historical awards' fair value attributable to precombination vesting that will be recorded as part of the consideration transferred. The remainder of the fair value of the replacement awards will be attributable to postcombination vesting.

Example BCG 3-8 illustrates the attribution of the fair value of replacement awards to the precombination and postcombination vesting when a portion of the original awards has been exercised prior to the acquisition date.

EXAMPLE BCG 3-8

Attribution of the fair value of replacement awards with graded-vesting features to precombination and postcombination vesting as part of a business combination when a portion of the original awards has been exercised

Company A acquires Company B on July 1, 20X3. Company A issues replacement awards with identical terms for Company B's outstanding awards held by grantees. The original awards were issued to grantees by Company B on January 1, 20X1 and provided grantees with the right to purchase 100 shares of Company B. The original awards vest annually over 5 years (i.e., the original awards vest at a rate of 20% per year on the anniversary of the date of grant). The first two tranches of the original awards were exercised prior to the acquisition and only the unvested tranches remain outstanding at the acquisition date. Company A's accounting policy for recognizing compensation cost for share-based awards is the straight-line approach under US GAAP. The fair value of an award to purchase one common share at the acquisition date is \$10. There is no excess fair value of the replacement awards over the fair value of the acquiree awards as of the acquisition date.

How should the fair value of the replacement awards be attributed to the precombination and postcombination vesting?

Analysis

The first two tranches of the original awards were exercised and are no longer outstanding. Therefore, the shares issued upon exercise of those awards would have already been included in the consideration transferred for Company B's outstanding shares. Company A will issue replacement awards for the 60 share-based awards outstanding at the acquisition date. The fair value of the 60 replacement awards is \$600 and Company A must determine the total amount attributable to precombination vesting that will be recorded as part of the consideration transferred for Company B. The remainder will be attributable to postcombination vesting.

One approach to attribute the fair value of the replacement awards to precombination and postcombination vesting would be to consider the initial awards to purchase 100 shares of Company B as if none of the awards had been exercised. In this case, the fair value as if all 100 of Company B's awards were outstanding on the acquisition date (i.e., as a single unit) would be \$1,000 (100 awards multiplied by \$10 fair value). The awards would have been 50% vested as 2.5 years have elapsed as of the acquisition date out of the 5-year total vesting period. The 50% vesting would include the 40 share-based awards that have been exercised as well as the portion of the 20 replacement awards in the third tranche, which are half-way through the vesting period of January 1, 20X3 to January 1, 20X4. Multiplying the 50% vesting percentage to the awards' entire fair value of \$1,000 results in \$500 attributable to precombination vesting (consideration transferred for Company B) if all 100 awards were outstanding and being replaced. However, since 40 of the awards with a hypothetical fair value of \$400 have already vested and been exercised (and therefore included as part of consideration transferred for outstanding shares), only \$100 of the \$500 attributable to precombination vesting is recorded for the replacement awards as part of the consideration transferred for Company B. The aggregate unvested portion (50% or \$500) of the entire awards' fair value of \$1,000 would be attributable to postcombination vesting. Or, said another way, subtracting the \$100 attributable to precombination vesting from the \$600 fair value of the 60 replacement awards results in \$500 attributable to postcombination vesting.

Another approach to attribute the fair value of the replacement awards to precombination and postcombination vesting may be to determine the hypothetical vesting inception date for the remaining outstanding awards, as the straight-line method inherently views each tranche as a series of awards with sequential vesting periods. In this fact pattern, the hypothetical vesting-inception date would be January 1, 20X3, coincident with the beginning of the vesting period of the third tranche, and the vesting period would end on January 1, 20X6, the final vesting date of the fifth tranche of the original award. The 60 remaining outstanding awards are therefore 16.7% vested as 6 months have elapsed (January 1, 20X3 to the acquisition date of July 1, 20X3) out of the 3-year vesting period from the hypothetical vesting-inception date until the final vesting date of the original award. Multiplying the \$600 fair value of the 60 replacement awards exchanged as of the acquisition date by 16.7% results in \$100 to be attributed to precombination vesting (consideration transferred for Company B). The remaining \$500 (\$600 - \$100) would be attributable to postcombination vesting.

Additional analyses may be necessary to attribute the fair value of the replacement awards to precombination and postcombination vesting in more complex fact patterns. Complex fact patterns may include situations where tranches are only partially exercised, awards do not vest ratably, or complete records are not available to specifically identify the tranche of exercised awards.

If Company A's accounting policy for recognizing share-based award compensation cost were to utilize a graded-vesting allocation approach, the allocation would be calculated differently. Under a graded-vesting allocation approach \$392 of the \$600 fair value of the replacement awards would be attributable to precombination vesting and be recorded as part of the consideration transferred for Company B. This is calculated as follows:

Replacement awards	Total fair value	% Vesting at acquisition date	Graded-vesting attributed to precombination vesting
Tranche 3	\$200	83.3% ¹	\$167
Tranche 4	200	62.5% ²	125

Replacement awards	Total fair value	% Vesting at acquisition date	Graded-vesting attributed to precombination vesting
Tranche 5	200	50.0% ³	100
Total	\$600		\$392

¹ Calculated as 30 months out of 36 months total service period.

² Calculated as 30 months out of 48 months total service period.

³ Calculated as 30 months out of 60 months total service period.

The remaining value of the 60 replacement awards is attributable to postcombination vesting. That is, \$600 fair value of the 60 replacement awards less the \$392 attributable to precombination vesting results in \$208 attributable to postcombination vesting.

3.4.2 *Additional service required postcombination*

A grantee may hold an award that is fully vested under its original terms, but the terms of the replacement award require additional service from the grantee. Although the holder of the award performed all of the service as required by the original award granted by the acquiree, the acquirer added an additional service period to the replacement awards. Therefore, a portion of the fair value of the replacement award will be attributable to postcombination vesting.

Consider a scenario in which the original terms of an award require four years of service which were completed as of the acquisition date. However, an additional year of service was added to the terms of the replacement award by the acquirer, resulting in a total service period of five years. The acquirer will use the ratio of the four years of service completed compared to the total service period of five years (the greater of the original service period or the total service period required by the replacement award, as described in BCG 3.4.1), resulting in 80% of the fair value of the acquiree award being attributed to precombination vesting and accounted for as consideration transferred for the acquiree. The remaining fair value of the replacement award, including any excess fair value, would be accounted for over the remaining service period of one year in the postcombination financial statements.

3.4.3 *Less service required postcombination*

A replacement award that requires less service after the acquisition than would have been required under the original award effectively accelerates the vesting of the original award, eliminating all or a portion of the postcombination vesting requirement. The amount of fair value attributable to the discretionary accelerated vesting of the award should be recognized as additional compensation cost separate from the business combination. The amount included in the consideration transferred for the acquiree is limited to the amount of the acquiree's award attributable to precombination vesting. The ratio of the precombination service period to the greater of the total service period or the original service period of the acquiree award should be used when calculating the amount of the replacement award attributable to precombination vesting. See BCG 3.4.3.1 for information on awards with an automatic change in control clause.

Example BCG 3-9 further illustrates this guidance when the service required after the acquisition date is less than the original requirement.

EXAMPLE BCG 3-9

Attribution of fair value when service required after the acquisition date is less than the original vesting requirement

Company X (the acquirer) exchanges replacement awards with a fair value of \$100 for Company Y's (the acquiree) awards with a fair value of \$100. When originally granted, Company Y's awards provided for cliff vesting after a service period of four years from the grant date. As of the acquisition date, three of the four years of service required by the original terms of Company Y's awards have been rendered. The replacement awards issued by Company X are fully vested. Company X was obligated to issue replacement awards under the terms of the acquisition agreement.

How should the fair value of the replacement awards be attributed to the precombination vesting?

Analysis

Company X effectively accelerated the vesting of the awards by eliminating the one year of postcombination vesting that would have been required under the awards' original terms. The amount of Company X's replacement awards' value attributable to precombination vesting is equal to the fair value of Company Y's awards at the acquisition date, multiplied by the ratio of precombination service period to the greater of the total service period or the original service period of Company Y's awards.

- The total service period is three years (i.e., the years of service rendered as of the acquisition date).
- The original service period of Company Y's awards was four years.
- The original service period of four years is greater than the total service period of three years; therefore, the original service period of four years should be used to determine the amount attributable to precombination vesting; the amount attributable to precombination vesting is \$75 (the value of Company Y's awards of \$100 × 3 years precombination vesting / 4 years original vesting).
- The fair value of Company Y's replacement awards of \$100, less the amount attributed to precombination vesting of \$75, or \$25 (the portion for which vesting was accelerated), should be recognized in the postcombination financial statements. Because the replacement awards are fully vested, the entire \$25 should be recognized immediately in the postcombination financial statements.

3.4.3.1 Automatic change in control provision in business combinations

The fair value of acquiree awards that include a preexisting, automatic change in control clause (whereby awards vest immediately upon a change in control) should be included in the consideration transferred for the acquiree. The excess fair value of any replacement awards over the fair value of the acquiree awards should be reflected as compensation cost in the postcombination period in accordance with ASC 805-30-55-18 through ASC 805-30-55-19.

Example BCG 3-10 illustrates the accounting for an award with an automatic change in control provision.

EXAMPLE BCG 3-10

Allocation of fair value when an automatic change in control provision accelerates vesting upon closing of an acquisition

Company X (the acquirer) exchanges vested shares with a fair value of \$100 for Company Y's (the acquiree) awards with a fair value of \$100. The original terms of Company Y's awards contain a change in control clause, whereby they automatically vest upon closing of an acquisition. When originally granted, Company Y's awards provide for cliff vesting after a service period of four years. As of the acquisition date, three of the four years of service required by the original terms of Company Y's awards have been rendered.

How should the fair value of the replacement awards be attributed to the precombination vesting?

Analysis

The change in control clause in Company Y's awards requires that all awards automatically vest upon closing of an acquisition. Due to the fact that the change in control clause was in the original terms of Company Y's awards prior to the acquisition and required automatic vesting of the awards, there is no need to compare the total service period to the original service period. Therefore, the amount attributable to precombination vesting is the entire \$100 fair value of the original Company Y awards (which is also the value of the replacement awards, so there is no amount to include in postcombination cost). If the replacement awards issued by Company X had a fair value greater than \$100, any excess would have been recognized immediately in the postcombination financial statements of the combined company.

However, in certain circumstances, what appears to be a preexisting change in control clause may have recently been added to the acquiree's awards in conjunction with the negotiation of the business combination. In this situation, the guidance in ASC 805-10-55-18 should be considered (see BCG 3.2) to determine if the change benefits the acquirer and should be accounted for separate from the business combination. If so, the determination of the portion of the fair value of the replacement award that is attributed to precombination service should exclude the effect of the acceleration feature. Therefore, the impact of the acceleration will be reflected in postcombination compensation cost, similar to the analysis in Example BCG 3-9. Accordingly, such features should be carefully assessed.

3.4.3.2 Discretionary change in control provision (business combinations)

Acquiree awards for which vesting is accelerated based on a discretionary change in control clause need to be analyzed to determine if the acceleration of the vesting of the awards by the acquiree was arranged primarily for the economic benefit of the acquirer (or combined entity), or if it was for the benefit of the acquiree. The portion of the fair value of the acquiree's award related to the acceleration of vesting under a discretionary change in control clause would be recognized in the postcombination financial statements of the combined company if it is for the benefit of the acquirer (as illustrated in Example BCG 3-9). Refer to BCG 3.2 for the factors to consider in this analysis, as well as BCG 3.6.2 for "dual trigger" acceleration provisions.

3.4.4 Excess fair value of replacement awards (business combinations)

Any excess fair value of the replacement awards over the fair value of the acquiree awards at the acquisition date is considered compensation cost incurred by the acquirer outside of the business

combination. The excess fair value at the acquisition date, typically, is not significant if the replacement awards have the same terms and conditions as the acquiree awards. The assumptions used to calculate fair value immediately before the business combination may converge with the assumptions used to calculate the fair value of the replacement awards immediately after the modification because the value of the equity of the acquirer and the acquiree will usually reflect the pending acquisition as the closing date approaches.

However, if the acquirer changes the terms and conditions of the awards or the grantees' awards are exchanged using a different ratio than that offered to other equity holders (as this would usually be a change to make the awards more valuable to the grantees), it is likely that there will be excess fair value. The acquirer should recognize the excess fair value over the remaining vesting period in the postcombination financial statements in accordance with ASC 805-30-55-10. Refer to ASC 805-30-55-18 through ASC 805-30-55-19 for an example of replacement awards with excess fair value.

3.4.5 *Acquiree awards that continue after the business combination*

There may be circumstances when acquiree awards are not exchanged and do not expire but continue after the business combination as rights to acquire noncontrolling interests. This may occur when the acquirer purchases a target company and the target company continues as a separate subsidiary of the acquirer. When the awards of the target are not exchanged but continue under the original terms after the business combination (see Figure BCG 3-1, scenario 3), we believe the acquirer could account for the continuation of the awards as if the acquirer was obligated to issue replacement awards. This is similar to an exchange of awards in a business combination under ASC 805-30-30-9. Alternatively, the acquirer could choose to account for the awards separate from the business combination. The acquirer would account for the awards as new grants and recognize the fair value of the awards as compensation cost in the postcombination period.

Under either approach, as the awards vest over time, the acquirer would recognize compensation cost for the share-based payment awards, with a corresponding credit to noncontrolling interests. See BCG 5.4.2 for further information.

3.4.6 *Awards with performance/market conditions (business combinations)*

For awards with performance conditions (as defined by ASC 718), the acquirer should follow the same principle used for awards with service conditions. That is, the fair value of the original awards should be allocated between precombination and postcombination vesting, and the amount by which the fair value of the replacement awards exceeds the fair value of the original awards should be recognized in the postcombination financial statements in accordance with ASC 805-30-55-10.

However, the amount attributable to precombination vesting should incorporate the acquirer's assessment of the probability of achieving the performance condition as of the acquisition date. The amount attributable to precombination vesting is determined by multiplying the fair value of the acquiree awards that are probable of vesting as of the acquisition date by the appropriate ratio of the precombination vesting period completed prior to the exchange to the total vesting period, as described in BCG 3.4.1. The amount attributable to postcombination vesting would then be calculated by subtracting the portion attributable to precombination vesting from the total fair value of the acquirer's replacement award. The determination of the postcombination vesting period for the replacement awards should include consideration of the performance condition and the period in which it is probable that the performance condition will be achieved. For awards with market conditions, the impact of the condition is incorporated into the determination of the fair value of the award, regardless of probability.

Example BCG 3-11 and Question BCG 3-5 illustrate application of this guidance to awards with a performance condition.

EXAMPLE BCG 3-11

Allocation of fair value for awards with a performance condition

Company Z (the acquirer) exchanges replacement awards with a fair value of \$300 for Company A's (the acquiree) employee awards with a fair value of \$300. Company Z was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company A's awards cliff vest following the completion of the development of a new product. Because the awards contain a performance condition, at the acquisition date Company Z should assess the probability of whether the performance condition will be achieved. Prior to the acquisition, Company A considered it probable that the product would be finished three years from the grant date. As of the acquisition date, one year has passed since the grant date; therefore, two years remain in the original requisite service period. Company Z assessed the performance condition on the acquisition date and determined that it is still likely that the new product will be completed two years from the acquisition date. This probability assessment should be consistent with the assumptions included in the valuation of Company A's in-process research and development (IPR&D).

How much of the fair value of the replacement awards should be attributed to precombination vesting?

Analysis

The amount of Company Z's replacement awards attributable to precombination vesting is equal to the fair value of Company A's awards at the acquisition date that are considered probable of vesting, multiplied by the ratio of the precombination service period to the greater of the total requisite service period or the original requisite service period of Company A's awards. The original requisite service period of Company A's awards was three years. At the acquisition date, Company Z determined that it is still probable that the development of the new product will be completed in two more years; therefore, the awards will have a total requisite service period of three years. That is, the original requisite service period and the total requisite service period are both three years. The amount attributable to precombination vesting is \$100 ($\$300 \times 1 \text{ year precombination service} / 3 \text{ years original service}$). The remaining fair value of the awards of \$200 should be recognized in the postcombination financial statements over the remaining service period of two years because the awards have not yet vested.

Alternatively, consider a situation when at the acquisition date, Company A still considered it probable that the product would be completed in two years (i.e., three years from the grant date, consistent with Company A's initial determination of the implicit requisite service period). However, the acquirer determined on the acquisition date that, due to synergies at Company Z, it was probable that the product would be completed one year from the acquisition date. In this case, the amount attributable to precombination vesting (\$100) would remain the same. This would be the case because the original requisite service period of three years is greater than the total requisite service period of the replacement award of two years. Therefore, the portion of the fair value of the award attributable to precombination vesting would still be determined by comparing one year of precombination vesting to three years, which is the greater of the original service period (three years) or the total service period of the replacement award (two years). The remaining fair value of \$200, however, would be recognized over the remaining service period of the replacement award of one year.

Question BCG 3-5

How should the acquirer account for the exchange of an equity settled award with a performance (nonmarket) condition (as defined by ASC 718), assuming it is not probable both before and after the exchange that the condition will be achieved?

PwC response

Under ASC 718, the probability that an award with a service or performance condition will vest is not incorporated into the fair value of the award; however, compensation cost is recognized only for awards expected to vest. In other words, compensation cost is recognized if and when it is probable that the performance condition will be achieved, in accordance with ASC 718-10-35-3.

Replacement share-based payment awards should be measured using the fair-value-based measurement method of ASC 718 in accordance with ASC 805-30-30-11 and ASC 805-30-55-7. If it is not probable before the exchange that the performance condition will be achieved, then no amount should be recorded for that replacement award in connection with the business combination for precombination services. Under ASC 718-10-35-3, no compensation cost is recognized for an award with a performance condition that is not expected to vest. Therefore, in this fact pattern, the acquirer should not record any compensation cost in the postcombination financial statements until achievement of the performance condition becomes probable.

Once achievement of the performance condition becomes probable, the company should begin recognizing cumulative compensation cost from the date it becomes probable based on the fair value of the entire replacement award as of the acquisition date. No adjustment should be made to the amounts recorded in connection with the business combination (e.g., goodwill) in accordance with ASC 805-30-55-11 through ASC 805-30-55-12.

As described in SC 2.5.2, the impact of market conditions should be incorporated into the determination of the fair value of a share-based payment award. The determination of the fair value attributable to precombination and postcombination vesting for awards with a market condition is consistent with the analysis performed for awards with service conditions. The determination of the precombination and postcombination service periods for the replacement awards, as well as the fair value of the acquiree and acquirer awards, should include consideration of the market condition. As noted in BCG 3.4.4, the assumptions used to calculate fair value immediately before the business combination may converge with the assumptions used to calculate the fair value of the replacement awards immediately after the exchange.

3.4.7 Attribution of fair value to pre/postcombination vesting

The examples presented in Figure BCG 3-3 are based on the following assumptions: (1) the original terms of the acquiree's employee awards cliff vest following four years of service, (2) the acquirer is obligated to issue replacement awards under the terms of the acquisition agreement, (3) the fair value of the replacement awards is equal to the fair value of the acquiree awards on the acquisition date (except as specified in Scenario 3), and (4) all of the replacement awards are expected to vest (i.e., there are no estimated forfeitures). See BCG 3.4.1.1 for information on awards with graded vesting features.

Figure BCG 3-3

Attribution of fair value to pre/postcombination vesting

Acquiree's awards	Acquirer's replacement awards	Greater of total service period or original service period	Fair value attributable to precombination vesting	Fair value attributable to postcombination vesting
Scenario 1:				
4 years of service required under original terms. All required services rendered prior to acquisition.	No service required after the acquisition date.	4 years. The original service period and the total vesting period are the same.	100% (4 years precombination service/4 years total service).	0%
Scenario 2:				
4 years of service required under original terms. 3 years of service rendered prior to acquisition.	1 year of service required after the acquisition date.	4 years (3 years prior to acquisition plus 1 year after acquisition). The original service period and the total service period are the same.	75% (3 years precombination service/4 years total service).	25% (total fair value of the replacement award less the 75% for precombination vesting). This amount is recognized in the postcombination financial statements over the remaining service period of 1 year.
Scenario 3:				
4 years of service required under original terms. 4 years of service rendered prior to acquisition.	1 year of service required after the acquisition date. The grantee has agreed to the additional year of service because the fair value of the replacement awards is greater than the fair value of the acquiree awards.	5 years (4 years completed prior to acquisition plus 1 year required after acquisition). The total service period of 5 years is greater than the original service period of 4 years.	80% of the acquiree award (4 years precombination service/5 years total service).	20% of the acquiree award and the excess fair value of the replacement award (total fair value of the replacement award less the 80% for precombination vesting). This amount is recognized in the postcombination financial statements over the remaining service period of 1 year.

Acquiree's awards	Acquirer's replacement awards	Greater of total service period or original service period	Fair value attributable to precombination vesting	Fair value attributable to postcombination vesting
Scenario 4:				
4 years of service required under original terms. 1 year of service rendered prior to acquisition.	2 years of service required after the acquisition date. Therefore, the replacement awards require one less year of service.	4 years (since only 2 years of service are required postcombination, the total service period for the replacement awards is 3 years, which is less than the original service period of 4 years). Therefore, the original service period is greater than the total service period.	25% (1 year precombination service / 4 years original service period).	75% (total fair value of the replacement award less the 25% for precombination vesting). This amount is recognized in the postcombination financial statements over the remaining service period of 2 years.
Scenario 5:				
4 years of service required under original terms. 3 years of service rendered prior to acquisition. There was no change in control clause in the terms of the acquiree awards.	No service required after the acquisition date.	4 years (since no additional service is required, the total service period for the replacement awards is 3 years, which is less than the original service period of 4 years). Therefore, the original service period is greater than the total service period.	75% (3 years precombination service / 4 years original service period).	25% (total fair value of the replacement award less the 75% for precombination vesting). This amount is recognized in the postcombination financial statements immediately because no future service is required.

Acquiree's awards	Acquirer's replacement awards	Greater of total service period or original service period	Fair value attributable to precombination vesting	Fair value attributable to postcombination vesting
Scenario 6:				
4 years of service required under original terms. 3 years of service rendered prior to acquisition. There was a change in control clause in the original terms of the acquiree awards when granted that accelerated vesting upon a change in control.	No service required after the acquisition date.	Not applicable. Because the awards contain a pre-existing change in control clause, the total fair value of the acquiree awards is attributable to precombination vesting.	100%. For acquiree awards with a change in control clause that accelerates vesting, the total fair value of the acquiree awards is attributable to precombination vesting.	0%. For acquiree awards with a pre-existing change in control clause, no amount is attributable to postcombination vesting because there is no future service required.

3.5 *Cash settlement of share-based awards (business combinations)*

An acquirer may elect to pay cash to settle outstanding awards held by grantees of the acquiree instead of granting replacement awards. The accounting for the cash settlement of share-based payment awards outside of a business combination is addressed by ASC 718-20-35-7. The accounting for the cash settlement of share-based payment awards within a business combination is not explicitly addressed. However, we believe many of the same principles that apply to the exchange of share-based payment awards should be applied to these transactions. That is, an acquirer should determine the portion of the cash settlement to be attributed to precombination vesting or postcombination vesting using the guidance for the exchange of share-based payment awards and the allocation formula described in Figure BCG 3-2. The following sections discuss cash settlements initiated by the acquirer as well as cash settlements initiated by the acquiree. Determining who initiated the cash settlement may require analysis of the factors listed in BCG 3.2 and BCG 3.3.

3.5.1 *Acquirer initiated cash settlement of share-based awards*

Cash payments made by the acquirer to settle vested awards should be included in the consideration transferred for the acquiree up to an amount equal to the fair value of the acquiree's awards measured at the acquisition date. To the extent the cash payment is greater than the fair value of the acquiree's awards, the excess fair value amount is considered an expense incurred by the acquirer outside of the business combination rather than as consideration transferred for the acquiree. Accordingly, the excess amount of cash paid over the fair value of the acquiree's awards should be immediately recognized as compensation cost in the postcombination financial statements in accordance with ASC 805-30-55-10.

If cash payments are made by the acquirer to settle unvested awards (assuming no future service is required to receive the cash payment), the acquirer has effectively accelerated the vesting of the awards by eliminating the postcombination vesting requirement and settled the awards for cash. The portion attributable to precombination vesting provided to the acquiree should be included in the consideration transferred for the acquiree. The remaining portion of the cash payment to the acquiree's grantees, attributable to the postcombination vesting, should be immediately recognized as compensation cost in the postcombination financial statements. This analysis is similar to the illustration in Example BCG 3-9, in which vested replacement share-based payment awards are transferred for unvested acquiree awards in accordance with ASC 805-30-55-10 and ASC 805-30-55-23 through ASC 805-30-55-24.

An acquirer may pay cash in exchange for unvested awards of the acquiree and additional postcombination vesting, with the cash payment made at the completion of the additional service period. In this case, the acquirer will need to determine the portion of the payment attributable to precombination vesting and postcombination vesting. The amount attributable to precombination vesting is determined by multiplying the fair value of the acquiree award by the appropriate ratio of the precombination vesting period completed prior to the acquisition date to the total vesting period, as described in BCG 3.4.1. The amount attributable to postcombination vesting would be recognized in the postcombination financial statements over the remaining vesting period, with a corresponding credit to a liability account for the future payment upon the vesting date.

3.5.2 Acquiree initiated cash settlement of share-based awards

The acquiree (as opposed to the acquirer) may cash-settle outstanding awards prior to the acquisition. However, these transactions, including their timing, should be assessed to determine whether the cash settlement, or a portion thereof, was arranged primarily for the economic benefit of the acquirer (or the combined entity). Even though the form of the transaction may indicate that the acquiree initiated the cash settlement, it may be determined that, in substance, the acquirer reimbursed the acquiree for the cash settlement (either directly or as part of the consideration transferred for the acquiree). This assessment should include an analysis of the factors listed in BCG 3.2.

If the acquiree cash-settles its awards and it is determined that the transaction was for the economic benefit of the acquiree, the settlement should be recorded in the acquiree's financial statements prior to the business combination in accordance with ASC 718-20-35-7. If it is determined that the acquirer reimbursed the acquiree for the cash settlement (either directly or as part of the transaction price paid for the acquiree), the accounting by the acquirer should generally be the same as if the acquirer had settled the awards directly (in which case the accounting described in BCG 3.5.1 should be followed).

Example BCG 3-12 illustrates an example of cash settlement of awards by the acquiree.

EXAMPLE BCG 3-12

Example of cash settlement of awards by the acquiree

Company D (the acquiree) cash-settles the outstanding unvested awards held by its grantees immediately prior to being acquired by Company C (the acquirer). The amount of cash paid by Company D is \$100 million, which is equal to the current fair value of the awards. At the time of settlement, the grantees had completed 75% of the service required to vest in the awards (and 25% of the service period remained).

How should Company C account for the cash settlement of the outstanding unvested awards?

Analysis

Company C should determine whether a portion of the consideration transferred for Company D is attributable to the settlement of unvested awards held by Company D's grantees. The settlement of the portion of the unvested awards not attributable to precombination vesting may be a transaction arranged primarily for the economic benefit of Company C. Factors to consider in this analysis (as discussed in ASC 805-10-55-18) include:

- The reasons for the transaction: Why did Company D elect to cash-settle the outstanding awards?
- Who initiated the transaction: Did Company C direct Company D to settle the awards? Was the settlement a condition of the acquisition?
- The timing of the transaction: Was the settlement in contemplation of the business combination?

If Company D was requested by Company C to cash-settle the awards, the settlement of the unvested awards would be deemed a transaction arranged primarily for the economic benefit of Company C. Similarly, if Company D chose to cash-settle the awards because Company C was not willing to issue replacement awards, in effect Company C initiated the cash settlement decision and the transaction was arranged primarily for the economic benefit of Company C. Therefore, a portion of the total consideration transferred should be attributed to the cash settlement of the awards and excluded from the consideration transferred to acquire Company D. In this example, the fair value of the unvested awards that is not attributable to precombination vesting, or \$25 million (the fair value of the awards of \$100 million multiplied by the remaining service period of 25%), is the amount that would be excluded from consideration transferred and recognized as expense in Company C's postcombination financial statements. The \$25 million should be recognized immediately because no postcombination vesting is required.

3.6 Other compensation arrangements (business combinations)

Other forms of compensation arrangements may be provided to the employees of the acquiree in conjunction with a business combination. Two common arrangements are "last-man-standing" arrangements and "dual trigger" arrangements.

3.6.1 "Last-man-standing" arrangements (business combinations)

Awards granted to a group of employees and reallocated equally among the remaining employees if any of the employees terminate employment prior to completion of the service period are often described as 'last-man-standing' arrangements. Because each employee has a service requirement, each individual grant of awards should be accounted for separately. Generally, the accounting for a reallocation under a "last man standing" arrangement is effectively treated as a forfeiture of an award by one employee and regrant of awards to the other employees. Therefore, if and when an employee terminates his or her employment and awards are reallocated to the other employees, the reallocated awards should be treated as a forfeiture of the terminated employee's awards and a new grant to the other employees. The same concepts apply to contingent consideration arrangements that are paid to a group of selling shareholders who remain as employees but reallocated amongst the participants if any of the employees terminate employment prior to the payout of the contingent arrangement. This would still be viewed to be dependent on future services and compensatory under ASC 805-10-55-

25(a), even though the entire amount will still be paid out if the other terms of the contingent payment arrangement are otherwise met.

Example BCG 3-13 illustrates a “last-man-standing” arrangement involving share-based payment awards. Example BCG 3-14 illustrates a “last-man-standing” arrangement involving cash-settled awards

EXAMPLE BCG 3-13

“Last-man-standing” arrangement involving share-based payment awards

On January 1, 20X1, Company M (the acquirer) acquires Company G (the acquiree) and, as part of the acquisition agreement, grants 100 awards to each of five former executives of Company G. Each set of awards has a fair value of \$300 on the acquisition date. The awards cliff vest upon two years of continued employment with the combined company. However, if the employment of any one of the executives is terminated prior to January 1, 20X3, any awards forfeited by that executive are reallocated equally among the remaining executives who continue employment. The reallocated awards will continue to cliff vest on January 1, 20X3. On January 1, 20X2, one of the five executives terminates employment with the combined company. The 100 unvested awards (100 awards \times 1 executive) are forfeited and redistributed equally to the other four executives. At the time of the forfeiture, the fair value of each set of awards is \$360.

How should Company M account for the “last-man-standing” arrangement?

Analysis

The fair value of all awards granted to the executives on the acquisition date is \$1,500 ($\300×5 sets of awards), which should be recognized over the two-year service period in the postcombination financial statements, as long as each employee continues employment with the combined company.

The accounting for a reallocation under a “last-man-standing” arrangement is effectively a forfeiture of the original awards and a grant of new awards. That is, if an employee terminates employment and the awards are reallocated to the other employees, the reallocation of the forfeited awards should be treated as (1) a forfeiture of the terminated employee’s awards and (2) a new award granted to the remaining employees. In this example, 100 unvested awards (100 awards \times 1 executive) were forfeited and regranted to the remaining four employees (25 awards each). Company M would reverse \$150 ($\300×1 terminated executive \times 1/2 of the service period completed) of previously recognized compensation for the terminated employee’s forfeited awards. Company M would then recognize an additional \$90 ($\$360 / 4$ executives) for each of the four remaining executives over the new service period of one year.

EXAMPLE BCG 3-14

“Last-man-standing” arrangement involving cash consideration

Company B (the acquirer) acquires Company A (the acquiree) for cash consideration of \$250. The selling shareholders of Company A were all key employees of Company A prior to the acquisition date and will continue as employees of the combined business following the acquisition by Company B. Company B will pay the selling shareholders additional consideration in the event Company A achieves pre-determined sales targets for the 3 years following the acquisition. This additional consideration will be paid to the previous shareholders in proportion to their relative previous ownership interests. Any shareholders who resign their employment with Company A during the

3-year period forfeit their portion of the additional payments. Amounts forfeited are redistributed among the previous shareholders who remain as employees for the 3-year period. If none of the previous shareholders remain employed at the end of the 3-year period, but the relevant sales targets are still achieved, all of the previous shareholders will receive the additional payment in proportion to their previous ownership interests. The selling shareholders will have the ability to influence sales volumes if they continue as employees.

How should Company B account for the “last-man-standing” arrangement?

Analysis

The contingent payments in the aggregate are not automatically forfeited if all the selling shareholders cease employment. However, each of the selling shareholders controls their ability to earn their portion of the additional payment by continuing employment. The selling shareholders have the ability to influence sales volumes if they continue as employees. The commercial substance of the agreement incentivizes the selling shareholders to continue as employees. Further, the scenario where all selling shareholders cease employment is unlikely because the last selling shareholder remaining in employment would not likely voluntarily leave employment and forfeit the entire amount of additional payment. Therefore, substantively, each employee’s ability to retain their portion of the contingent payment is dependent on their continued employment. As a result, the entire additional payment, given this combination of factors, would be accounted for as compensation cost in the postcombination period, consistent with the guidance in ASC 805-10-55-25(a).

3.6.2 “Dual trigger” arrangements (business combinations)

Preexisting employment agreements often include clauses that accelerate vesting of awards upon a change of control and termination of employment within a defined period of time from the acquisition date, often referred to as “dual trigger” arrangements. In such cases, if employment is terminated in conjunction with the acquisition (or soon thereafter), the arrangement should be assessed to determine whether acceleration of vesting is primarily for the economic benefit of the acquirer by considering the following factors:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction

If it is determined the clause or transaction that accelerates vesting is primarily for the economic benefit of the acquirer, the acceleration of vesting of unvested awards should be accounted for separately from the business combination and will be recognized as compensation cost to the acquirer in accordance with ASC 805-10-25-20 through ASC 805-10-25-22.

The dual trigger clause effectively places the decision to retain the acquiree’s employees in the control of the acquirer, and thus a decision to terminate (or not offer employment in conjunction with the acquisition) would be made primarily for the acquirer’s economic benefit (e.g., reduce cost). Therefore, since the acquirer makes the decision to terminate the employees, the acquirer should recognize the compensation cost in the postcombination period for the acceleration of the unvested portion of the awards (measured as of the acquisition date using the methodology described in ASC 805-30-30-12 through ASC 805-30-30-13 and ASC 805-30-55-10).

An acquiree may put in place a new, or alter an existing, compensation arrangement at the direction of the acquirer. In these instances, it may be necessary to record compensation cost in both the acquirer's postcombination financial statements and the acquiree's precombination financial statements. These scenarios typically arise when the acquiree legally incurred the related obligation, and other accounting standards (such as ASC 718) require the acquiree to recognize the related cost even though the cost was incurred for the benefit of the acquirer.

Example BCG 3-15 illustrates the accounting for a dual trigger arrangement.

EXAMPLE BCG 3-15

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

Company A acquires Company B in a business combination, and Company A is obligated to grant replacement awards as part of the business combination in accordance with ASC 805-30-30-9.

Company B has an existing employment agreement in place with one of its key employees that states that all of the key employee's unvested awards will fully vest upon a change in control and termination of employment within 12 months following the acquisition date. The employment agreement was in place before Company A and Company B began negotiations for the acquisition of Company B. The vesting of the awards only accelerates if the employee is subsequently terminated without cause or leaves for good reason as defined in the employment contract (generally as a result of demotion or similar reduction of responsibilities or salary). Prior to the acquisition date, Company A had determined it would not offer employment to the key employee of Company B, effectively terminating employment on the acquisition date. This resulted in the acceleration of all the key employee's unvested awards upon closing of the acquisition.

How should Company A account for the accelerated vesting of the awards?

Analysis

The accelerated vesting is conditioned upon both a change in control of the acquiree and the termination of employment of the key employee. At the acquisition date, both conditions were triggered. The decision not to employ the key employee was in the control of Company A and effectively made for its primary economic benefit (e.g., reduce cost) and, therefore, should be recorded separate from the business combination in accordance with ASC 805-10-25-20 through ASC 805-10-25-22. Accordingly, the portion attributed to precombination service and included in consideration for the acquired business would be based on the original service period of the award in accordance with ASC 805-30-55-8. Company A should immediately recognize compensation cost related to the accelerated vesting of the awards for the portion of the award that is attributed to postcombination service (measured as of the closing of the acquisition using the methodology described in ASC 805-30-30-12 through ASC 805-30-30-13 and ASC 805-30-55-10) in its postcombination period.

Question BCG 3-6

How should an acquirer account for the acceleration of unvested share-based payment awards that is triggered when the acquirer does not issue equivalent replacement awards as part of a business combination?

PwC response

If the provision that accelerates vesting is primarily for the benefit of the acquirer, the acceleration of vesting of unvested awards should be accounted for separate from the business combination and be recognized as compensation cost in the acquirer's postcombination financial statements in accordance with ASC 805-10-25-20 through ASC 805-10-25-22. The acquirer's decision not to issue replacement awards is in the control of the acquirer. Therefore, the acquirer should separate the portion of total consideration issued in the merger that is associated with the acceleration of the unvested portion of the awards, and immediately recognize compensation cost in the postcombination period for this amount. The accounting would be the same if the acquirer issued fully vested replacement awards.

3.7 *Postcombination accounting for share-based awards*

Compensation cost associated with share-based payment awards that is recorded in the acquirer's postcombination financial statements should be accounted for in accordance with ASC 805-30-35-3, which states that replacement share-based payment awards issued by the acquirer that are attributable to employees' future services should be subsequently measured and accounted for based on the guidance in ASC 718. For example, the determination of whether the acquirer's replacement awards should be classified as equity or as a liability and the period over which compensation cost is recognized should be based on the guidance in ASC 718.

Modifications of awards after the acquisition date should be accounted for based on the modification guidance in ASC 718. No adjustments are made to the accounting for the business combination as a result of changes in forfeiture estimates (refer to Question BCG 3-2 and Question BCG 3-3) or modifications of replacement awards after the acquisition date in accordance with ASC 805-30-55-11 through ASC 805-30-55-12. This includes fair value adjustments for the remeasurement of liability-classified awards at each balance sheet date until the settlement date under ASC 805-30-55-13.

New share-based payment awards (as opposed to replacement awards) granted by the acquirer to the former employees of the acquiree will be subject to the guidance in ASC 718, and will not affect the accounting for the business combination.

Question BCG 3-7

How should the acquirer account for a modification to an arrangement with contingent payments in a business combination when the modification occurs during the measurement period?

PwC response

A subsequent change to a compensation arrangement does not lead the acquirer to reassess its original conclusion under ASC 805-10-55-25 regarding whether the arrangement is treated as consideration transferred or is accounted for outside of the business combination. Assuming the original conclusion reached as of the acquisition date was not an error, the original treatment should be respected even if the subsequent change was made during the measurement period.

Example BCG 3-16 illustrates an arrangement that includes contingent payments that is modified during the measurement period.

EXAMPLE BCG 3-16

Accounting for modifications during the measurement period to compensation arrangements

Company A acquired Company B in a business combination. Company A wanted to retain the services of the former Company B shareholders to help transition the business. Therefore, Company A agreed to pay a portion of the consideration to the former shareholders of Company B over the length of their new employment contracts (three years) with the combined entity. The former shareholders would forfeit any unearned portion of the contingent payment if employment were voluntarily terminated.

After considering the guidance in ASC 805-10-55-25, Company A determined that it should account for the contingent payment as compensation cost because the contingent payment was linked to the former shareholders' continued employment. Six months after the business combination, Company A decided it no longer needed the former shareholders for transition purposes and terminated their employment. As part of the termination, Company A agreed to settle the contingent payment arrangement with an additional payment to the former shareholders.

How should Company A account for the modification?

Analysis

Company A appropriately concluded at the acquisition date that the arrangement should be treated as compensation cost. A subsequent change to that arrangement does not cause Company A to reassess its original conclusion under ASC 805-10-55-25. This would apply even if the subsequent change was made while Company A was in the process of finalizing any measurement period adjustments. Company A should consider the payment to the former shareholders of Company B as being made to settle their employment contracts with Company A (i.e., Company A accelerated the service period) and not as consideration transferred to acquire Company B.

3.8 Income tax effects of share-based awards (business combinations)

Under US tax law, employers may be entitled to a tax deduction equal to the intrinsic value (i.e., the current market value of the underlying equity less exercise price) of a share option at the exercise date (or vesting date in the case of restricted shares). Tax deductions are also available for share-based payment transactions in some non-US jurisdictions.

For guidance on the accounting for tax effects of share-based awards, refer to TX 17.

3.9 Recognition of payroll taxes (business combinations)

Payroll taxes on employee share-based payment awards are not recognized until the date of the event triggering the measurement and payment of the tax to the taxing authority in accordance with ASC 718-10-25-22. For a nonqualified option in the United States, this date is usually the exercise date. For restricted shares, this date is usually the vesting date. Therefore, practice has been not to record a liability for these charges at the acquisition date, nor adjust the consideration transferred for the acquiree. There is no liability to the company until the award is exercised; therefore, the liability will generally be recognized in the postcombination financial statements when the award is exercised (or vested for restricted shares).

***Chapter 4:
Intangible assets acquired in
a business combination—
updated June 2023***

4.1 Overview: intangible assets acquired in a business combination

An essential part of the acquisition method is the recognition and measurement of identifiable intangible assets, separate from goodwill, at fair value. This chapter discusses the criteria for recognizing intangible assets in a business combination and covers some of the challenges that reporting entities face in recognizing and measuring intangible assets.

Related content

- The accounting for finite-lived intangible assets, including how to determine their useful lives and methods of amortization, is included in PPE 4. How to assess, calculate, and record impairments on finite-lived intangible assets is included in PPE 5.
- Further discussion on the valuation of intangible assets acquired in a business combination is included in FV 7.3.4.
- Presentation and disclosure guidance related to finite-lived intangible assets is included in FSP 8.8. Additionally, for private companies, see FSP 8.10.3.2.
- If the acquired intangible assets meet the held-for-sale criteria in ASC 360-10, *Property, Plant and Equipment*, they are an exception to the fair value measurement principle (i.e., measured at fair value less cost to sell). Refer to BCG 2.5.8 for further information.
- Guidance on the accounting for intangible assets acquired in an asset acquisition is in PPE 2.

4.2 Intangible assets: identifiable criteria (business combinations)

Intangible assets are assets, excluding financial assets, that lack physical substance. In determining whether an identifiable intangible asset should be recognized separately from goodwill, the acquirer should evaluate whether the asset meets either of the following criteria:

- **Contractual-legal criterion:** The intangible asset arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired business or from other rights and obligations) in accordance with ASC 805-20-55-2.
- **Separability criterion:** The intangible asset is capable of being separated or divided from the acquired business and sold, transferred, licensed, rented, or exchanged. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something of value meets the separability criterion, even if the acquirer does not intend to sell, license, or otherwise exchange it. If an intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually, it is still considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability (ASC 805-20-55-5). However, there cannot be restrictions on the transfer, sale, or exchange of the asset in accordance with ASC 805-20-55-3 through ASC 805-20-55-4.

Intangible assets that meet either of these criteria are considered identifiable and are separately recognized at fair value on the acquisition date. Certain intangible assets, however, do not typically meet either of the identifiable criteria and, therefore, are not recognized as separate intangible assets. Examples include:

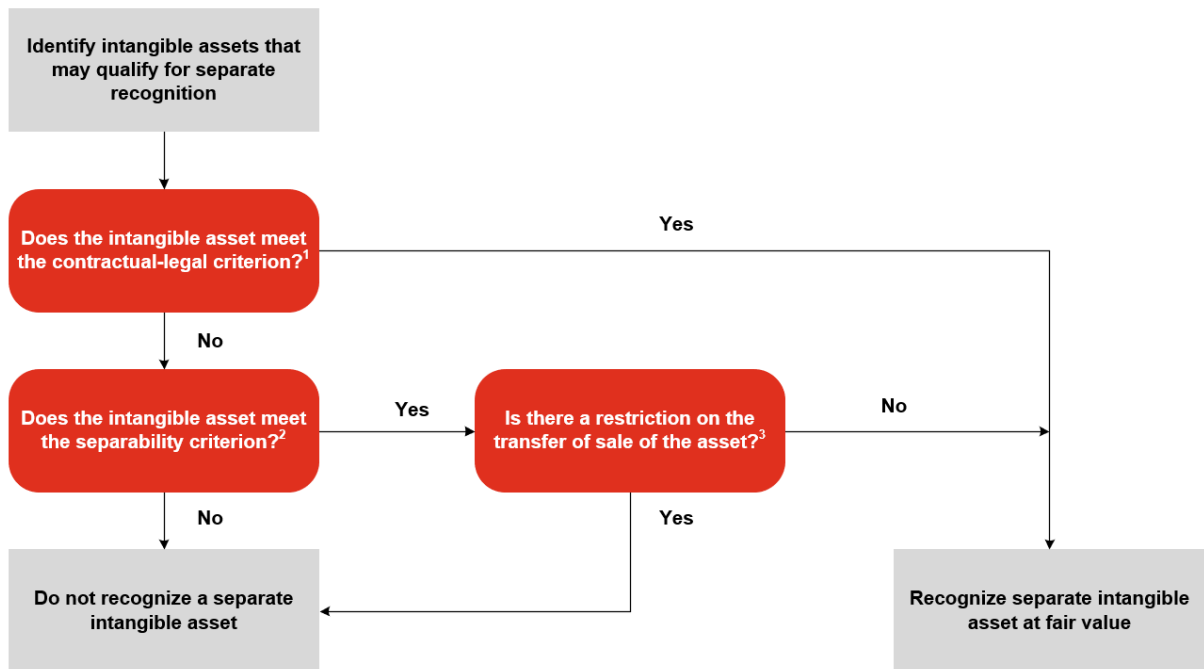
- Customer base or unidentifiable “walk-up” customers
- Noncontractual customer relationships that are not separable
- Customer service capability
- Presence in geographic locations or markets
- Specially trained employees

In a business combination an assembled workforce is not recognized as a separate intangible asset in accordance with ASC 805-20-55-6. See BCG 4.3.3.2 for further information on an assembled workforce.

The flowchart in Figure BCG 4-1 outlines a process that may be used to determine whether an intangible asset meets the identifiable criteria for separate recognition.

Figure BCG 4-1

Does an intangible asset meet the identifiable criteria?



¹ Consider whether the intangible asset arises from contractual or other legal rights, even if the asset is not transferable or separable from the acquiree in accordance with ASC 805-20-55-2.

- ² Consider whether the intangible asset is capable of being separated; whether there are sales of similar types of assets in the market; or whether it is separable in conjunction with a related contract, asset, or liability in accordance with ASC 805-20-55-3 through ASC 805-20-55-4.
- ³ Consider whether the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging the underlying information in accordance with ASC 805-20-55-4.

4.2.1 Contractual-legal criterion (intangible assets)

Intangible assets that arise from contractual or other legal rights are recognized separately from goodwill, even if the asset is not transferable or separable from the acquiree or from other rights and obligations. Intangible assets may arise from licenses, contracts, lease agreements, or other types of arrangements that the acquired business has entered into with other parties.

ASC 805 does not define the term “contractual or other legal rights,” but the list of contractual-legal intangible assets included in ASC 805 makes it clear that the definition is intended to be broad. For instance, a purchase order, even if cancellable, meets the contractual-legal criterion, although it may not be considered a contract from a legal perspective in certain jurisdictions. In accordance with ASC 805-20-55-25, customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether there is an outstanding contract or purchase order at the acquisition date. In addition, the use of the contractual-legal criterion to recognize intangible assets under ASC 805 may be broader than that used in other accounting literature in US GAAP. For example, a signed contract is not necessary at the acquisition date to recognize a customer-related intangible asset. However, in applying other accounting literature in US GAAP, an entity may be precluded from recognizing revenue without a signed contract because it may not be able to support existence of a contract.

Contracts or agreements may also contain clauses that explicitly prohibit the transfer or sale of a specified item separately from the acquiree (e.g., transfer restrictions related to a government contract). These types of prohibitions should not affect an acquirer from recognizing the contractual rights as an intangible asset. However, such restrictions may affect the fair value of the intangible asset. For example, a restriction to sell an asset may impact its fair value if such restrictions would transfer to market-participants.

Contracts may also be cancellable at the option of either party. The ability to cancel a contract does not affect its recognition as a separate intangible asset acquired in a business combination, although it may affect its fair value.

Sometimes a contract of the acquired entity states that the right to an asset (such as a license or permit) does not survive a change in control, but reverts back to the issuer. The new owner of the business must execute a new arrangement to acquire the asset from the issuer. In such circumstances, the contractual asset is not an asset of the acquiree to be recognized in the acquisition accounting.

4.2.2 Separability criterion (intangible assets)

The determination of whether an intangible asset meets the separability criterion can be challenging. An acquirer should determine whether the asset is capable of being separated from the acquired business, regardless of the intent of the acquirer with respect to that particular asset. For example, a brand is generally capable of being separated from the acquired business and, therefore, would meet the separability criterion, even if the acquirer does not intend to sell it.

In determining whether an intangible asset is capable of separation, a company could observe sales or exchanges in the market for the same or similar types of assets. Sales of the same or similar types of assets indicate that the asset is able to be sold separately, regardless of the acquirer's involvement in such sales or the frequency of such transactions. Intangible assets may be closely related to a contract, identifiable asset, or liability, and cannot be separated individually from the contract, asset, or liability. An intangible asset will still meet the separability criterion as long as it is transferable in combination with a related contract, identifiable asset, or liability.

However, to meet the separability criterion, there cannot be restrictions on the transfer, sale, or exchange of the asset. For example, customer information is often protected by a confidentiality agreement (e.g., patient relationships at a healthcare facility). A customer list that cannot be leased or sold due to a confidentiality agreement would not be considered capable of being separated from the rest of the acquired business and would not meet the separability criterion found in ASC 805-20-55-4.

4.2.3 *Examples of applying the identifiable criteria (intangibles)*

Example BCG 4-1, Example BCG 4-2, and Example BCG 4-3 demonstrate the application of the identifiable criteria when determining whether an intangible asset should be recognized in a business combination.

EXAMPLE BCG 4-1

Sales to customers through contracts

Company X acquires Company Y in a business combination on December 31, 20X1. Company Y conducts business with its customers solely through purchase orders. At the acquisition date, Company Y has customer purchase orders in place from 60% of its customers, all of whom are recurring customers. The other 40% of Company Y's customers are also recurring customers. However, as of December 31, 20X1, Company Y does not have any open purchase orders with those customers.

Which portion of Company Y's customer relationships would be recognized and measured at the acquisition date?

Analysis

Company X needs to determine whether any of the acquired customer relationships are identifiable intangible assets that should be recognized. The purchase orders (whether cancellable or not) in place at the acquisition date from 60% of Company Y's customers meet the contractual-legal criterion. Further, Company X needs to determine if a production backlog arises from the acquired purchase orders as this may meet the contractual-legal criterion for recognition. Consequently, the relationships with customers through these types of contracts also arise from contractual rights and, therefore, meet the contractual-legal criterion. The fair value of these customer relationships are recognized as an intangible asset apart from goodwill. Additionally, since Company Y has established relationships with the remaining 40% of its customers through its past practice of establishing contracts, those customer relationships would also meet the contractual-legal criterion and be recognized at fair value. Therefore, even though Company Y does not have contracts in place at the acquisition date with a portion of its customers, Company X would consider the value associated with all of its customers for purposes of recognizing and measuring Company Y's customer relationships.

EXAMPLE BCG 4-2**Deposit liabilities and related depositor relationships**

A financial institution that holds deposits on behalf of its customers is acquired. There are no restrictions on sales of deposit liabilities and the related depositor relationships.

Should deposit liabilities and related depositor relationships be accounted for at the acquisition date?

Analysis

Yes. Deposit liabilities and the related depositor relationship intangible assets may be exchanged in observable exchange transactions. As a result, the depositor relationship intangible asset would be considered identifiable and meet the separability criterion since the depositor relationship intangible asset can be sold in conjunction with the deposit liability.

EXAMPLE BCG 4-3**Unpatented process closely related to a trademark**

An acquirer, a food and beverage manufacturer, sells hot sauce using a secret recipe. The acquirer owns a registered trademark, a secret recipe formula, and unpatented process used to prepare its famous hot sauce. If the trademark is sold, the seller would also transfer all knowledge associated with the trademark, which would include the secret recipe formula and the unpatented process used to prepare its hot sauce.

How should the trademark and complementary assets be accounted for at the acquisition date?

Analysis

The acquirer would recognize an intangible asset for the registered trademark based on the contractual-legal criterion. Separate intangible assets would also be recognized for the accompanying secret recipe formula and the unpatented process based on the separability criterion. The separability criterion is met because the secret recipe formula and unpatented process would be transferred with the trademark. As discussed in BCG 4.4, the acquirer may group complementary intangible assets (registered trademark, related secret recipe formula, and unpatented process) as a single intangible asset if their useful lives are similar.

4.3 Types of identifiable intangible assets

Figure BCG 4-2 includes a list of intangible assets by major category and identifies whether the asset would typically meet the contractual-legal criterion or the separability criterion in accordance with ASC 805-20-55-11 through ASC 805-20-55-45. In certain cases, an intangible asset may meet both criteria. However, the table highlights the primary criterion under which the specific intangible asset would be recognized. The list is not intended to be all-inclusive; therefore, other acquired intangible assets might also meet the criteria for recognition apart from goodwill.

Figure BCG 4-2

Intangible assets that generally meet the criteria for separate recognition

Intangible asset	Contractual-legal criterion	Separability criterion
Marketing-related:		
Trademarks, trade names	✓	
Service marks, collective marks, certification marks	✓	
Trade dress (unique color, shape, or package design)	✓	
Newspaper mastheads	✓	
Internet domain names	✓	
Noncompetition agreements	✓	
<hr/>		
Artistic-related:		
Plays, operas, ballets	✓	
Books, magazines, newspapers, other literary works	✓	
Musical works, such as compositions, song lyrics, advertising jingles	✓	
Pictures, photographs	✓	
Video and audiovisual material, including motion pictures, music videos, television programs	✓	
<hr/>		
Contract-based:		
Licensing, royalty, standstill agreements	✓	
Advertising, construction, management, service, or supply contracts ¹	✓	
Lease agreements ²	✓	
Construction permits	✓	
Franchise agreements	✓	

Intangible asset	Contractual-legal criterion	Separability criterion
Operating and broadcast rights	✓	
Use rights, ³ such as drilling, water, air, mineral, timber cutting, and route authorities	✓	
Servicing contracts (e.g., mortgage servicing contracts)	✓	
Employment contracts ⁴	✓	
Technology-based:		
Patented technology	✓	
Research and development		✓
Computer software and mask works	✓	
Unpatented technology		✓
Databases, including title plants		✓
Trade secrets, such as secret formulas, processes, recipes	✓	
Customer-related:		
Customer lists		✓
Order or production backlog	✓	
Customer contracts and related customer relationships	✓	
Noncontractual customer relationships		✓

¹ In most cases, such intangible assets would be favorable or unfavorable contracts. See BCG 4.3.3.5 for additional information.

² Acquired lease contracts of a lessee that are favorable or unfavorable are not recorded as a separate intangible. See BCG 4.3.3.7 for further information on lease intangibles.

³ Only in certain circumstances. See BCG 4.3.3.3 for further information.

⁴ Only in certain circumstances. See BCG 4.3.3.2 for further information.

4.3.1 Marketing-related intangible assets

Marketing-related intangible assets are primarily used in the marketing or promotion of products or services. They are typically protected through legal means and, therefore, generally meet the contractual-legal criterion for recognition separately as an intangible asset.

4.3.1.1 Trademarks, trade names, and other marks (intangible assets)

Trademarks, trade names, and other marks are often registered with governmental agencies or are unregistered, but otherwise protected. Whether registered or unregistered, but otherwise protected, trademarks, trade names, and other marks have some legal protection and would meet the contractual-legal criterion. If trademarks or other marks are not protected legally, but there is evidence of similar sales or exchanges, the trademarks or other marks would meet the separability criterion.

A brand is the term often used for a group of assets associated with a trademark or trade name. An acquirer can recognize a group of complementary assets, such as a brand, as a single asset apart from goodwill if the assets have similar useful lives and either the contractual-legal or separable criterion is met. See BCG 4.4 for further information on complementary intangible assets and grouping of other intangible assets.

4.3.1.2 Trade dress, newspaper mastheads, and internet domains

Trade dress refers to the unique color, shape, or packaging of a product. If protected legally (as discussed above in relation to trademarks), then the trade dress meets the contractual-legal criterion. If the trade dress is not legally protected, but there is evidence of sales of the same or similar trade dress assets, or if the trade dress is sold in conjunction with a related asset, such as a trademark, then it would meet the separability criterion.

Newspaper mastheads are generally protected through legal rights, similar to a trademark and, therefore, would meet the contractual-legal criterion. If not protected legally, a company would look at whether exchanges or sales of mastheads occur to determine if the separability criterion is met.

Internet domain names are unique names used to identify a particular internet site or internet address. These domain names are usually registered and, therefore, would meet the contractual-legal criterion found in ASC 805-20-55-19.

4.3.1.3 Noncompetition agreements (intangible assets)

Noncompetition (“noncompete”) agreements are legal arrangements that generally prohibit a person or business from competing with a company in a certain market for a specified period of time. An acquiree may have preexisting noncompete agreements in place at the time of the acquisition. As those agreements arise from a legal or contractual right, they would meet the contractual-legal criterion and represent an acquired asset that would be recognized as part of the business combination. The terms, conditions, and enforceability of noncompete agreements may affect the fair value assigned to the intangible asset but would not affect their recognition.

Other payments made to former employees that may be described as noncompete payments might actually be compensation for services in the postcombination period. See BCG 3 for further information on accounting for compensation arrangements.

A noncompete agreement negotiated as part of a business combination generally prohibits former owners or key employees from competing with the combined entity. The agreement typically covers a set period of time that commences after the acquisition date or termination of employment with the combined entity. A noncompete agreement negotiated as part of a business combination will typically be initiated by the acquirer to protect the interests of the acquirer and the combined entity.

Transactions are to be treated separately if they are entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer. As such, noncompete agreements negotiated as part of a business combination should generally be accounted for as transactions separate from the business combination. For example, if an entity pays \$20 million to acquire a target, including a noncompete agreement with a fair value of \$2 million, the noncompete agreement should be recognized separately at a fair value of \$2 million. The remaining purchase price (\$18 million) will be allocated to the net assets acquired, excluding the noncompete agreement.

A noncompete agreement will normally have a finite life requiring amortization of the asset. The amortization period should reflect the period over which the benefits from the noncompete agreement are derived. Determining the period is a matter of judgment in which all terms of the agreement, including restrictions on enforceability of the agreement, should be considered.

4.3.2 *Artistic-related intangible assets*

Artistic-related intangible assets are creative assets that are typically protected by copyrights or other contractual and legal means. Artistic-related intangible assets are recognized separately in accordance with ASC 805-20-55-30 if they arise from contractual or legal rights, such as copyrights. Artistic-related intangible assets include (1) plays, operas, ballets; (2) books, magazines, newspapers, other literary works; (3) musical works, such as compositions, song lyrics, advertising jingles; (4) pictures and photographs; and (5) video and audiovisual material, including motion pictures or films, music videos, and television programs. Copyrights can be assigned or licensed, in whole or in part, to others. A copyright-protected intangible asset and related assignments or license agreements may be recognized as a single complementary asset as long as the component assets have similar useful lives. See BCG 4.4 for further information on grouping of complementary assets.

4.3.3 *Contract-based intangible assets*

Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible assets. Contract-based intangible assets include (1) licensing, royalty, and standstill agreements; (2) advertising, construction, management, service, or supply contracts; (3) construction permits; (4) franchise agreements; (5) operating and broadcast rights; (6) contracts to service financial assets; (7) employment contracts; (8) use rights; and (9) lease agreements. Contracts whose terms are considered at-the-money, as well as contracts in which the terms are favorable relative to market may also give rise to contract-based intangible assets. If the terms of a contract are unfavorable relative to market, the acquirer recognizes a liability assumed in the business combination. See BCG 4.3.3.5 for further information on favorable and unfavorable contracts.

4.3.3.1 *Contracts to service financial assets (intangible assets)*

Contracts to service financial assets may include collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure, if necessary; temporarily investing funds pending distribution; remitting fees to

guarantors, trustees and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets.

Although servicing is inherent in all financial assets, it is not recognized as a separate intangible asset unless (1) the underlying financial assets (e.g., receivables) are sold or securitized and the servicing contract is retained by the seller; or (2) the servicing contract is separately purchased or assumed. ASC 860-50, *Servicing Assets and Liabilities*, provides guidance on the accounting for service contracts.

If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination along with the contract to service those assets, then neither of the above criteria has been met and the servicing rights will not be recognized as a separate intangible asset. However, the fair value of the servicing rights should be considered in measuring the fair value of the underlying mortgage loans, credit card receivables, or other financial assets.

4.3.3.2 *Employment contracts (intangible assets)*

Employment contracts may result in contract-based intangible assets or liabilities according to ASC 805-20-55-36. An employment contract may be above or below market in the same way as a lease or a servicing contract. However, the recognition of employment contract intangible assets and liabilities is rare in practice. Employees can choose to leave employment with relatively short notice periods, and employment contracts are usually not enforced. In addition, the difficulty of substantiating market compensation for specific employees may present challenges in measuring such an asset or liability.

An exception might be when a professional sports team is acquired. The player contracts may well give rise to employment contract intangible assets and liabilities. The athletes often work under professional restrictions, such that they cannot leave their contracted teams at will and play with another team to maintain their professional standing. Player contracts may also be separable, in that they are often the subject of observable market transactions.

Preexisting employment contracts in the acquired business may also contain noncompetition clauses. These noncompetition clauses may have value and should be assessed separately as intangible assets. See BCG 4.3.1.3 for further information on noncompetition agreements.

Assembled workforce

An assembled workforce is defined in ASC 805-20-55-6 as an existing collection of employees that permits an acquirer to continue to operate from the date of the acquisition. Although individual employees may have employment agreements with the acquiree, which may, at least theoretically, be separately recognized and measured as discussed above, the entire assembled workforce does not have such a contract. Therefore, an assembled workforce does not meet the contractual-legal criterion. Furthermore, an assembled workforce is not considered separable because it cannot be sold or transferred without causing disruption to the acquiree's business. An assembled workforce is not an identifiable intangible asset that is to be separately recognized and, as such, any value attributable to the assembled workforce is included in goodwill.

An intangible asset may be recognized for an assembled workforce acquired in an asset acquisition. However, an assembled workforce may be indicative that a business was acquired, as discussed in BCG 1. See PPE 2 for information on the accounting for an assembled workforce in an asset acquisition.

The intellectual capital that has been created by a skilled workforce may be embodied in the fair value of an entity's other intangible assets that would be recognized at the acquisition date as the employer retains the rights associated with those intangible assets. For example, in measuring the fair value of proprietary technologies and processes, the intellectual capital of the employee groups embedded within the proprietary technologies or processes would be considered.

Collective bargaining agreements

A collective bargaining or union agreement typically dictates the terms of employment (e.g., wage rates, overtime rates, and holidays), but does not bind the employee or employer to a specified duration of employment. The employee is still an at-will employee and has the ability to leave or may be terminated. Therefore, similar to an assembled workforce, typically no intangible asset would be separately recognized related to the employees covered under the agreement. However, a collective bargaining agreement of an acquired entity may be recognized as a separate intangible asset or liability if the terms of the agreement are favorable or unfavorable when compared to market terms.

4.3.3.3 *Use rights (intangible assets)*

Use rights, such as drilling, water, air, mineral, timber cutting, and route authorities' rights, are contract-based intangible assets. Use rights are unique in that they may have characteristics of both tangible and intangible assets. Use rights should be recognized based on their nature as either a tangible or intangible asset. For example, mineral rights, which are legal rights to explore, extract, and retain all or a portion of mineral deposits, are tangible assets in accordance with ASC 805-20-55-37.

4.3.3.4 *Insurance and reinsurance contract intangible assets*

An intangible asset (or a liability) may be recognized at the acquisition date for the difference between the fair value of all assets and liabilities arising from the rights and obligations of any acquired insurance and reinsurance contracts and their carrying amounts. See IG 12 for further information on the accounting for insurance and reinsurance contract intangible assets acquired in a business combination.

4.3.3.5 *Favorable and unfavorable contracts (intangible assets)*

This section addresses acquired contracts that are favorable or unfavorable, except for lease contracts, which are discussed in BCG 4.3.3.7. Intangible assets or liabilities may be recognized for certain off balance sheet contracts whose terms are favorable or unfavorable compared to current market terms. In making this assessment, the terms of a contract should be compared to market prices at the date of acquisition to determine whether an intangible asset or liability should be recognized. If the terms of an acquired contract are favorable relative to market prices, an intangible asset is recognized. On the other hand, if the terms of the acquired contract are unfavorable relative to market prices, then a liability is recognized. The FASB has characterized the differences in contract terms relative to market terms as assets and liabilities, but these adjustments in value are unlikely to meet the definitions of an asset and liability. Within this guide, these adjustments are referred to as assets and liabilities for consistency with the treatment by the FASB.

A significant area of judgment in measuring favorable and unfavorable contracts is whether contract renewal or extension terms should be considered. Generally, an unfavorable contract would not be recorded as a result of a contract renewal or extension. The following factors should be considered in determining whether to include renewals or extensions:

- Whether renewals or extensions are discretionary without the need to renegotiate key terms or are within the control of the acquiree. Renewals or extensions that are within the control of the acquiree would likely be considered if the terms are favorable to the acquirer.
- Whether the renewals or extensions provide economic benefit to the holder of the renewal right. The holder of a renewal right, either the acquiree or the counterparty, will likely act in their best interest.
- Whether there are any other factors that would indicate a contract may or may not be renewed.

Each arrangement is recognized and measured separately. The resulting amounts for favorable and unfavorable contracts are not offset.

Example BCG 4-4 and Example BCG 4-5 demonstrate the recognition and measurement of favorable and unfavorable contracts, respectively.

EXAMPLE BCG 4-4

Favorable purchase contract

Company N acquires Company O in a business combination. Company O purchases electricity through a purchase contract, which is in year three of a five-year arrangement. At the end of the original term, Company O has the option at its sole discretion to extend the purchase contract for another five years. The annual cost of electricity per the original contract is \$80 per year, and the annual cost for the five-year extension period is \$110 per year. The current annual market price for electricity at the acquisition date is \$200; and market rates are not expected to change during the original contract term or the extension period. For the purpose of this example, assume that Company N does not account for the contract as a derivative.

How should Company N account for the acquired favorable purchase contract?

Analysis

Company O's purchase contract for electricity is favorable. Both the original contract and extension terms allow Company O to purchase electricity at amounts below the annual market price of \$200. Because the contract terms are favorable based on the remaining two years of the original contractual term and the extension terms are favorable, Company N would likely consider the five-year extension term as well in measuring the favorable contract.

EXAMPLE BCG 4-5

Unfavorable purchase contract

Company N acquires Company O in a business combination. Company O purchases electricity through a purchase contract, which is in year three of a five-year arrangement. At the end of the original term, Company O has the option at its sole discretion to extend the purchase contract for another five years. The annual cost of electricity per the original contract is \$80 per year, and the annual cost for the five-year extension period is \$110 per year. The current annual market price for electricity at the acquisition date is \$50 per year and market rates are not expected to change during the original contract term or the extension period.

How should Company N account for the acquired unfavorable purchase contract?

Analysis

Company O's purchase contract is unfavorable. Both the original contract and extension term require it to pay amounts in excess of the current annual market price of \$50. While Company N would recognize and measure a liability for the two years remaining under the original contract term, the extension term would not be considered in measuring the unfavorable contract because Company N can choose not to extend the unfavorable contract.

The fair value of an intangible asset or liability associated with favorable and unfavorable contract terms would generally be determined based on present-value techniques. For example, the difference between the contract price and the current market price for the remaining contractual term, including any expected renewals, would be calculated and then discounted to arrive at a net present-value amount. The fair value of the intangible asset or liability would then be amortized over the remaining contract term, including renewals, if applicable.

4.3.3.6 *At-the-money contracts (intangible assets)*

At-the-money contracts should be evaluated for any intangible assets that may need to be separately recognized. At-the-money contract terms reflect market terms at the date of acquisition. However, the contract may have value for which market participants would be willing to pay a premium because the contract provides future economic benefits.

In assessing whether a separate intangible asset exists for an at-the-money contract, an entity should consider other qualitative reasons or characteristics, such as (1) the uniqueness or scarcity of the contract or leased asset; (2) the unique characteristics of the contract; (3) the efforts to date that a seller has expended to obtain and fulfill the contract; (4) the potential for future contract renewals or extensions; or (5) exclusivity. The existence of these characteristics may make the contract more valuable, resulting in market participants being willing to pay a premium for the contract.

4.3.3.7 *Acquisition accounting for lease agreements*

A lease agreement represents an arrangement in which one party obtains the right to use an asset from another party for a period of time, in exchange for the payment of consideration. Lease arrangements that exist at the acquisition date may result in the recognition of various assets and liabilities, including separate intangible assets based on the contractual-legal criterion. The type of lease (e.g., operating lease) and whether the acquiree is the lessee or the lessor to the lease will impact the various assets and liabilities that may be recognized in a business combination.

A lessee will record right-of-use assets and lease liabilities on their balance sheet for all leases, unless the lessee makes an accounting policy election that exempts the measurement and recognition of short-term leases. A lessee will record the favorable or unfavorable terms of the lease in the right-of-use asset. A lessee will classify leases as operating or finance leases. Operating leases will be reported on a lessee's balance sheet.

A lessor will classify leases as operating, sales-type, or direct financing.

See LG 3 for further information on lease classification for lessees and lessors.

Acquiree is a lessee

Leases are one of the limited exceptions to the recognition (ASC 805-20-25-17) and measurement (ASC 805-20-30-12) principles under ASC 805 and follow specific guidance for acquired leases under ASC 842 and ASC 805. Furthermore, paragraph BC416 in the Basis for Conclusions of ASU 2016-02 acknowledged that the acquiree's right-of-use assets and lease liabilities would not be recorded at fair value, although the net carrying amount for the lease will approximate the fair value at the date of acquisition.

In a business combination, ASC 842-10-55-11 requires that the acquirer retain the acquiree's previous lease classification, unless the lease is modified. If the lease is modified and the modification is not accounted for as a separate new lease, the modification is evaluated in accordance with the guidance on lessee lease modifications. See LG 5.2 for further information.

This means that even when the assumptions used to measure the lease liability indicate that the lease would be classified differently, the acquirer is required to retain the classification used by the acquiree. For example, for a new lease, a purchase option that is reasonably certain of exercise would result in the lease being classified as a finance lease. However, if the acquiree classified the lease as an operating lease because, prior to the acquisition date, the purchase option was not reasonably certain of exercise, the acquirer is required to retain the acquiree's lease classification as an operating lease. The acquirer would include the exercise of the purchase option when measuring the lease liability and right-of-use asset. The acquirer would also consider the purchase option when determining the useful life of the right-of-use asset (i.e., the useful life of the underlying leased asset).

ASC 805-20-30-24 provides guidance on the recognition and measurement of leases acquired in a business combination in which the acquiree is the lessee. This guidance applies to operating and finance leases.

ASC 805-20-30-24

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

The acquired lease liability should be measured as if it were a new lease following the guidance under ASC 842 (e.g., reassessment of the lease term, discount rate, lease payments, purchase options), except when taking into account the lease classification requirements under ASC 842-10-55-11.

The right-of-use asset is measured at the amount of the lease liability and adjusted by any favorable or unfavorable terms of the lease as compared to market terms. When determining whether there are any favorable or unfavorable terms of a lease that require recognition, the acquirer should consider all of the terms of the lease (e.g., contractual rent payments, renewal or termination options, purchase options, lease incentives). For example, assume an acquired lease includes an option to purchase the underlying asset for \$15 and the option has a fair value of \$4 at the acquisition date. If the purchase option is reasonably certain of being exercised, the purchase option payment of \$15 would be included in the lease payments used to measure the lease liability and right-of-use asset. Assume that after including the purchase option of \$15, the acquirer determines that the lease liability is \$20. Besides

the purchase option, the terms of the lease are determined to be at market. As such, the favorable terms of the lease are equal to the value of the purchase option of \$4. The favorable terms of the lease would be recorded as an adjustment to the right-of-use asset and the value of the right-of-use asset recorded in the acquisition would be \$24. Refer to LG 3.4 and LG 4.2.1 for more information on the application of the reasonably certain threshold and the measurement of the lease liability, respectively.

If there is a renewal option that allows the lessee to renew with favorable lease terms (i.e., contractual rent payments are less than market rent), the renewal option should be considered in measuring the favorable terms of the lease. Renewal options should also be considered when determining the lease term. When renewal options are reasonably certain of being exercised, the lease term should include the additional term provided by the renewal option. The contractual rent payments made during the lease term will be included when measuring the lease liability and right-of-use asset.

If an option (e.g., renewal option, termination option, purchase option) is not reasonably certain of being exercised, the lease term used to determine the lease liability and right-of-use asset would not be impacted by the option. However, when the option is not reasonably certain of being exercised, there would still be value associated with the option; this value would be included when determining any adjustment to the right-of-use asset for favorable or unfavorable terms of the lease.

When recording the right-of-use asset for an acquired finance lease, the acquirer does not record the right-of-use asset at the fair value of the underlying asset. Under the guidance in ASC 805-20-30-24, the fair value of a purchase option that is reasonably certain of exercise would be included as an adjustment to the right-of-use asset when recording the favorable terms of the lease. When there is an automatic transfer of title at the end of the lease, the fair value of the underlying asset would be included when recording the favorable or unfavorable terms of the lease.

When calculating the adjustment to the right-of-use asset for favorable or unfavorable terms of the lease, market participant assumptions should be used following the fair value principles of ASC 820. In calculating the fair value of the favorable or unfavorable terms of the lease, the discount rate applied should be that of a market participant which, would not necessarily be the same as the lessee's incremental borrowing rate that was used to measure the lease liability. When the terms of the lease are above market (i.e., unfavorable to the lessee), the acquirer should use a discount rate that takes into consideration credit risk given that the unfavorable terms are similar to an acquired uncollateralized financing liability.

As discussed in ASC 805-20-25-28B, an acquirer in a business combination can make an accounting policy election to not measure or recognize leases that have a remaining lease term of 12 months or less at the acquisition date. In addition, under this policy election, the acquirer would not recognize an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms. The election is made by class of underlying asset and is applicable to all of the company's acquisitions. See LG 2.2.1 for information on the short-term lease measurement and recognition exemption.

There may also be value associated with an at-the-money lease contract depending on the nature of the leased asset (e.g., a lease of gates at an airport for which a market participant might be willing to pay for the lease even when the lease is at market terms). See BCG 4.3.3.6 for further information on at-the-money contracts.

Leasehold improvements of the acquired entity would be recognized as tangible assets on the acquisition date at their fair value. ASC 805-20-35-6 provides guidance on the amortization of leasehold improvements acquired in a business combination.

ASC 805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.

Acquiree is a lessor: operating lease

Leases are one of the limited exceptions to the recognition (ASC 805-20-25-17) and measurement (ASC 805-20-30-12) principles under ASC 805 and follow specific guidance for acquired leases under ASC 842 and ASC 805.

In a business combination, ASC 842-10-55-11 requires the acquirer to retain the acquiree's previous lease classification, unless the lease is modified. If the lease is modified and the modification is not accounted for as a separate new lease, the modification is evaluated in accordance with the guidance on lessor lease modifications. See LG 5.6 for information.

If the acquiree is a lessor in an operating lease, the asset subject to the lease would be recognized and measured at fair value unencumbered by the related lease. In other words, the leased property (including any acquired tenant improvements) is measured at the same amount, regardless of whether an operating lease is in place. In accordance with ASC 805-20-25-12, an intangible asset or liability may also be recognized if the lease contract terms are favorable or unfavorable as compared to market terms. In addition, in certain circumstances, an intangible asset may be recognized at the acquisition date in accordance with ASC 805-20-30-5 for the value associated with the existing lease (referred to as an "in-place" lease, as further discussed in this section) and for any value associated with the relationship the lessor has with the lessee. Further, a liability may be recognized for any unfavorable renewal options or unfavorable written purchase options if the exercise is beyond the control of the lessor.

If the lease is classified as an operating lease and provides for non-level rent payments, the acquiree will have recorded an asset or liability to recognize rent revenue on a straight-line basis. Such asset or liability would not be carried forward by the acquirer. Rather, the acquirer would recognize rent revenue prospectively on a straight-line basis. See BCG 2.5.17 for further information on deferred charges arising from leases when the acquiree is a lessor. Additionally, the presence of a straight-line asset or liability is presumed to be indicative of a favorable or unfavorable contract that should be recognized.

Intangible assets related to "in-place" leases

There may be value associated with leases that exist at the acquisition date (referred to as "in-place" leases) when the acquiree is a lessor and leases assets through operating leases. That value may relate to the economic benefit of acquiring the asset or property with "in-place" leases, rather than an asset or property that was not leased. At a minimum, the acquirer would typically avoid costs necessary to

obtain a lease, such as any sales commissions, legal, or other lease incentive costs. That value, in addition to any recognized customer-related intangible assets and favorable or unfavorable contract assets or liabilities, is typically recognized as a separate intangible asset in a business combination. Further, the underlying property subject to the operating leases would be measured at fair value, without regard to the underlying lease contracts.

Example BCG 4-6 illustrates the recognizable intangible and tangible assets related to operating leases of a lessor acquired in a business combination.

EXAMPLE BCG 4-6

Lease-related assets and liabilities

Company A, the lessor of a commercial office building subject to various operating leases, was acquired by Company G during 20X1 in a business combination. Included in the assets acquired is a building fully leased by third parties with leases extending through 20X9. As market rates have fluctuated over the years, certain of the leases are at above-market rates and others are at below-market rates at the acquisition date. All of the leases are classified as operating leases, as determined by the acquiree at lease commencement.

How would Company G measure and record the assets and liabilities related to the lease arrangements upon acquisition?

Analysis

Using the acquisition method, Company G would consider the following in recognizing and measuring the assets and liabilities, if applicable, associated with the lease arrangements:

- **Building:** A tangible asset would be recognized and measured at fair value. Although the building is fully leased, it should be valued without regard to the lease contracts under FAS 141(R).B147. Company G may also need to recognize other lease or building-related tangible assets (e.g., tenant or building improvements, furniture, and fixtures) not included in this example.
 - **Favorable or unfavorable leases:** Intangible assets or liabilities would be recognized and measured for the original lease contracts that are considered favorable or unfavorable, as compared to market terms at the acquisition date. For purposes of measuring the liability associated with an unfavorable lease, renewal provisions would likely be considered because there would be an expectation that a lessee would renew. On the other hand, it would be difficult to assume renewals of favorable leases as the lessees typically would not be economically motivated to renew.
 - **“In-place” leases:** An intangible asset that represents the economic benefit associated with the building being leased to others would be recognized because the acquirer would avoid costs necessary to obtain a lease (e.g., sales commissions, legal, or other lease incentive costs). The “in-place” lease value recognized should not exceed the value of the remaining cash payments under the lease; otherwise, the asset would be immediately impaired.
 - **Customer (tenant) relationships:** An intangible asset may be recognized, if applicable, for the value associated with the existing customer (tenant) base at the acquisition date. Such value may include expected renewals, expansion of leased space, etc.
-

Acquiree is a lessor: sales-type or direct financing lease

The acquired entity may also be a lessor in a lease other than an operating lease, such as a direct financing or sales-type lease. In those situations, the acquirer recognizes and measures its net investment in the lease in accordance with ASC 805-20-30-25, which will be equal to the sum of the lease receivable and the unguaranteed residual asset. In applying this guidance, the acquirer will need to determine the fair value of the net investment in the lease that takes into account the terms and conditions of the lease. The acquirer would incorporate into the fair value of the net investment in the lease any terms or conditions in the lease that are favorable or unfavorable (i.e., off market contract terms which could include rental payments, residual value guarantees, purchase options, renewal options, termination options, etc.). Therefore, the acquirer would not record a separate intangible asset or liability for any favorable or unfavorable terms of the lease.

An intangible asset may be recognized for any value associated with the relationship the lessor has with the lessee (e.g., customer or tenant relationships). Generally, we believe the value of an in-place lease is incorporated in the fair value of the net investment in the lease. However, we are aware of an alternative view in practice in which an in-place lease intangible asset is separately recorded.

ASC 805-20-30-25

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

- a. The lease receivable at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:
 1. The remaining lease payments
 2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.
- b. The unguaranteed residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.

Items to consider when recognizing lease-related assets and liabilities

Figure BCG 4-3 summarizes the typical items to consider in the recognition of assets and liabilities associated with lease arrangements in a business combination.

Figure BCG 4-3**Items to consider when recognizing lease-related assets and liabilities**

Lease classification	Lease-related assets and liabilities
Acquired entity is a lessee in an operating lease or a finance lease	<ul style="list-style-type: none"> <input type="checkbox"/> Right-of-use asset <input type="checkbox"/> Lease liability <input type="checkbox"/> Intangible asset or liability - premium paid for certain at-the-money contracts (BCG 4.3.3.6) <input type="checkbox"/> Leasehold improvements <p><i>The following are not recorded as a separate intangible, instead they are included as an adjustment to the right-of-use asset:</i></p> <ul style="list-style-type: none"> <input type="checkbox"/> Favorable or unfavorable rental rates <input type="checkbox"/> Purchase or renewal options
Acquired entity is a lessor in an operating lease	<ul style="list-style-type: none"> <input type="checkbox"/> Leased asset (including tenant improvements) recognized without regard to the lease contract <input type="checkbox"/> Intangible asset or liability - favorable or unfavorable rental rates <input type="checkbox"/> Unfavorable renewal or written purchase options <input type="checkbox"/> “In-place” leases <input type="checkbox"/> Customer (or tenant) relationships
Acquired entity is a lessor in a sales-type or direct financing lease	<ul style="list-style-type: none"> <input type="checkbox"/> Net investment in the lease - equal to the sum of the lease receivable and the unguaranteed residual asset, measured following ASC 805-20-30-25 <input type="checkbox"/> Customer (or tenant) relationships

Acquiree entered into a sale and leaseback transaction prior to being acquired in a business combination

An acquiree may have previously applied sale and leaseback accounting in a transaction with a third party that was separate from the business combination. When the acquiree’s original sale and leaseback transaction qualified as a sale, the acquisition accounting will depend on whether the acquiree had previously recognized additional financing under ASC 842-40-30-2. Refer to LG 6 for more information on sale and leaseback transactions.

In the acquiree’s original sale and leaseback transaction, if the sale proceeds exceeded the fair value of the asset, the seller-lessee would have recorded a financing payable to the buyer-lessor for the excess, while the buyer-lessor would have recorded a financing receivable from the seller-lessee. The seller-lessee and the buyer-lessor would have allocated the contractual lease payments between the lease and the financing arrangement. In the subsequent acquisition accounting, the financing arrangement will continue to be recorded separate from the lease and will be recorded following ASC 805 (i.e., a financial liability when the acquiree was the seller-lessee, a financial asset when the acquiree was the buyer-lessor). The portion of the contractual payments relating to the lease will be used to record the

lease in acquisition accounting. These lease-related payments will be used to assess whether there are any favorable or unfavorable terms of the lease that need to be included as an adjustment to the right-of-use asset (seller-lessee) or as an intangible asset or liability (buyer-lessor).

In the acquiree's original sale and leaseback transaction, if the sale proceeds were less than the fair value of the asset, the seller-lessee and the buyer-lessor would have treated the shortfall as prepaid rent. Prepaid rent will not be recorded in acquisition accounting. The acquirer will use the remaining contractual lease payments to record the acquired lease, including the determination of favorable or unfavorable terms of the lease.

If the acquiree's original leaseback transaction was a failed sale and leaseback transaction, the acquiree would have recorded the transaction as a financing arrangement and the seller-lessee would not have derecognized the underlying asset. The acquirer would retain the acquiree's accounting as a failed sale and leaseback and continue to follow the guidance under ASC 842-40 to determine if and when a sale occurs. If the acquiree is the seller-lessee, the acquirer will value the tangible property independent from the financing arrangement. The financing arrangement will be recorded following ASC 805 (i.e., a financial liability when the acquiree was the seller-lessee in a failed sale and leaseback, a financial asset when the acquiree was the buyer-lessor in a failed sale and leaseback). Refer to LG 6.5 for more information on leaseback transactions not accounted for as a sale.

The following table summarizes the accounting for sale and leaseback transactions that an acquiree entered into with a third party prior to being acquired in a business combination.

Sale leaseback transaction (SLB)	Accounting considerations
Acquiree is the buyer-lessor, SLB qualified for sale accounting	<p>Acquirer values the acquired tangible property independently from the terms of the leaseback</p> <p>Acquirer will continue to record any financing receivable from the seller-lessee (i.e., a financial asset)</p> <p>After consideration of the contractual payments that relate to any financing receivable, the acquirer will record an intangible asset or liability for any favorable or unfavorable terms of the lease</p>
Acquiree is the buyer-lessor, SLB did not qualify for sale accounting	<p>Retain the acquiree's accounting as a failed sale and leaseback transaction and continue to follow the guidance under ASC 842-40 to determine if and when a sale occurs</p> <p>Acquirer will record the acquired financial asset (i.e., a loan receivable); the acquirer will not record the tangible property at the acquisition date</p>
Acquiree is the seller-lessee, SLB qualified for sale accounting	<p>Acquirer will continue to record any financing payable to the buyer-lessor (i.e., a financial liability)</p> <p>After consideration of the contractual payments that relate to any financing payable, the acquirer will determine whether there are any favorable or unfavorable terms of the lease that need to be included as an adjustment to the right-of-use asset</p>

Sale leaseback transaction (SLB)**Accounting considerations**

Acquiree is the seller-lessee, SLB did not qualify for sale accounting

Retain the acquiree's accounting as a failed sale and leaseback transaction and continue to follow the guidance under ASC 842-40 to determine if and when a sale occurs

Acquirer values the acquired tangible property independent from the terms of the leaseback

In accordance with ASC 842-40-25-5, the acquirer will record the acquired financing payable

Treatment of leases between an acquirer and an acquiree at the acquisition date

An acquirer may have a preexisting relationship with the acquiree in the form of an operating lease agreement (e.g., the acquirer is the lessor and the acquiree is the lessee). The lease contract will effectively be settled for accounting purposes as a result of the acquisition (as the acquirer consolidates the acquiree following the acquisition). The acquirer 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 acquirer relative to market terms, or (b) the amount of any stated settlement provisions in the lease available to the counterparty to whom the contract is unfavorable. See BCG 2.7.2 for further information on the accounting for the settlement of preexisting relationships.

Question BCG 4-1

How should the acquirer account for the acquisition of an existing lease arrangement with the acquiree (i.e., acquirer leased assets from acquiree) in its acquisition accounting?

PwC response

Before the acquisition, the acquirer would have recognized a right-of-use asset and a lease liability. As a result of the acquisition, the lease arrangement will cease to exist for accounting purposes because it will represent an intercompany relationship beginning on the acquisition date. The right-of-use asset and lease liability of the acquirer is derecognized upon settlement of the preexisting relationship. As a result, the acquirer should recognize a gain or loss for the effective settlement of a preexisting relationship. See BCG 2.7.2.1 for further information on calculating the gain or loss on the settlement of preexisting relationships.

The acquired underlying asset would be recognized and measured at fair value. The acquirer should also reconsider the useful life of the formerly leased underlying asset.

4.3.4 Technology-based intangible assets

Technology-based intangible assets generally represent innovations on products or services but can also include collections of information held electronically.

4.3.4.1 *Intangible assets used in research and development*

Intangible assets used in research and development activities acquired in a business combination are initially recognized at fair value and classified as indefinite-lived assets until completion or abandonment. Research and development activities acquired in a business combination are not required to have an alternative future use to be recognized as an intangible asset. In subsequent periods, the intangible assets are subject to periodic impairment testing. Additionally, research and development projects should be capitalized at the project level for purposes of recognition, measurement, and subsequent impairment testing. Upon completion or abandonment of the research and development efforts, the reporting entity would need to reassess the useful life of the indefinite-lived intangible asset. Determining useful lives and potential impairment issues related to intangible assets used in research and development activities is discussed in BCG 8.2.4.

In December 2013, the AICPA issued the *AICPA Accounting and Valuation Guide Assets Acquired to Be Used in Research and Development Activities* (the IPR&D Guide). While the IPR&D Guide is non-authoritative, it reflects the input of financial statement preparers, auditors, and regulators and serves as a resource for entities that acquire in-process research and development (IPR&D) assets.

The IPR&D Guide addresses the recognition and measurement of IPR&D assets for all industries, but focuses primarily on the software, electronic devices, and pharmaceutical industries. In addition to having to meet the requirements of ASC 805-20-25-1 through ASC 805-20-25-3, the IPR&D Guide indicates that there must be persuasive evidence that the IPR&D project has substance and is incomplete in order for it to be recognized as an intangible asset. In other words, the acquiree must have performed more than an insignificant amount of research and development efforts that result in the creation of value prior to the acquisition, and there must still be remaining risks (e.g., technological) or regulatory approvals at the acquisition date.

4.3.4.2 *Patented/unpatented technology and trade secrets*

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

Unpatented technology is typically not protected by legal or contractual means and, therefore, does not meet the contractual-legal criterion. Unpatented technology, however, is often sold in conjunction with other intangible assets, such as trade names or secret formulas. As it is often sold with a related asset, the unpatented technology generally would meet the separability criterion.

Trade secrets are information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process, that derives independent economic value from not being generally known and is the subject of reasonable efforts to maintain its secrecy. If the future economic benefits from a trade secret acquired in a business combination are legally protected, then that asset would meet the contractual-legal criterion. Even if not legally protected, trade secrets acquired in a business combination are likely to be identifiable based on meeting the separability criterion. That is, an asset would be recognized if the trade secrets could be sold or licensed to others, even if sales are infrequent or if the acquirer has no intention of selling or licensing them.

4.3.4.3 *Computer software and mask works (intangible assets)*

Mask works are software permanently stored on read-only memory chips. Mask works, computer software, and program formats are often protected legally, through patent, copyright, or other legal

means. If they are protected legally, they meet the contractual-legal criterion. If they are not protected through legal or contractual means, these types of assets may still meet the separability criterion if there is evidence of sales or exchanges of the same or similar types of assets.

4.3.4.4 Databases, including title plants (intangible assets)

Databases are collections of information, typically stored electronically. Sometimes databases that include original works of authorship can be protected by legal means, such as copyrights, and if so, meet the contractual-legal criterion. More frequently, databases are information collected through the normal operations of the business, such as customer information, scientific data, or credit information. Databases, similar to customer lists, are often sold or leased to others and, therefore, meet the separability criterion.

Title plants are a historical record of all matters affecting title to parcels of land in a specific area. These assets are sold or licensed to others and, therefore, meet the separability criterion.

4.3.5 Customer-related intangible assets

Customer-related intangible assets include, but are not limited to: (1) customer contracts and related customer relationships, (2) noncontractual customer relationships, (3) customer lists, and (4) order or production backlog.

In many cases, the relationships that an acquiree has with its customers may encompass more than one type of intangible asset (e.g., customer contract and related relationship, customer list and backlog). The interrelationship of various types of intangible assets related to the same customer can pose challenges in recognizing and measuring customer-related intangible assets. The values ascribed to other intangible assets, such as brand names and trademarks, may impact the valuation of customer-related intangible assets as well. Also, because the useful lives and the pattern in which the economic benefits of the assets are consumed may differ, it may be necessary to separately recognize intangible assets that relate to a single customer relationship according to ASC 805-20-55-24.

Additionally, customer award or loyalty programs may create a relationship between the acquiree and the customer. Such programs may enhance the value of a customer-related intangible asset. These programs are expected to meet the contractual-legal criterion in ASC 805 because the parties have agreed to certain terms and conditions, have had a previous contractual relationship, or both. In addition to evaluating the need to recognize and measure a customer-related intangible asset for these programs, the acquirer must separately evaluate the need to recognize and measure any assumed liabilities related to these programs on the date of acquisition. The terms and conditions associated with these programs can impact the recognition and measurement of any related intangible assets.

4.3.5.1 Customer contracts and related customer relationships

A customer relationship exists between a company and its customer if (1) the company has information about the customer and has regular contact with the customer, and (2) the customer has the ability to make direct contact with the company.

If the entity has a practice of establishing relationships with its customers through contracts, the customer relationship would meet the contractual-legal criterion for separate recognition as an intangible asset, even if no contract (e.g., purchase order or sales order) is in place on the acquisition date. A practice of regular contact by sales or service representatives may also give rise to a customer

relationship. A customer relationship may indicate the existence of an intangible asset that should be recognized if it meets the contractual-legal or separable criteria in accordance with ASC 805-20-55-25.

Overlapping customers

An acquirer may have relationships with the same customers as the acquiree (sometimes referred to as “overlapping customers”). If the customer relationship meets the contractual-legal or separable criteria, an intangible asset should be recognized for the customer relationships of the acquiree, even though the acquirer may have relationships with those same customers. Determining the fair value of the acquired asset will depend on facts and circumstances. The acquired customer relationship may have value because the acquirer has the ability to generate incremental cash flows based on the acquirer’s ability to sell new products to the customer.

The fair value of the overlapping customer relationship would be estimated by reflecting the assumptions market participants would make about their ability to generate incremental cash flows. See FV 7.3.4 for further information on the valuation of intangible assets.

Example BCG 4-7 and Example BCG 4-8 demonstrate the assessment of the contractual-legal criterion for various contract-related customer relationships.

EXAMPLE BCG 4-7

Cancellable and noncancellable customer contracts

An acquired business is a manufacturer of commercial machinery and related aftermarket parts and components. The acquiree’s commercial machines, which comprise approximately 70% of its sales, are sold through contracts that are noncancellable. Its aftermarket parts and components, which comprise the remaining 30% of the acquiree’s sales, are also sold through contracts. However, the customers can cancel those contracts at any time.

Should the acquirer recognize the cancellable and noncancellable customer contracts?

Analysis

Yes. The acquiree has a practice of establishing contractual relationships with its customers for the sale of commercial machinery and the sale of aftermarket parts and components. The ability of those customers that purchase aftermarket parts and components to cancel their contracts at any time would factor into the measurement of the intangible asset, but would not affect whether the contractual-legal recognition criterion has been met.

EXAMPLE BCG 4-8

Potential contracts being negotiated at the acquisition date

An acquiree is negotiating contracts with a number of new customers at the acquisition date for which the substantive terms, such as pricing, product specifications, and other key terms, have not yet been agreed to by both parties.

Should the acquirer recognize the potential customer contracts?

Analysis

No. Although the acquirer may consider these prospective contracts to be valuable, potential contracts with new customers do not meet the contractual-legal criterion because there is no contractual or legal right associated with them at the acquisition date. Potential contracts also do not meet the separability criterion because they are not capable of being sold, transferred, or exchanged, and therefore, are not separable from the acquired business. In this fact pattern, the value of these potential contracts would be included in goodwill. Changes to the status of the potential contracts subsequent to the acquisition date would not result in a reclassification from goodwill to an intangible asset. See ASC 805-20-55-7 for additional information.

Question BCG 4-2

Should the acquirer recognize a customer relationship intangible asset when the acquirer is a customer of the acquiree?

PwC response

We believe that when the acquirer is a customer of the acquiree, it would not be appropriate for the acquirer to recognize a customer relationship intangible asset with itself since a “customer relationship” no longer exists after the acquisition. A customer relationship with oneself does not meet either the contractual-legal or the separable criterion and, therefore, would not be recognized as a separate intangible asset. In addition, from the perspective of the consolidated entity, the definition of an asset is not met since the asset cannot be disposed of and there are no future economic benefits from the customer relationship.

All preexisting relationships between two parties that have consummated a business combination should be evaluated to determine whether settlement of a preexisting relationship has occurred requiring accounting separate from the business combination in accordance with ASC 805-10-55-19(a). See BCG 2.7.2 for further information on the settlement of preexisting relationships between the acquirer and the acquiree.

4.3.5.2 *Noncontractual customer relationships (intangible assets)*

Customer relationships that do not arise from contracts between an acquiree and its customers (i.e., noncontractual customer relationships) do not meet the contractual-legal criterion. However, there may be circumstances when these relationships can be sold or otherwise exchanged without selling the acquired business, thereby meeting the separability criterion. If a noncontractual customer relationship meets the separability criterion, the relationship is recognized as an intangible asset in accordance with ASC 805-20-55-27.

Evidence of separability of a noncontractual customer relationship includes exchange transactions for the same or similar type of asset. These transactions do not need to occur frequently for a noncontractual customer relationship to be recognized as an intangible asset apart from goodwill. Instead, recognition depends on whether the noncontractual customer relationship is capable of being separated and sold or transferred. Noncontractual relationships that are not separately recognized, such as customer bases, market share, and unidentifiable “walk-up” customers, should be included as part of goodwill.

4.3.5.3 Customer lists (intangible assets)

A customer list represents a list of known, identifiable customers that contains information about those customers, such as name and contact information. A customer list may also be in the form of a database that includes other information about the customers (e.g., order history and demographic information).

A customer list does not usually arise from contractual or other legal rights and, therefore, typically does not meet the contractual-legal criterion. However, customer lists may be leased or otherwise exchanged and, therefore, meet the separability criterion. An acquired customer list does not meet the separability criterion if the terms of confidentiality or other agreements prohibit an acquirer from leasing or otherwise exchanging information about its customers. Restrictions imposed by confidentiality or other agreements pertaining to customer lists do not impact the recognition of other customer-related intangible assets that meet the contractual-legal criterion.

Customer list intangible assets generally have a relatively low fair value and a short life because of the nature of the customer information, how easily it may be obtained by other sources, and the period over which the customer information provides a benefit.

4.3.5.4 Customer base (intangible assets)

A customer base represents a group of customers that are not known or identifiable (e.g., persons who purchase newspapers from a newsstand or customers of a fast-food franchise or gas station). A customer base may also be described as “walk-up” customers. A customer base is generally not recognized separately as an intangible asset because it does not arise from contractual or legal rights and is not separable. However, a customer base may give rise to a customer list if information is obtained about the various customers. For example, a customer list may exist, even if only basic contact information about a customer, such as name and address or telephone number, is available.

4.3.5.5 Order or production backlog (intangible assets)

Order or production backlog arises from unfulfilled purchase or sales order contracts and may be significant in certain industries, such as manufacturing or construction. The order or production backlog acquired in a business combination meets the contractual-legal criterion and, therefore, may be recognized separately as an intangible asset even if the purchase or sales order contracts are cancellable. However, the fact that contracts are cancellable may affect the measurement of the fair value of the associated intangible asset.

4.3.6 Translation procedures related to intangible assets

When an intangible asset is separately recognized in acquisition accounting and is attributable to a foreign entity, the acquirer should evaluate where the intangible asset is recorded in the company’s financial systems. If it is recorded at the parent company level, the acquirer should account for the balance as if it was “pushed down” into the currency in which the foreign entity maintains its books and records. This may occur, for example, if a reporting entity acquires a business that is entirely a foreign entity or if the reporting entity acquires a multinational company domiciled in the United States with foreign operations to which the intangible asset relates to as part of the business combination. See FX 5.2 for additional information on translation procedures.

4.4 Complementary intangible assets and grouping of other intangibles

Separate intangible assets often work together or complement each other. In some cases, an acquirer may wish to group complementary intangible assets together for purposes of measuring their initial fair value at the acquisition date and for subsequent amortization and impairment testing. An example is a brand or brand names.

A brand is a general marketing term that refers to a group of complementary intangible assets, such as a trademark and its related trade name, formula, recipe, and technology. If the assets that make up that group meet the criteria for separate recognition and have similar useful lives, an acquirer is not precluded from recognizing them as a single intangible asset in accordance with ASC 805-20-55-18.

An acquirer may also recognize other groups of complementary intangible assets as a single asset if the underlying component assets have similar useful lives. Examples of assets that may be recognized as a single asset if the useful lives are similar include:

- A nuclear power plant and the license to operate the plant
- A copyright intangible asset and any related assignments or license agreements
- A series of easements that support a gas pipeline
- A group of permits issued by governmental agencies, all of which are required to operate a single facility

In making this assessment, the acquirer would identify the component assets and determine each component asset's useful life to evaluate whether such lives are similar.

An acquirer should also consider other factors in determining whether the component assets should be combined as a single asset. ASC 350-30-35 addresses when separately recognized indefinite-lived intangible assets should be combined into a single unit of accounting for purposes of impairment testing, and provides a list of factors to be considered. See BCG 8 for further information. In accordance with ASC 350-30-35, separately recorded indefinite-lived intangible assets should be combined into a single unit for accounting purposes if those assets are operated as a single asset and, as such, are essentially inseparable from one another. Although this guidance applies to grouping of assets for impairment testing purposes, it may be useful in determining whether acquired complementary assets should be grouped as of the acquisition date.

4.5 Assets an acquirer does not intend to use (defensive assets)

The intended use of an asset by the acquirer does not affect its fair value. Rather, the acquirer should look to an asset's highest and best use when measuring its fair value. The fair value of the intangible asset, therefore, should be based on assumptions made by market-participants, not acquirer-specific assumptions.

ASC 805-20-30-6 requires an entity to recognize and measure an asset acquired in a business combination at its fair value in accordance with ASC 820 based on the asset's highest and best use by market-participants, irrespective of whether the acquirer intends to use the asset in the same manner. For example, an entity may acquire a trade name and decide to actively use it only for a short period of time, given its plan to rebrand the existing products sold under that trade name with its own trade name. An entity must consider market-participant assumptions in measuring an asset's fair value. Acquirers will need to consider how others might use these assets, as well as how these assets might benefit other assets acquired, or those they already own.

Future impairment losses or higher depreciation charges in earlier periods may result because the acquirer's use of an asset may differ from the asset's highest and best use as determined by reference to market-participants. Additionally, there could be other postacquisition issues associated with measuring an asset based on its highest and best use (rather than an entity's intended use). See FV 7.3.4.4 for further information on the valuation of intangible assets based on their highest and best use/market-participant assumptions.

An intangible asset acquired in a business combination that the acquirer does not intend to actively use but does intend to prevent others from using is commonly referred to as a "defensive intangible asset" or a "locked-up asset." Notwithstanding the lack of active use by the acquirer, ASC 805 requires that fair value be determined through the lens of a market-participant. The asset is likely contributing to an increase in the cash flows of other assets owned by the acquirer. Conversely, an intangible asset acquired in a business combination that the acquirer does not intend to actively use and does not intend to prevent others from using is not a defensive intangible asset.

Example BCG 4-9 and Example BCG 4-10 demonstrate how to distinguish defensive intangible assets from other intangible assets.

EXAMPLE BCG 4-9

Defensive intangible asset

Company A, a consumer products manufacturer, acquires an entity that sells a product that competes with one of Company A's existing products. Company A plans to discontinue the sale of the competing product within the next six months, but will maintain the rights to the trade name, at minimal expected cost, to prevent a competitor from using it. As a result, Company A's existing product is expected to experience an increase in market share. Company A does not have any current plans to reintroduce the acquired trade name in the future.

Does the trade name represent a defensive intangible asset for Company A?

Analysis

Yes. Because Company A does not intend to actively use the acquired trade name, but intends to hold the rights to the trade name to prevent its competitors from using it, the trade name meets the definition of a defensive intangible asset in accordance with ASC 350-30-55-28G through ASC 350-30-55-28I.

EXAMPLE BCG 4-10

Not a defensive intangible asset

Company A acquires a business and one of the assets acquired is billing software developed by the acquired entity for its own use. After a six-month transition period, Company A plans to discontinue use of the internally developed billing software. In valuing the billing software in connection with the acquisition, Company A determines that a market-participant would use the billing software, along with other assets in the asset group, for its full remaining economic life (that is, Company A does not intend to use the asset in a way that is its highest and best use). Due to the specialized nature of the software, Company A does not believe the software could be sold to a third party without the other assets acquired.

How should Company A account for the billing software developed by the acquired entity for its own use?

Analysis

Although Company A does not intend to actively use the internally developed billing software after a six-month transition period, Company A is not holding the internally developed software to prevent its competitors from using it. Therefore, the internally developed software asset does not meet the definition of a defensive intangible asset in accordance with ASC 350-30-55-28J through ASC 350-30-55-28L. However, consistent with other separable and identifiable acquired intangible assets, Company A should recognize and measure an intangible asset for the billing software utilizing market-participant assumptions and amortize the intangible asset over the billing software's expected remaining useful life to Company A.

As the value of many defensive assets will likely diminish over a period of time, judgment will be required to determine the period over which the defensive asset will either directly or indirectly contribute to the acquirer's cash flows. Generally, the period over which a defensive intangible asset diminishes in fair value is an acceptable proxy for the period over which the reporting entity expects a defensive intangible asset to contribute directly or indirectly to the future cash flows of the entity. The amortization method used should reflect the pattern in which the fair value of a defensive intangible asset diminishes over time. For example, if the defensive asset acquired is a brand name, consumer preferences for the acquired asset may result in continuing value even if the brand is not being actively marketed. Further, the absence of the brand name in the marketplace will likely indirectly benefit other brand names (e.g., increase revenues) of the acquirer. However, the value of the defensive asset will likely diminish over time.

Excerpt from ASC 350-30-25-5

A defensive intangible asset, other than an intangible asset that is used in research and development activities, shall be accounted for as a separate unit of accounting. Such a defensive intangible asset shall not be included as part of the cost of an entity's existing intangible asset(s).

Excerpt from ASC 350-30-35-5A

A defensive intangible asset shall be assigned a useful life that reflects the entity's consumption of the expected benefits related to that asset. The benefit a reporting entity receives from holding a defensive intangible asset is the direct and indirect cash flows resulting from the entity preventing others from

realizing any value from the intangible asset (defensively or otherwise). An entity shall determine a defensive intangible asset's useful life, that is, the period over which an entity consumes the expected benefits of the asset, by estimating the period over which the defensive intangible asset will diminish in fair value. The period over which a defensive intangible asset diminishes in fair value is a proxy for the period over which the reporting entity expects a defensive intangible asset to contribute directly or indirectly to the future cash flows of the entity.

ASC 350-30-35-5B

It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors. Additionally, if an acquired intangible asset meets the definition of a defensive intangible asset, it shall not be considered immediately abandoned.

As applicable, defensive assets need to be tested for impairment under the provisions of ASC 350 or ASC 360-10, depending on whether the asset is deemed an indefinite-lived or finite lived intangible asset, respectively. If fair value needs to be determined for purposes of an impairment assessment, the defensive asset's fair value will be based on market-participant assumptions at that time and not acquirer-specific assumptions.

An acquired asset that an acquirer does not intend to actively use and does not intend to prevent others from using is not a defensive asset. An example could be a customized software program internally developed by the target. Similar to other market-participants, the acquirer may only plan to use the program for a short transition period until the target company is successfully transitioned to the acquirer's existing software system. The acquirer's initial measurement of the customized software program is based on it likely having limited value and a short economic life, since the acquired asset will only generate value to the acquirer and to market-participants over the transitional period. This type of an acquired asset would not be considered a defensive asset. Example BCG 4-11 provides an example of a defensive intangible asset.

EXAMPLE BCG 4-11

Defensive intangible asset

Company Z purchases Company B, an international widget manufacturer, which sells its products under a well-known trade name. Company Z intends to actively use the acquired trade name for only one year, and then rebrand the existing products sold under that trade name with its own trade name. After this transition period, Company Z will continue to hold the trade name as a defensive asset but will no longer market it.

How should Company Z recognize, initially measure, and subsequently measure the acquired trade name asset?

Analysis

Although Company Z intends to actively use the acquired trade name for only one year, ASC 805 requires Company Z to recognize and initially measure the acquired trade name asset at fair based on its highest and best use by market participants. Company Z should consider how others might use the trade name, as well as how the trade name might benefit other assets acquired, or those they already

own. Company Z's intent to actively use the acquired trade name for only one year is irrelevant for recognition and initial measurement of the asset.

The subsequent measurement of the defensive asset can be complicated as Company Z's use of the trade name might differ from the asset's highest and best use. It would be rare for a defensive intangible asset to have an indefinite life, so Company Z will likely need to assign the trade name a useful life. The useful life should reflect the entity's consumption of the expected benefits related to the trade name. Company Z will directly benefit from the cash flows related to the trade name during the one year that it is marketing the trade name. It will indirectly benefit by preventing others from realizing any value from the intangible asset. Additionally, the finite lived trade name will need to be tested for impairment under the provisions of ASC 360-10.

4.6 *Typical intangible assets' useful lives by major industry*

Figure BCG 4-4 highlights typical intangible assets found in major industries and their typical life characteristics. This table serves as a broad overview only and is not intended to reflect all of the intangible assets that may be present for an industry participant or in a particular situation. In determining the useful lives of its recognized intangible assets, an entity must perform a thorough evaluation of the relevant facts and circumstances.

Figure BCG 4-4

Typical intangible assets found in major industries and some of their typical life characteristics

Industry	Typical significant intangible assets	Typical life characteristics
Retail & consumer products	<ul style="list-style-type: none"> <input type="checkbox"/> Trade and brand names <input type="checkbox"/> Franchise rights <input type="checkbox"/> Customer and supplier contracts <input type="checkbox"/> Favorable/unfavorable contract terms <input type="checkbox"/> Process technology and know-how <input type="checkbox"/> Liquor licenses <input type="checkbox"/> Customer relationships (e.g., pharmacy script files) <input type="checkbox"/> Customer lists <input type="checkbox"/> Internet domain names 	Trade names, brand names, and franchise rights are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Supplier arrangements are based on contractual terms, assuming renewals when appropriate (excluding a reacquired right). Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how range from short- to long-term.
Industrial products	<ul style="list-style-type: none"> <input type="checkbox"/> Trade names <input type="checkbox"/> Customer and supplier contracts <input type="checkbox"/> Favorable/unfavorable contract terms <input type="checkbox"/> Process technology and know-how 	Trade names are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how

Industry	Typical significant intangible assets	Typical life characteristics
	<ul style="list-style-type: none"> □ Customer relationships 	range from short- to long-term. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.
Real estate	<ul style="list-style-type: none"> □ Tenant relationships □ Favorable/unfavorable lease terms when the acquiree is a lessor in an operating lease □ “In-place” leases 	Determined by lease life and expectation of tenant renewals.
Banking	<ul style="list-style-type: none"> □ Core deposit intangibles (CDI) □ Distribution channels (e.g., agents) □ Brands and trade names □ Customer relationships (including purchased credit card relationships) □ Customer lists 	<p>CDI is short to moderate, based on customer churn, although may be longer for companies based outside the United States.</p> <p>Brands and trade names are long and possibly indefinite-lived if sustainable. Others are typically short to moderate. Contractual relationships are driven by contractual life.</p>
Insurance	<ul style="list-style-type: none"> □ Customer relationships, such as renewal rights on short-duration insurance contracts, cross-selling opportunities, and customer/member lists □ Distribution channels (including the distributor’s ability to generate new business from new customers) □ Insurance licenses □ Service contracts and provider contracts (particularly relevant for health insurers) □ Brands and trade names □ Process technology and know-how 	Customer relationships and distribution channels are moderate. Trade names are long and possibly indefinite-lived if sustainable; otherwise, are short to moderate. Certain insurance licenses can be maintained indefinitely without substantial cost.
Investment management	<ul style="list-style-type: none"> □ Trade names □ Customer relationships □ Fund manager contracts 	Trade names are long and possibly indefinite-lived if sustainable; otherwise, are short to moderate. Customer relationships are moderate, but may be longer where focus is on institutional clients rather than retail. Fund

Industry	Typical significant intangible assets	Typical life characteristics
Technology	<ul style="list-style-type: none"> □ Trade names □ Customer and supplier contracts □ Favorable/unfavorable contract terms □ Process technology and know-how □ Customer relationships □ Computer software and mask works □ Internet domain names □ Databases □ IPR&D 	<p>manager contracts and the customer relationships of the funds are interdependent and require special analysis. The lives of fund manager contracts are driven by the expectation of renewal with the funds and are likely to be moderate- to long-term, or possibly indefinite-lived.</p> <p>Trade names are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how range from short- to long-term. Customer relationships are often short to moderate but may be longer depending on rate of customer churn and the degree to which customer retention is dependent on the future technology development.</p> <p>IPR&D would be an indefinite-lived intangible asset until the asset is abandoned or put to use or in operation as a product, at which time the life may be short to moderate, depending on the product and degree of patent protection.</p>
Life sciences and pharmaceuticals	<ul style="list-style-type: none"> □ Brands and trade names □ Patents, product rights, and know-how □ Partnering and alliance arrangements □ IPR&D □ Customer relationships and customer base □ Supplier contracts 	<p>Brands and trade names are likely short to moderate, depending on product portfolio (i.e., remaining legal life of identifiable intangible assets). The exception is where brands and trade names have value and are sustainable, which could be long and possibly indefinite-lived.</p> <p>IPR&D would be an indefinite-lived intangible asset until the asset is abandoned or put to use or in operation as a product, at which time the life may be short to moderate,</p>

Industry	Typical significant intangible assets	Typical life characteristics
Entertainment and media	<ul style="list-style-type: none"> <input type="checkbox"/> Trade names/trademarks <input type="checkbox"/> Artistic properties (e.g., cartoon characters, copyrights) <input type="checkbox"/> Licenses (e.g., broadcast licenses, program material licenses) <input type="checkbox"/> Favorable/unfavorable contract terms 	<p>depending on the product and degree of patent protection.</p> <p>Trade names/trademarks and certain licenses and artistic properties likely to be longer term or possibly indefinite-lived if sustainable.</p>
Telecommunications	<ul style="list-style-type: none"> <input type="checkbox"/> Trade names <input type="checkbox"/> Licenses and rights of use <input type="checkbox"/> Installed base <input type="checkbox"/> Technology <input type="checkbox"/> Subscriber/customer relationships 	<p>Trade names likely to be long or possibly indefinite-lived if sustainable; otherwise, short to moderate. Other intangible assets range from short (technology) to long or indefinite (licenses), depending on ability to renew and risk of obsolescence. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.</p>
Energy & resources (including oil & gas)	<ul style="list-style-type: none"> <input type="checkbox"/> Trade and brand names where downstream operations are present (e.g., retail front) <input type="checkbox"/> Contractual relationships <input type="checkbox"/> Favorable/unfavorable contract terms (e.g., drilling contract) <input type="checkbox"/> Agreements (franchise service, interconnection, operations and maintenance, railroad crossing) <input type="checkbox"/> Contracts (purchased power, fuel, and other supply contracts) <input type="checkbox"/> Easements, rights of way, and rights of use <input type="checkbox"/> Siting, environmental, and other licenses <input type="checkbox"/> Customer relationships¹ 	<p>Trade or brand names likely to be longer term or possibly indefinite-lived, if sustainable; otherwise, short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.</p>

¹ If there is a monopoly in place, an intangible asset would generally not exist as it would be unlikely that the customer relationship would be separable from the business.

4.7 *The intangible assets alternative (private companies/NFPs)*

In accordance with ASC 805-20-25-30, a private company/NFP entity may elect an alternative that simplifies the accounting for intangible assets acquired in a business combination. Under the intangible assets alternative, an acquirer other than a public business entity can make an accounting policy election not to recognize and measure: (a) customer-related intangibles (unless they are capable of being sold or licensed independent from the other assets of the acquired business) and (b) noncompetition agreements.

A private company/NFP entity that elects the intangible assets alternative should continue to separately recognize and measure customer-related intangible assets that are capable of being sold or licensed independently, as well as all other identifiable intangible assets (e.g., trade names). A private company/NFP entity that elects the intangible assets alternative on intangibles must also adopt the accounting alternative related to amortizing goodwill. See BCG 9.11 for further information. However, the opposite is not the case. That is, a private company/NFP entity can elect to adopt the goodwill accounting alternative without being required to adopt the intangible assets alternative.

The intangible assets alternative is available to private companies/NFP entities and applies when the entity is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following qualifying transactions subsequent to the adoption of both accounting alternatives:

- a. Business combinations under ASC 805
- b. Investments in an equity method investee under ASC 323 with respect to intangible assets acquired (when assessing basis differences between the investor basis and the investee's net assets)
- c. Fresh-start reporting under ASC 852 for reorganizations

Similar to other PCC alternatives, there is no effective date (also referred to as an "open-ended" effective date) for the intangible assets alternative; a private company/NFP entity has an unconditional one-time election to apply the alternative to prospective acquisitions, as long as the entity also adopts the goodwill amortization alternative. A private company/NFP entity that elects the alternative on intangibles for the first time does not need to justify that the use of the accounting alternative is preferable.

The guidance for intangible assets is required to be applied prospectively to all new acquisitions after adoption. That is, customer-related intangible assets and noncompetition agreement intangible assets that have been recognized in previously issued financial statements prior to the period of adoption of the accounting alternatives are not affected by the intangible assets alternative and should not be subsumed into goodwill.

Before electing any of the PCC alternatives, companies should consider the possibility of a future initial public offering (IPO) or a sale of the company to (or a significant ownership interest by) a public entity. The SEC staff has indicated that any changes in the entity's status as a private company (e.g., as a result of an IPO), or if its financial statements are included in an SEC filing (e.g., subject to the requirements of SEC Regulation S-X Rule 3-05 upon acquisition as a significant subsidiary), would

require the retrospective reversal of all elected private company alternatives. See FSP 30.4 for additional information on private companies assessing preferability.

Disclosures

The intangible assets alternative does not include any incremental disclosure requirements. ASC 805 disclosure requirements continue to apply to private companies/NFP entities electing the intangible assets alternative. Those disclosures include a qualitative description of intangible assets that do not qualify for separate recognition. Accordingly, while the fair value of certain intangible assets would not need to be determined by private companies/NFP entities, the nature of all acquired intangible assets should be described in the financial statement footnotes. See FSP 17.4.8 for additional information.

4.7.1 Customer-related intangible assets (private companies/NFPs)

Private companies/NFP entities electing the intangible assets alternative would generally recognize and measure fewer customer-related intangibles separate from goodwill because most acquired customer contracts and relationships are not capable of being sold or licensed independent from other assets of the acquired business. Customer-related intangible assets that would not be recognized under the intangible assets alternative include non-transferable customer contracts (regardless of their duration, cancellability, or other terms) and non-transferable customer relationships (with or without outstanding contracts). Examples of customer-related intangible assets that would continue to be separately recognized include customer lists and information (e.g., contact information that is capable of being bought and sold), mortgage servicing rights, commodity supply contracts, and core deposits.

Example BCG 4-12 illustrates how a private company that has elected the accounting alternative for intangible assets would account for acquired customer relationships (an NFP entity would follow the same accounting treatment).

EXAMPLE BCG 4-12

Private company acquisition with customer relationships

Company A, a privately-held equipment manufacturer and servicer, acquired Company B in a business combination. Company B is in the same industry as Company A. Company B typically conducts business with its customers through purchase orders. Company B also has a five-year agreement with one of its customers to service equipment. The purchase orders are non-transferable (i.e., they must be fulfilled by Company B), and the five-year service agreement cannot be transferred to a third party without the consent of the customer. Company A has elected the private company alternative for intangible assets.

How should Company B account for the acquired customer relationships?

Analysis

The acquired customer relationships arising from the purchase orders and the service agreement cannot be sold independent from other assets of the business. Essentially, the value of these intangibles would be subsumed into goodwill. If Company A had not elected the alternative, it would have had to separately recognize the customer relationship intangibles at their acquisition date fair values, apart from goodwill.

The intangible assets alternative is likely to have less of an impact in industries in which customer information is capable of being independently sold or exchanged (such customer information is often referred to as customer lists). In these cases, the customer lists should continue to be recognized and measured apart from goodwill.

Example BCG 4-13 illustrates how a private company that has elected the accounting alternative for intangible assets would account for acquired customer lists (an NFP entity would follow the same accounting treatment).

EXAMPLE BCG 4-13

Private company acquisition of an online apparel business with customer lists

Company C, a privately-held apparel business, acquired Company D, an online apparel business. The acquired business includes identifiable intangibles, including Company D's trade name, technology, and customer lists. Customer lists include known information about its preferred customers, such as customer names, contact information, and order histories. Some preferred customers consented to the sale of their information to third parties, while others have not. Company D makes regular contact with all of its preferred customers. Company C has elected to apply the private company alternative for intangible assets.

How should Company C account for the acquired customer lists?

Analysis

In addition to the trade name and technology intangibles, Company C should recognize and measure the fair value of Company D's customer lists that can be independently sold or exchanged (i.e., information about customers that gave their consent) as a separate intangible. The expected selling price of the customer lists typically would approximate the related intangible's fair value. The customer information that cannot be sold, whether due to lack of customer consent or other restrictions, would not be recognized and measured separate from goodwill.

If Company C had not elected the private company alternative, in addition to the customer lists, it also would have recognized and measured an intangible for its ability to generate future cash flows from the sale of the apparel to preferred customers (i.e., customer relationship intangible).

Companies often do not distinguish between customer relationships and customer lists relating to the same group of customers when measuring their acquired intangible assets; a single intangible asset is often recognized for both. Private companies/NFP entities electing the intangible assets alternative would need to consider the recognition and fair value of customer lists separate from customer relationships since, unlike customer lists, customer relationships cannot be sold independent from other assets.

The intangible assets alternative indicates that unfavorable customer contracts (for example, a customer contract with forecasted costs in excess of revenues over the term of the contract) should continue to be recognized as liabilities at fair value. Even if a customer contract has certain terms that are unfavorable relative to market, the overall value of the customer contract could still be in a net asset position. In that case, a private company/NFP entity electing the intangible assets alternative would recognize neither a customer contract intangible asset nor an unfavorable contract liability.

The intangible assets alternative does not apply to acquired contract assets that represent rights to consideration in exchange for goods or services that have been transferred prior to the acquisition date, and would eventually be reclassified as a receivable. Furthermore, the intangible assets alternative does not apply to leases. Thus, right-of-use assets and liabilities and favorable and unfavorable lease terms should continue to be recognized and measured separate from goodwill.

4.7.2 *Noncompetition agreements under the intangible assets alternative*

Noncompetition agreements are legal arrangements that generally prohibit another party (e.g., a person or business) from competing with the acquired business for a specified period of time. The intangible assets alternative allows private companies/NFP entities to subsume noncompetition agreements into goodwill, thereby eliminating the need to estimate their fair value. Private companies/NFP entities electing the intangible assets alternative would not recognize noncompetition agreements acquired in a business combination separate from goodwill.

The intangible assets alternative applies to noncompetition agreements acquired in a business combination, for example, those already in place between the acquired business and its employees at the acquisition date. The intangible assets alternative also applies to new noncompetition agreements when a reporting entity determines that such agreements were entered into concurrent with the business combination.

***Chapter 5:
Partial acquisitions and
changes in NCI—updated
November 2022***

5.1 Overview: partial acquisitions and changes in NCI

A noncontrolling interest (NCI) is the equity interest in a subsidiary that is not attributable, directly or indirectly, to a parent. This chapter discusses the accounting for partial acquisitions, step acquisitions, and changes in a company's NCI in a business pursuant to ASC 810-10. The initial recognition and subsequent measurement of NCI is addressed in BCG 6. NCI valuation considerations are discussed in FV 7.3-5.

For changes in ownership interest in an asset or group of assets that do not constitute a business, or for changes in ownership in a legal entity that is a variable interest entity (VIE) that is not a business, the appropriate consolidation or derecognition model should be identified, which may be different from the guidance for a business. See PPE 2 and PPE 6 for additional guidance on asset acquisitions and asset disposals, respectively. See CG 6.1 and BCG 2.11 for additional guidance on accounting for a legal entity that is a VIE that is not a business.

A reporting entity may incur exit or restructuring costs in conjunction with a disposal of a business or a change in interest. ASC 420-10, *Exit or Disposal Cost Obligations*, addresses the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. See PPE 6.4 for additional details.

The examples provided in this chapter assume a simple equity structure (i.e., one class of common shares). Other issues may arise if a subsidiary that is a business has a complex equity structure.

5.2 Accounting for changes in ownership interest

A partial acquisition of a business occurs when a company obtains control through the acquisition of less than 100% of the equity interests of an entity. Step acquisitions occur when a company acquires equity interests in a business over a period of time in a series of transactions through which the company eventually obtains control of the business.

When a company obtains additional interests in a business or sells a portion of its interest in a business, the accounting results vary depending upon whether the company continues to control the business.

A summary of the types of changes in ownership interest in a business and the accounting impact on the financial statements is included in Figure BCG 5-1. Each is described in more detail in BCG 5.3 through BCG 5.5. In addition, refer to Figure CG 1-4 in CG 1.4.2.3, which summarizes the accounting for changes in ownership interest beyond that discussed within the scope of this chapter.

Note that Figure BCG 5-1 does not address asset acquisitions or the acquisition of a VIE that is not a business. For guidance on the accounting for an acquisition or disposal of an asset or group of assets that does not constitute a business, refer to PPE 2 and PPE 6, respectively.

Figure BCG 5-1

Summary of accounting for changes in ownership interests in businesses

Change in ownership interest	Impact
Partial acquisition: control is obtained, but less than 100% of business is acquired	Consolidate as of date control is obtained Recognize 100% of identifiable assets, liabilities, and goodwill Recognize the NCI at fair value in equity
Step acquisition: control is obtained when there is a previously held equity interest	Consolidate as of date control is obtained Remeasure the previously held equity interest to fair value and recognize any difference between the fair value and carrying value, if any, as a gain or loss in income Recognize 100% of the identifiable assets, liabilities, and goodwill If less than 100% acquired, recognize the NCI at fair value in equity
Additional interest obtained (or reduction in parent's ownership interest) ¹ : control is maintained	Account for as an equity transaction Do not recognize a gain or loss in the income statement Recognize the difference between the fair value of the consideration paid (received) and the related carrying value of the NCI acquired (sold) in the controlling entity's equity/APIC Reclassify the carrying value of the NCI obtained from the NCI to the controlling entity's equity (reclassify the carrying value of the controlling interest sold from the controlling entity's equity to the NCI)
Reduction in parent's ownership interest: control to noncontrolling investment ²	Deconsolidate investment Remeasure any retained noncontrolling investment at fair value ³ Recognize the gain or loss on interest sold and the gain or loss on the retained noncontrolling investment in the income statement

¹ A parent's ownership interest in a subsidiary might change while the parent retains control, including when (1) a parent purchases additional interest in a subsidiary (sells part of its interest in its subsidiary) or (2) the subsidiary reacquires some of its shares, thereby increasing the parent's ownership interest in the subsidiary (issues shares, thereby reducing the parent's ownership in the subsidiary). See ASC 810-10-45-22.

² Loss of control by a parent may occur in different ways, including when (1) a parent sells all or part of its interest in its subsidiary; (2) a contractual agreement that gave control of the subsidiary to the parent expires; (3) control is obtained by another party through a contract; (4) the subsidiary issues shares, thereby reducing the parent's ownership in the subsidiary; or (5) the subsidiary becomes subject to the control of a government, court, administrator, or regulator. See ASC 810-10-40-4 and ASC 810-10-55-4A.

³ If the reduction in parent's ownership interest and loss of control is achieved via a spinoff, refer to ASC 845-10-30-10 and ASC 505-60 (see PPE 6.3.2).

5.3 Accounting for partial and step acquisitions

Equity interests acquired prior to obtaining control are accounted for in accordance with US GAAP guidance applicable to the investment interest. An investor that exerts significant influence over an investee accounts for that interest as an equity method investment in accordance with ASC 323. See

PwC's *Equity method investments and joint ventures* guide for additional information. If an investor is unable to exert significant influence over an investee, the investment is generally accounted for as an equity security in accordance with ASC 321. See LI 2 for additional information.

The purchase of the additional interest in which the company obtains control is accounted for as a business combination if it meets the requisite criteria. See BCG 1 for further information. When an acquirer obtains control of a business, its consolidated financial statements include 100% of the assets acquired, liabilities assumed, and noncontrolling interests, generally at fair value, in accordance with ASC 805. The acquirer records 100% even when less than 100% of the acquiree is obtained.

5.3.1 Fair value method (partial and step acquisitions)

If a partial acquisition or a step acquisition in which control is obtained is considered a business combination, then a reporting entity should recognize the following at the acquisition date:

- 100% of the identifiable net assets
- NCI at fair value
- Goodwill as the excess of (a) over (b) below, in accordance with ASC 805-30-30-1:
 - a. The aggregate of (1) the consideration transferred, which generally requires acquisition-date fair value, (2) the fair value of any noncontrolling interest in the acquiree, and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
 - b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed

As discussed in BCG 2 and BCG 5.3, the identifiable assets acquired, liabilities assumed, and noncontrolling interests are generally measured at fair value in accordance with ASC 805. ASC 805-20-25-16 and ASC 805-20-30-10 provide for limited exceptions for certain assets and liabilities to be recognized and measured in accordance with other GAAP.

If no consideration is transferred, goodwill will be measured by reference to the fair value of the acquirer's interest in the acquiree, determined using an appropriate valuation technique in accordance with ASC 805-30-30-3. See FV 7.3 for further information on valuation techniques.

Example BCG 5-1 in BCG 5.3.3 illustrates the amount of goodwill that would be recognized in a partial acquisition.

5.3.2 Remeasurement of previously held equity interest

A step acquisition occurs when a shareholder obtains control over an entity by acquiring an additional interest in that entity. If that entity is a business, or if that entity is a VIE (whether a business or not), the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired. The remeasurement of the previously-held equity interest is recognized in the income statement in accordance with ASC 805-10-25-10. This remeasurement is not likely to result in the recognition of a loss since companies are required to periodically evaluate their investments for

impairment. Any amounts previously recorded in other comprehensive income relating to the investee should be reclassified and included in the calculation of the gain or loss as of the acquisition date.

As discussed in ASC 321-10-35-2, a reporting entity may elect to measure its existing equity investment (that does not have a readily determinable fair value) using the measurement alternative. The measurement alternative requires the reporting entity to measure the equity investment at cost minus any impairment, plus or minus value changes based on observable prices in orderly transactions for the identical or similar investment of the same issuer. A step acquisition in which the reporting entity increases its existing equity investment to a level that provides the acquirer with control of a business is an observable transaction that the reporting entity would use to remeasure its previously held interest in the acquiree to fair value through net income at the date control is obtained. See FV 7.3.5.3 for further information on the considerations in valuing the previously held equity interest.

There may be circumstances when a reporting entity owns a noncontrolling equity interest (e.g., shares) in an entity that is a business and also an option to acquire an incremental equity interest that, upon exercise, would give the reporting entity control over that entity. If the reporting entity exercises the option, we believe the reporting entity should include both the previously held equity interest and the option to acquire the additional equity interest in calculating the gain or loss on the remeasurement of the previously held equity interests in the step acquisition.

In a step acquisition in which control is obtained, but the acquirer does not purchase all of the remaining ownership interests, an NCI is recorded in equity at the acquisition date at fair value. See BCG 5.3.4 and FV 7.3.5 for further detail.

5.3.3 Examples of partial and step acquisitions

Example BCG 5-1, Example BCG 5-2, and Example BCG 5-3 demonstrate the accounting for partial acquisitions and step acquisitions.

EXAMPLE BCG 5-1

Accounting for a partial acquisition of a business or VIE when control is obtained

Company A acquires Company B (a business) by purchasing 60% of its equity for \$150 million in cash. The fair value of the noncontrolling interest is determined to be \$100 million.¹ The net of the fair value of the identifiable assets acquired and liabilities assumed is determined to be \$50 million.

How should Company A account for the partial acquisition of Company B?

Analysis

At the acquisition date, the acquirer would recognize (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill.

The journal entry recorded on the acquisition date for the 60% interest acquired would be as follows (in millions):

Dr. Identifiable net assets	\$50	
Dr. Goodwill	\$200 ²	
Cr. Cash		\$150
Cr. NCI ¹		\$100

¹ See BCG 5.3.4 and FV 7.3.5 for a discussion of how to determine the fair value of NCI.

² Goodwill is recorded (in millions):

Fair value of consideration transferred	\$150
Fair value of the NCI	100
Fair value of previously held equity interest	n/a
Subtotal	<u>250</u>
Recognized value of 100% of the identifiable net assets	(50)
Goodwill recognized	<u>\$200</u>

EXAMPLE BCG 5-2

Accounting for a step acquisition of a business or VIE when control is obtained

Company A has a 40% previously held equity method investment in Company B (a business). The carrying value of the previously held equity method investment is \$20 million. Company A purchases the remaining 60% interest in Company B for \$300 million in cash. The fair value of the 40% previously held equity method investment is \$200 million.¹ The net of the fair value of the identifiable assets acquired and liabilities assumed is determined to be \$440 million. (For illustrative purposes, the tax consequences on the gain on the remeasurement of the previously held equity interest have been ignored.)

How should Company A account for the step acquisition of Company B?

Analysis

At the acquisition date, the acquirer would recognize (1) 100% of the identifiable net assets, (2) NCI at fair value (not applicable in this example), and (3) goodwill. Any gain or loss on the previously held equity method investment is recognized in the income statement.

The journal entry recorded on the acquisition date is as follows (in millions):

Dr. Identifiable net assets	\$440	
Dr. Goodwill	\$60 ²	
Cr. Cash		\$300
Cr. Equity method investment		\$20 ³
Cr. Gain on equity method investment ¹		\$180 ⁴

¹ See BCG 5.3.4 and FV 7.3.5 for a discussion of how to determine the fair value of previously held equity interests.

² Goodwill is recorded (in millions):

Fair value of consideration transferred	\$300
Fair value of the NCI	n/a
Fair value of previously held equity method investment	200
Subtotal	<u>500</u>
Recognized value of 100% of the identifiable net assets	(440)
Goodwill recognized	<u>\$60</u>

³ Elimination of the carrying value of the 40% previously held equity method investment

⁴ The gain on the 40% previously held equity method investment is recognized in the income statement: fair value of the previously held equity method investment less the carrying value of the previously held equity method investment (\$200 – \$20)

EXAMPLE BCG 5-3

Accounting for a step acquisition when control is obtained, but less than 100% is acquired

Company A has a 40% previously held equity method investment in Company B, with a carrying value of \$20 million. Company A purchases an additional 50% interest in Company B for \$250 million in cash. The fair value of Company A's 40% previously held equity method investment is determined to be \$200 million.¹ The fair value of the NCI is determined to be \$50 million.¹ The net of the fair value of the identifiable assets acquired and liabilities assumed is determined to be \$440 million. (For illustrative purposes, the tax consequences on the gain on the remeasurement of the previously held equity interest have been ignored.)

How should Company A account for the partial acquisition of Company B?

Analysis

At the acquisition date, the acquirer would recognize (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill. Any gain or loss on the previously held equity method investment is recognized in the income statement.

The journal entry recorded on the acquisition date for the 50% controlling interest acquired would be as follows (in millions):

Dr. Identifiable net assets	\$440	
Dr. Goodwill	\$60 ²	
Cr. Cash		\$250
Cr. Equity method investment		\$20 ³
Cr. Gain on equity method investment ¹		\$180 ⁴
Cr. NCI ¹		\$50

¹ See BCG 5.3.4 and FV 7.3.5 for a discussion of how to determine the fair value of NCI and previously held equity interests.

² Goodwill is recorded (in millions):

Fair value of consideration transferred	\$250
Fair value of the NCI	50
Fair value of previously held equity method investment	200
Subtotal	<u>500</u>
Recognized value of 100% of the identifiable net assets	(440)
Goodwill recognized	<u>\$60</u>

³ Elimination of the carrying value of the 40% previously held equity method investment

⁴ The gain on the 40% previously held equity method investment is recognized in the income statement: fair value of the previously held equity method investment less the carrying value of the previously held equity method investment (\$200 – \$20)

5.3.4 Fair value considerations (partial and step acquisitions)

ASC 805-20-30-7 through ASC 805-20-30-8 provide the guidance for measuring a noncontrolling interest in an acquiree at fair value.

ASC 805-20-30-7

Paragraph 805-20-30-1 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. An acquirer sometimes will be able to measure the acquisition-date fair value of a noncontrolling interest on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the noncontrolling interest using another valuation technique.

ASC 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.

If the noncontrolling interest consists of publicly-traded securities, the fair value of the noncontrolling interest should be measured on the basis of market price. The acquirer must measure the fair value of the noncontrolling interest using other valuation techniques if the securities are not publicly traded, as described in ASC 805-20-30-7. See FV 7.3.5.2 for additional information on valuation techniques for measuring the fair value of NCI.

A control premium represents the amount paid by a new controlling shareholder for the benefits resulting from synergies and other potential benefits derived from controlling the acquired company. Control premiums should be applied when the noncontrolling interest will benefit in ways similar to the acquirer. Certain operational synergies will often impact the cash flows of the acquiree as a whole, including the noncontrolling interest. In such case, deducting those operational synergies (control premium) from the value of the noncontrolling interest would not be appropriate.

In limited situations, operational synergies may only benefit the acquirer, in which case it may be appropriate to exclude a control premium or include a discount for lack of control when valuing the NCI. For example, revenue synergies resulting from the combination may benefit only the existing business of the acquirer. In such cases, the per-share fair value of the acquirer's interest in the acquiree and the noncontrolling interest may differ as described in ASC 805-20-30-8.

5.3.5 *Consideration of goodwill when NCI exists*

In a partial acquisition, consideration needs to be given to the attribution of goodwill to controlling and noncontrolling interests in the event that goodwill is later impaired. When goodwill is impaired, ASC 350-20-35-57A requires that the impairment loss be attributed to the parent and the NCI on a rational basis. One rational approach would be to attribute the impairment loss to the controlling interest and the NCI using their relative interests in the carrying value of goodwill. See BCG 9 for further information on impairment testing of goodwill.

5.3.6 *Bargain purchase in partial or step acquisition*

Occasionally, an acquirer will make a bargain purchase; that is, a business combination in which (a) the acquisition-date amount of the identifiable assets acquired and the liabilities assumed exceeds (b) the aggregate of (1) the consideration transferred, which generally requires acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

Similar to a bargain purchase in an acquisition of 100% of the equity interests, in a partial acquisition or step acquisition the acquirer should reassess whether it has identified all of the assets acquired and liabilities assumed. The acquirer should also review its valuation procedures used to measure the amounts recognized for the identifiable net assets, the NCI, the previously held equity interest, and the consideration transferred. If a bargain purchase is still indicated, the acquirer recognizes a gain in the income statement on the acquisition date in accordance with ASC 805-30-25-2 through ASC 805-30-25-4.

NCI is recognized at its acquisition-date fair value in accordance with ASC 805-20-30-7. Therefore, no portion of a bargain purchase gain should be allocated to the NCI in a partial acquisition or step acquisition. See Example 1: Bargain Purchases in ASC 805-30-55-14 through ASC 805-30-55-16 for additional information.

Example BCG 5-4 demonstrates the accounting for a bargain purchase in a partial acquisition.

EXAMPLE BCG 5-4

Accounting for a bargain purchase in a partial acquisition of a business

Company A acquires Company B by purchasing 70% of its equity for \$150 million in cash. The fair value of the NCI is determined to be \$69 million.¹ The net of the fair value of the identifiable assets acquired and liabilities assumed is determined to be \$220 million. (For illustrative purposes, the tax consequences on the bargain purchase gain have been ignored.)

How should Company A account for the bargain purchase gain?

Analysis

The bargain purchase gain is calculated as the excess of (a) the recognized amount of the identifiable net assets acquired over (b) the fair value of the consideration transferred plus the fair value of the NCI and, in a step acquisition, the fair value of the previously held equity interest.

Fair value of 100% of the identifiable net assets (a)	\$220
Fair value of consideration transferred	(150)
Fair value of the NCI ¹	(69)
Fair value of previously held equity interest	n/a
Less: subtotal (b)	(219)
Bargain purchase gain (a – b)	<u>\$1</u>

The recognized amount of the identifiable net assets is greater than the fair value of the consideration transferred plus the fair value of the NCI, and there was no previously held equity interest in Company B to value. Therefore, a bargain purchase gain of \$1 million would be recognized in the income statement.

The journal entry recorded on the acquisition would be as follows (in millions):

Dr. Identifiable net assets	\$220	
Cr. Cash		\$150
Cr. Gain on bargain purchase		\$1 ²
Cr. NCI ¹		\$69

¹ See BCG 5.3.4 and FV 7.3.5 for a discussion of how to determine the fair value of NCI.

² Gain recognized on bargain purchase: fair value of the identifiable net assets less (fair value of consideration transferred and the fair value of the NCI) (\$220 – (\$150 + \$69))

Because the NCI is required to be recorded at fair value, a bargain purchase gain is recognized only for \$1 million. The NCI is recognized at fair value, which includes embedded goodwill of \$3 million: Fair value of NCI – NCI's share of identifiable net assets ($\$69 - (\$220 \times 30\%) = \$3$). Although the NCI value includes embedded \$3 million of goodwill, the consolidated financial statements do not contain a separate goodwill line item. Consistent with the guidance on bargain purchases in BCG 2.6.2, when a bargain purchase gain is recognized in a business combination (regardless of whether or not there is NCI), no goodwill is recognized.

5.3.7 *Multiple transactions that result in gaining control*

Sometimes a company gains control of a business as a result of two or more transactions (e.g., purchase of 40% of a business and a second purchase of 20% of the business shortly thereafter). The same principles discussed in BCG 5.5.4 for a loss of control may be applied for gaining control of a business in multiple transactions. Companies may consider the factors included in BCG 5.5.4 to assess whether a series of transactions that results in gaining control should be considered as a single transaction.

5.4 *Changes in ownership interest without loss of control*

Changes in a parent's ownership interest that do not result in a change in control of the subsidiary that is a business are accounted for as equity transactions (i.e., no gain or loss is recognized in earnings) and are accounted for in accordance with ASC 810-10-45-22 through ASC 810-10-45-24. The carrying amount of the NCI will be adjusted to reflect the change in the NCI's ownership interest in the subsidiary. Any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid or received is recognized in equity/APIC and attributed to the equity holders of the parent in accordance with ASC 810-10-45-23. See TX 10.9 for information on recording the tax effects of transactions with noncontrolling shareholders.

The scope of the guidance for changes in a parent's ownership interest in a subsidiary is set forth in ASC 810-10-45-21A.

ASC 810-10-45-21A

The guidance in paragraphs 810-10-45-22 through 45-24 applies to the following:

- a. Transactions that result in an increase in ownership of a subsidiary
- b. Transactions that result in a decrease in ownership of either of the following while the parent retains a controlling financial interest in the subsidiary:
 1. A subsidiary that is a business or a nonprofit activity, except for either of the following:
 - i. Subparagraph superseded by Accounting Standards Update No. 2017-05
 - ii. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360).
 - iii. A transfer of a good or service in a contract with a customer within the scope of Topic 606.

2. A subsidiary that is not a business or a nonprofit activity if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
 - i. Topic 606 on revenue from contracts with customers
 - ii. Topic 845 on exchanges of nonmonetary assets
 - iii. Topic 860 on transferring and servicing financial assets
 - iv. Topic 932 on conveyances of mineral rights and related transactions
 - v. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

A subsidiary may issue shares to a third party, thereby diluting the controlling interest's ownership percentage. The issuance of additional instruments of the subsidiary, such as preferred shares, warrants, puts, calls, and options, may also dilute the controlling interest's ownership percentage when issued or exercised. If this dilution does not result in a change in control, it is accounted for as an equity transaction.

Similarly, the ownership interest of a parent may increase when it purchases additional shares of a subsidiary from a third party or if a subsidiary reacquires some of its own shares, thereby increasing the parent's proportionate ownership interest in the subsidiary. If the additional interest does not result in a change in control, the transaction is accounted for as an equity transaction. However, the reporting entity should also consider the guidance in ASC 505-30, *Treasury Stock*, and FG 9.3.4 on multiple element treasury stock transactions if the purchase price of the shares is greater than fair value.

Example BCG 5-5, Example BCG 5-6, and Example BCG 5-7 demonstrate changes in ownership interest when control of a business does not change.

EXAMPLE BCG 5-5

Acquisition of additional shares – control of business before and after transaction (i.e., no loss of control)

Company A previously acquired Company B by purchasing 60% of its equity for \$300 million in cash. The journal entry to record the transaction was as follows:

Dr. Identifiable net assets	\$370	
Dr. Goodwill	\$130	
Cr. Cash		\$300
Cr. NCI		\$200

Two years after the business combination, Company A purchases the outstanding 40% interest from the subsidiary's noncontrolling shareholders for \$300 million in cash. The carrying value of the 40% NCI is \$260 million (original value of \$200 million, plus \$60 million, assumed to be allocated to the

NCI over the past two years for its share in the income of the subsidiary and its share of accumulated other comprehensive income).

How should Company A account for the change in ownership interest?

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged and any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid is recognized directly in equity/APIC and attributed to the controlling interest in accordance with ASC 810-10-45-23.

The journal entry recorded for the 40% interest acquired would be as follows (in millions):

Dr. NCI	\$260 ¹	
Dr. Equity/APIC	\$40 ²	
Cr. Cash		\$300

¹ Elimination of the carrying value of the 40% NCI on Company A's books.

² Fair value of the consideration paid less the carrying value of NCI (\$300 – \$260)

EXAMPLE BCG 5-6

Sale of shares in a business but control is maintained (i.e., no loss of control)

Company A previously acquired Company B, a wholly-owned subsidiary. Company A sells a 20% interest in the subsidiary to outside investors for \$200 million in cash. Company A maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is \$600 million, including goodwill of \$130 million from the initial acquisition of the subsidiary.

How should Company A account for the change in ownership interest?

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged and any difference between the amount by which the NCI is recorded, and the fair value of the consideration received, is recognized directly in equity and attributed to the controlling interest in accordance with ASC 810-10-45-23. NCI is recognized at fair value only at the date of the business combination. For subsequent changes in ownership interest that do not result in a change of control, the change in the NCI is recorded at its proportionate interest of the carrying value of the subsidiary.

The journal entry recorded on the disposition date for the 20% interest sold would be as follows (in millions):

Dr. Cash	\$200	
Cr. NCI		\$120 ¹
Cr. Equity/APIIC		\$80 ²

¹ Recognition of the 20% NCI at its proportionate interest in the carrying value of the subsidiary ($\$600 \times 20\%$)

² Fair value of the consideration received less the carrying value of the NCI ($\$200 - (\$600 \times 20\%)$)

EXAMPLE BCG 5-7

Sale of additional shares by subsidiary which dilutes controlling interest's ownership percentage, but control is maintained

On December 31, 20X1, Company A owns 90 shares (90%) of Subsidiary Z. On January 1, 20X2, Subsidiary Z sells an additional 20 shares to Company C (an unrelated party) for \$200 million in cash.

Assume the following facts on December 31 and January 1 (\$ in millions):

	December 31 (pre-sale)	January 1 (post-sale)
Total shares outstanding— subsidiary Z	100 shares	120 shares
Company A's ownership percentage in subsidiary Z	90% ¹	75% ²
Company A's basis in subsidiary Z	\$370 ³	\$458 ⁴
Subsidiary Z's net equity	\$411	\$611

¹ 90 shares divided by 100 shares outstanding

² 90 shares divided by 120 shares outstanding

³ Subsidiary Z's net equity \times 90%

⁴ Subsidiary Z's net equity \times 75%

For purposes of this example, it is assumed that there is no basis difference between Company A's investment in Subsidiary Z and Subsidiary Z's net equity.

How should Company A account for the change in ownership interest?

Analysis

Company A's ownership percentage of Subsidiary Z has been diluted from 90% to 75%. This is a change in Company A's ownership interest that does not result in a change of control and, therefore, is considered an equity transaction. Any difference between the amount by which the carrying value of Company A's basis in Subsidiary Z would be adjusted and the fair value of the consideration received is

recognized directly in equity and attributed to the controlling interest in accordance with ASC 810-10-45-23.

In its consolidated accounts, Company A would record the following journal entry (in millions):

Dr. Cash	\$200	
Cr. Equity/APIC		\$88 ¹
Cr. NCI		\$112 ²

¹ Company A's share of the fair value of the consideration received ($\$200 \times 75\%$) less the change in Company A's basis in Subsidiary Z ($\$411 \times (90\% - 75\%)$)

² The change in the recorded amount of NCI represents:

NCI's share of the fair value of the consideration received ($\$200 \times 25\%$)	\$50
Change in NCI's basis in Subsidiary Z ($\$411 \times 15\%$)	\$62
	<hr/>
Additional NCI recorded	\$112
	<hr/>

5.4.1 Equity-classified freestanding written call options

Equity-classified freestanding written call options may be issued on the subsidiary's shares. The accounting differs depending on whether the shares are issued by the parent or the subsidiary.

5.4.1.1 Equity-classified freestanding written call option on subsidiary's shares issued by parent

A freestanding written call option on a subsidiary's shares (that is a business) issued by a parent that qualifies for equity classification should be accounted for by the parent as noncontrolling interest for the amount of consideration received for the written call option. However, during the period the option is outstanding, the option holder should not be attributed any profit or loss of the subsidiary. The noncontrolling interest remains in existence until the option expires. See FG 5.6 for additional guidance on the accounting for freestanding equity-linked instruments after adoption of ASU 2020-06 (or FG 5.6A for additional guidance on the accounting for freestanding equity-linked instruments prior to adoption of ASU 2020-06).

If the option is exercised and the parent retains control of the subsidiary, the change in the parent's ownership interest should be accounted for as an equity transaction in accordance with ASC 810-10-45-23. Upon exercise, the newly issued shares should be reported as noncontrolling interest equal to the noncontrolling interest holder's proportionate share of the parent's basis in the subsidiary's equity. Conversely, if the option expires, the carrying amount of the written option should be reclassified from noncontrolling interest to the equity of the controlling interest in accordance with ASC 810-10-45-17A.

Example BCG 5-8 illustrates the accounting for an equity-classified freestanding written call option on a subsidiary's shares (that is a business) issued by a parent.

EXAMPLE BCG 5-8

Accounting for a freestanding written call option on a subsidiary's shares (that is a business) issued by a parent

Company A issues a warrant (written call option) to purchase 10% of wholly-owned Subsidiary's shares with an exercise price of \$150 to Investor B for \$60. Before and after Investor B's exercise of the warrant, Company A's carrying amount in Subsidiary, including goodwill, is \$1,000. There are no basis differences between Company A's investment in Subsidiary and Subsidiary's equity. There is no other existing noncontrolling interest.

How should Company A account for the freestanding written call option?

Analysis

In consolidation, Company A would record the following journal entries:

To record the issuance of the warrant

Dr. Cash	\$60	
Cr. Noncontrolling interest		\$60

To record the exercise of the warrant

Dr. Cash	\$150	
Cr. Noncontrolling interest		\$40 ¹
Cr. APIC		\$110 ²

¹ Company A's basis in Subsidiary's equity after exercise of warrant	\$1,000
Investor B's ownership percentage	x 10%
	<hr/>
Noncontrolling interest after exercise	100
Less: Noncontrolling interest prior to exercise	(60)
	<hr/>
Increase in noncontrolling interest	\$40
	<hr/>
² Warrant consideration received by Company A	\$60
Plus: Exercise price	150
	<hr/>
Total consideration received by Company A	210
Less: 10% of Company A's basis in Subsidiary's equity	(100)
	<hr/>
Change in Company A's APIC	\$110
	<hr/>

If the warrant was not exercised but expires, Company A would record the following entry to reclassify the premium received for the warrant in accordance with ASC 810-10-45-17A:

To account for the expiration of the warrant

Dr. Noncontrolling interest	\$60	
Cr. APIC		\$60

5.4.1.2 ***Equity-classified freestanding written call option on subsidiary's shares issued by subsidiary***

A freestanding written call option on a subsidiary's shares issued by the subsidiary that qualifies for equity classification should also be accounted for by the parent as noncontrolling interest for the amount of consideration received for the written call option. During the period the option is outstanding, the option holder should not be attributed any profit or loss of the subsidiary. The noncontrolling interest remains in existence until the option expires.

If the option is exercised and the parent maintains control of the subsidiary, the change in the parent's ownership interest should be accounted for as an equity transaction. Upon exercise, the newly issued shares should be reported as noncontrolling interest equal to the noncontrolling interest holder's proportionate share of the parent's investment in the subsidiary's equity. Conversely, if the option expires, the parent should record a reduction in the noncontrolling interest for the parent's proportionate share of the carrying amount of the written option in accordance with ASC 810-10-45-17A.

Example BCG 5-9 illustrates the accounting for an equity-classified freestanding written call option on a subsidiary's shares (that is a business) issued by a subsidiary.

EXAMPLE BCG 5-9

Accounting for a freestanding written call option on a subsidiary's shares (that is a business) issued by a subsidiary

Subsidiary, which is wholly-owned and controlled by Company A, issues a warrant (written call option) to purchase 10% of Subsidiary's shares with an exercise price of \$150 to Investor B for \$60. After Investor B's exercise of the warrant, Subsidiary's equity, including goodwill, is \$1,210 (\$1,000 of net assets plus \$60 of cash received for issuance of the warrant and \$150 received for the exercise price). There are no basis differences between Company A's investment and Subsidiary's equity. There is no other existing noncontrolling interest.

How should Company A account for the freestanding written call option?

Analysis

In consolidation, Company A would record the following journal entries:

To record the issuance of the warrant

Dr. Cash	\$60	
Cr. Noncontrolling interest		\$60

To record the exercise of the warrant

Dr. Cash	\$150	
Cr. Noncontrolling interest		\$61 ¹
Cr. APIC		\$89 ²

¹ Company A's basis in Subsidiary's equity after exercise of warrant	\$1,210
Investor B's ownership percentage	x 10%
Noncontrolling interest after exercise	121
Less: Noncontrolling interest prior to exercise	(60)
Increase in noncontrolling interest	<u>\$61</u>

² Subsidiary's carrying amount of net assets after exercise	\$1,210
Company A's ownership percentage after exercise	x 90%
Company A's ownership in Subsidiary's net assets after exercise	1,089
Company A's ownership investment in Subsidiary before exercise	(1,000)
Change in Company A's ownership interest	<u>\$89</u>

If the warrant was not exercised but expires, Company A would record the following entry to reclassify the premium received for the warrant in accordance with ASC 810-10-45-17A.

To account for the expiration of the warrant

Dr. Noncontrolling interest	\$60	
Cr. APIC		\$60

Note that the change in interest calculation may be more complex if there is an existing noncontrolling interest prior to the issuance of the option, or if there is a basis difference between the parent's investment in the subsidiary and the equity in the subsidiary's separate financial statements.

5.4.2 *Accounting for employee stock option issued by a subsidiary*

An employee stock option issued by the subsidiary may be accounted for by the parent based on the grant date fair value of the option and recognized as NCI as the option vests. However, during the period the option is outstanding, no profit or loss of the subsidiary should be attributed to the NCI related to the option. This is because even though a portion of the profit or loss is compensation expense related to the NCI, until the option is exercised, the NCI related to the option is not an actual equity interest in the entity.

When the option is exercised, an adjustment should be made to NCI to reflect the proportionate share of the subsidiary's equity, with a corresponding adjustment to APIC. Subsequent to exercise, a proportionate share of the profit or loss of the subsidiary business would be attributed to NCI. If the option vests but subsequently expires without exercise, the parent would record a reduction in the NCI and an increase to APIC for the amount previously recognized for the value of the award in accordance with ASC 810-10-45-23. See Example BCG 5-9 in BCG 5.4.1 for an illustration of the relevant journal entries, except that cash, rather than employee services, is received in Example BCG 5-9. When services are received as consideration, instead of a debit to cash and immediate recognition of NCI, the grant date fair value of the award would be recorded as compensation cost over the requisite service period, with a corresponding credit to NCI.

An alternative approach would be for the parent to recognize the employee stock option as a credit to APIC as the option vests. When the option is exercised, the newly issued shares would be reported as NCI at an amount equal to the proportionate share of the subsidiary's equity with a corresponding offset to APIC.

5.4.3 *NCI exchanged for controlling interest in another entity*

If an entity issues a noncontrolling interest in its wholly-owned subsidiary that is a business in exchange for an interest in an unrelated entity and the interest obtained in the unrelated entity is a controlling interest, the transaction is accounted for as a business combination. The acquirer would record the assets acquired and liabilities assumed of the acquired entity in accordance with ASC 805-20-25-1. As part of the business combination, the acquirer would also measure the noncontrolling interest issued to the seller of the unrelated entity, which represents the consideration issued in the business combination, at its fair value.

As discussed in BCG 5.4, changes in ownership interests in a business that do not result in loss of control should be accounted for as equity transactions. Therefore, when an entity sells/exchanges a noncontrolling interest in its wholly-owned subsidiary, it creates a noncontrolling interest in that subsidiary which should be accounted for as an equity transaction. The noncontrolling interest would be reflected at the noncontrolling interest's proportionate share of the net equity of the subsidiary, and no gain or loss would be recognized by the entity that relinquished the noncontrolling interest in its subsidiary. The acquirer's controlling interest in its existing subsidiary may need to be adjusted to reflect the change in ownership interest in the subsidiary, with a corresponding adjustment to APIC.

The noncontrolling interest in the acquirer's consolidated financial statements would comprise the sum of the noncontrolling interest's share of the fair value in the acquired business and the noncontrolling interest's share in the proportionate interest of the net equity of the subsidiary exchanged in the transaction.

Example BCG 5-10 illustrates the accounting for a transaction in which NCI in a subsidiary that is a business is exchanged for a controlling interest in another entity.

EXAMPLE BCG 5-10

Accounting for a transaction in which NCI in a subsidiary that is a business is exchanged for a controlling interest in another entity

Company A enters into a venture with Company X where each company will contribute a subsidiary, each representing a business, into a NewCo in a series of planned and integrated transactions. Company A forms the NewCo and transfers an existing subsidiary (Subsidiary A) into the NewCo. NewCo then issues 46% of its common shares to Company X in return for 100% of Company X's subsidiary (Target). Company A maintains control of the NewCo with an ownership interest of 54%, and Company X owns 46%. Economically, this transaction is an exchange of 46% of Company A's interest in Subsidiary A for a 54% controlling interest in Target.

Fair and book values for Target and Subsidiary A are as follows:

Target fair value	\$690
Subsidiary A net equity	\$300
Subsidiary A fair value	\$810

How should Company A account for the transaction?

Analysis

Company A's interest in NewCo would be equal to the sum of (1) 54% of its historical cost of Subsidiary A plus (2) 54% of the fair value of Target (which is equal to 46% of the fair value of Subsidiary A's business). Company A's retained interest in Subsidiary A's business is recorded at carryover basis. In Company A's consolidated financial statements, all of the assets and liabilities of Target would be recorded and measured in accordance with ASC 805. The noncontrolling interest of NewCo is the combination of the fair value of the noncontrolling interest in Target and the noncontrolling interest in the net equity of Subsidiary A's business.

Company A would record net assets acquired of \$690 (100% of Target's fair value) and noncontrolling interest of \$455 (46% of Target's fair value of \$690 plus 46% of the net equity of Subsidiary A of \$300).

Company A would record the following journal entry to account for the acquisition:

Dr. Target net assets acquired	\$690	
Cr. Noncontrolling interest		\$455
Cr. APIC—controlling interest		\$235 ¹

¹ The change in ownership interest is calculated in accordance with ASC 810-10-45-23 as follows:

NewCo equity before acquisition of Target	\$300
NewCo equity issued to acquire Target	690
	<hr/>
Total NewCo equity after acquisition of Target	\$990
Company A's ownership interest in NewCo after acquisition of Target	× 54%
	<hr/>
Company A's investment in NewCo after acquisition of Target	\$535
Company A's investment in NewCo before acquisition of Target	(300)
	<hr/>
Change in Company A's ownership interest in NewCo	\$235
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5.4.4 ***AOCI considerations (changes in ownership interest)—updated September 2023***

Comprehensive income or loss is allocated to the controlling interest and the NCI each reporting period. Upon a change in a parent's ownership interest without a change in control, the carrying amount of accumulated other comprehensive income (AOCI) is adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity (e.g., APIC) attributable to the parent in accordance with ASC 810-10-45-24. AOCI is reallocated proportionately between the controlling interest and the NCI. See Example 1, Case C: Change if Entity Has Accumulated Other Comprehensive Income, in ASC 810-10-55-4F for additional information.

Changes in ownership interest that do not result in a change of control should be accounted for as equity transactions. Example BCG 5-11 demonstrates the accounting for a reallocation of accumulated other comprehensive income upon a change in ownership that does not result in a change of control.

EXAMPLE BCG 5-11

Reallocation of accumulated other comprehensive income

Company A owns 80% of a subsidiary that is a business which has net assets of \$250 million and AOCI with a credit balance of \$20 million. The carrying value of the 20% NCI is \$50 million, which includes \$4 million of its proportionate share of AOCI.

Company A acquires an additional 10% of the subsidiary (i.e., 50% of the existing NCI) for \$35 million in cash.

How should Company A account for the acquisition of the additional 10% interest?

Analysis

A change in ownership interests of a business that does not result in a change of control is considered an equity transaction.

The identifiable net assets remain unchanged, and any difference between the amount by which the NCI is adjusted (\$50 million × 50% = \$25 million) and the fair value of the consideration paid (\$35

million) is recognized directly in equity and attributed to the controlling interest per ASC 810-10-45-23.

The AOCI balance is also adjusted to reflect the change in the parent's ownership interest through a corresponding adjustment to equity/APIC per ASC 810-10-45-24.

As a result of this acquisition, Company A's interest in its subsidiary's AOCI balance increases by \$2 million (\$4 million x 50%).

The journal entry to record the acquisition of the 10% interest, including reallocating the AOCI previously attributable to the NCI holder to Company A, would be as follows (in millions):

Dr. NCI	\$25 ¹	
Dr. Equity/APIC	\$12 ⁴	
Cr. Cash		\$35 ²
Cr. AOCI		\$2 ³

¹ Elimination of the carrying value of the 10% of NCI acquired ($\$50 \times 50\%$).

² Consideration paid.

³ Reallocation of the AOCI previously attributable to the NCI holder to Company A ($\$4 \times 50\%$).

⁴ Adjustment to equity/APIC = Consideration paid (\$35) less the change in the carrying value of NCI (\$25), plus the reallocation of AOCI (\$2) = $\$35 - \$25 + \$2 = \12 .

5.4.5 ***AOCI: disposal of business in consolidated foreign entity***

A parent may sell a group of assets that constitute a business within a consolidated foreign entity while retaining ownership of the foreign entity. Alternatively, the group of assets may be sold directly by the foreign entity.

ASC 830-30 provides for the release of the cumulative translation adjustment (CTA) into earnings upon sale or upon complete or substantially complete liquidation of an investment in an entire foreign entity. ASC 810-10 requires a parent to deconsolidate a subsidiary, or derecognize a group of assets that is a business, including CTA, as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. ASC 810-10-40-4A clarifies that a parent should follow the guidance in ASC 830-30 and release CTA to earnings only when a disposal of a subsidiary or group of assets that constitutes a business within the foreign entity represents a complete or substantially complete liquidation of the foreign entity. The determination of what constitutes a foreign entity is based on the definition found in ASC 830. See FX 1.1 for additional information.

Example BCG 5-12 demonstrates the accounting for CTA in a foreign entity under ASC 830-30 and ASC 810-10 when a group of assets which qualifies as a business is disposed.

EXAMPLE BCG 5-12**Disposal of a foreign entity—release of CTA in a foreign entity into earnings**

Company A owns 100% of two branches (X and Y). Branch X and branch Y are individual businesses with different functional currencies and are reported to Company A separately and translated directly into Company A's group consolidation. For this example, branch X is considered a distinct and separable foreign entity (see FX 2 for further information).

Company A's carrying amount of branch X is \$20 exclusive of a credit balance of \$2 for CTA related to branch X. Company A disposes of branch X for \$24 in cash, which is remitted to Company A.

How should Company A account for the disposal of foreign entity branch X?

Analysis

Under ASC 360-10-40-5, a gain is recognized on the disposal of a business for the amount received that is greater than the carrying amount of the business. Under ASC 830-30 and ASC 810-10, as the disposal of the business represents a complete liquidation of the foreign entity, CTA should be released into earnings.

Company A's journal entry to record the disposal of branch X would be as follows (in millions):

Dr. Cash	\$24	
Dr. Accumulated other comprehensive income	\$2 ¹	
Cr. Disposal group of assets		\$20 ²
Cr. Gain on disposal of net assets		\$6 ³

¹ CTA attributable to branch X

² Carrying amount of disposal group of assets that constitutes a business, exclusive of CTA

³ Sum of the gain on disposal of the group assets ($\$24 - \$20 = \$4$) and the portion of CTA released into earnings ($\$2$).

If branch X and branch Y had the same functional currency and were considered a single foreign entity based on ASC 830-30, the disposal of the business would not represent a complete or substantially complete liquidation of the foreign entity (assuming each branch is approximately the same size). As such, no CTA would be released into earnings.

If a parent sells a noncontrolling interest in a foreign subsidiary that does not result in a loss of control, the transaction would not constitute a complete or substantially complete liquidation of an investment in an entire foreign entity. Therefore, the parent would not release any related CTA to earnings. However, AOCI would be reallocated proportionately between the controlling interest and the NCI, as described in BCG 5.4.4.

5.4.6 Acquisition of an NCI through a business combination

A change in a parent's ownership interest in an entity that is a business where control is maintained is accounted for as an equity transaction in accordance with ASC 810-10-45-23. When an additional noncontrolling interest is obtained indirectly through the acquisition of a controlling interest in

another entity, which owns the noncontrolling interest, the transaction should be accounted for as two separate transactions.

Example BCG 5-13 demonstrates the accounting for the acquisition of a controlling interest in an entity and indirectly obtaining an additional interest in a controlled entity.

EXAMPLE BCG 5-13

Acquisition of additional noncontrolling interest in a business through a business combination

Company A owns a 90% controlling interest in Subsidiary B that is a business. Company C holds the 10% noncontrolling interest with a carrying value of \$70 million in Company A's consolidated financial statements and a fair value of \$100 million. Company A acquires Company C in a business combination for \$1,000 million, which includes the indirect acquisition of the noncontrolling interest in Subsidiary B for \$100 million.

How should Company A account for the acquisition of additional noncontrolling interest?

Analysis

The accounting for the acquisition of Company C and the acquisition of the noncontrolling interest in Subsidiary B should be treated as separate transactions. The consideration transferred would be allocated between the business acquired and the purchase of the noncontrolling interest based on their fair values. The fair value of the consideration transferred would be allocated to the fair value of the acquired business of \$900 million and the fair value of the noncontrolling interest in Subsidiary B of \$100 million.

Through this transaction, Company A obtained an additional interest in and maintained control of Subsidiary B. A change in ownership interest that does not result in a change of control is considered an equity transaction. The identifiable net assets of Subsidiary B remain unchanged and the \$30 million excess amount paid over the carrying amount of the noncontrolling interest in Subsidiary B in Company A's financial statements would be recorded in equity in accordance with ASC 810-10-45-23.

Company A would also recognize and measure the other identifiable assets acquired and liabilities assumed of Company C at the acquisition date, generally at fair value. In this example, it is assumed that there is no excess between the net value of the assets and liabilities acquired and the consideration paid that would need to be recorded as goodwill or shortfall that would be recorded as a bargain purchase gain.

Company A would record the following journal entry to account for the transaction (in millions):

Dr. Identifiable net assets of Company C	\$900	
Dr. Noncontrolling interest of Subsidiary B	\$70 ¹	
Dr. Equity/APIC	\$30 ²	
Cr. Cash		\$1,000

¹ Elimination of the carrying value of the 10% NCI on Company A's books

² Consideration paid for the NCI less the carrying value of NCI (\$100 – \$70)

5.4.7 Changes in ownership interest in a VIE

After initial measurement, the assets, liabilities, and the NCI of a consolidated VIE will be accounted for in the consolidated financial statements as if the entity were consolidated based on voting interests in accordance with ASC 810-10-35-3. A primary beneficiary's acquisition or disposal of additional ownership interests in the VIE (while remaining the primary beneficiary) is accounted for in the same manner as the acquisition or disposal of additional ownership interests (where control is maintained) in a voting interest entity. Therefore, subsequent acquisitions or sales of additional ownership interests by the primary beneficiary that do not result in a change in the primary beneficiary are accounted for as equity transactions.

A primary beneficiary's acquisition or disposal of additional ownership interests is a reconsideration event that requires a reassessment of whether the entity is a VIE and whether the party designated as the primary beneficiary has changed because the accounting as described above is applicable only if the primary beneficiary remains the same (i.e., control is maintained). See CG 4.8 for further discussion of VIE reconsideration events.

The carrying amount of the NCI is adjusted to reflect the primary beneficiary's change in interest in the VIE's net assets. Any difference between the amount by which the NCI is adjusted and the fair value of the consideration transferred is recognized in equity (APIC) and attributed to the equity holders of the primary beneficiary.

5.4.8 Acquisition of additional NCI with contingent consideration

In certain situations, the acquisition of additional ownership interests by a parent may involve contingent consideration payable to the selling (noncontrolling) shareholders. ASC 810-10-45-23 does not address the recognition and measurement of contingent consideration arrangements in a transaction when control is maintained. As such, the parent should consider other guidance to determine how to recognize and measure such contingent consideration arrangements.

First, the contingent consideration arrangement should be assessed to determine whether it should be accounted for as a derivative under ASC 815, *Derivatives and Hedging*, or as compensation under ASC 710, *Compensation – General*. See BCG 2.6.4 for additional information in evaluating whether contingent consideration arrangements should be accounted for as a derivative or compensation.

Diversity in practice exists for both the initial recognition and subsequent measurement for contingent consideration arrangements not accounted for as a derivative or compensation. We believe the parent may make an accounting policy election for both the initial recognition and subsequent measurement of the contingent consideration arrangement by analogy to other guidance. Acceptable methods include:

- Analogize to ASC 805-30, or the business combinations model, with the contingent consideration recognized at fair value within equity as of the acquisition date. Under this model, subsequent changes in the fair value of contingent consideration recognized may be either (1) recorded through earnings each reporting period until settlement based on the guidance in ASC 805-30, or (2) reflected directly within equity based on the guidance in ASC 810-10-45-23.
- Analogize to the model applied for asset acquisitions, with the amount of contingent consideration recognized in equity when probable and reasonably estimable or when the contingency is resolved and payable. Under this model, subsequent changes in contingent consideration should be

recognized directly in equity based on the guidance in ASC 810-10-45-23. See PPE 2.3.3 for additional information.

Once an accounting policy is elected, the parent should apply this accounting policy on a consistent basis to similar transactions.

5.4.9 *Transaction costs associated with purchase or sale of NCI*

Transaction costs associated with the purchase or sale of a noncontrolling interest in a subsidiary when control is maintained are treated similar to those incurred in a treasury stock or capital raising transaction; they are accounted for as an equity transaction in accordance with ASC 810-10-45-23. When an entity reacquires its own equity instruments, consideration paid is recognized in equity and transaction costs are accounted for as a deduction from equity under ASC 505-30-30-7. Additionally, incremental and directly attributable costs to issue equity instruments are accounted for as a deduction from equity under ASC 340-10-S99-1. Other transaction costs (e.g., general and administrative costs) should be expensed as incurred.

We understand that the SEC has allowed companies to elect an accounting policy to record all transaction costs as an expense in the statement of operations by analogy to the treatment of transaction costs in a business combination.

5.5 *Changes in interest resulting in a loss of control*

The loss of control of a subsidiary that is a business, other than in a nonreciprocal transfer to owners, results in the recognition of a gain or loss on the sale of the interest sold and on the revaluation of any retained noncontrolling investment. A loss of control is an economic event, similar to that of gaining control, and therefore is a remeasurement event.

The scope of the guidance for changes in a parent's ownership interest in a subsidiary that result in loss of control is set forth in ASC 810-10-40-3A.

ASC 810-10-40-3A

The deconsolidation and derecognition guidance in this Section 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 No. 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 Subtopic 932-360)
 3. A transfer of a good or service in a contract with a customer within the scope of 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 No. 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 Subtopic 932-360)

3. A transfer of a good or service in a contract with a customer within the scope of 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 Topics that include, but are not limited to, all of the following:
1. Topic 606 on revenue from contracts with customers
 2. Topic 845 on exchanges of nonmonetary assets
 3. Topic 860 on transferring and servicing financial assets
 4. Topic 932 on conveyances of mineral rights and related transactions
 5. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

In accordance with ASC 810-10-55-4A, events resulting in deconsolidation of a subsidiary that is a business include the following:

- A parent sells all or part of its ownership interest in its subsidiary, thereby losing its controlling financial interest in its subsidiary
- A contractual agreement that gave control of the subsidiary to the parent expires
- The subsidiary issues shares, thereby reducing the parent's ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary
- The subsidiary becomes subject to the control of a government, court, administrator, or regulator

For example, once a subsidiary files for bankruptcy protection, a parent no longer has control over the subsidiary (as the bankruptcy court must approve all significant actions). The parent should deconsolidate the subsidiary on that date. The parent company should also determine the gain or loss to recognize on the date of the bankruptcy filing. See BLG 3.18 for further information.

5.5.1 Accounting for changes in interest if control is lost

If a parent loses control of a subsidiary that is a business through means other than a nonreciprocal transfer to owners, it must:

- derecognize the assets (including an appropriate allocation of goodwill) and liabilities of the subsidiary at their carrying amounts at the date control is lost,
- derecognize the carrying amount of any NCI at the date control is lost (including any components of accumulated other comprehensive income attributable to it),
- recognize the fair value of the proceeds from the transaction, event, or circumstances that resulted in the loss of control,
- recognize any noncontrolling investment retained in the former subsidiary at its fair value at the date control is lost,

- reclassify to income the amounts recognized in other comprehensive income in relation to that subsidiary, and
- recognize any resulting difference as a gain or loss in income attributable to the parent.

The gain or loss is calculated as the difference between (a) and (b):

- a. The aggregate of:
 - the fair value of the consideration received,
 - the fair value of any retained noncontrolling investment in the former subsidiary on the date the subsidiary is deconsolidated, and
 - the carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income or loss attributable to the NCI) on the date the subsidiary is deconsolidated.
- b. The carrying amount of the former subsidiary's net assets

The calculation outlined above, as described in ASC 810-10-40-5, results in an amount that includes the gain or loss for both the interest sold and the noncontrolling investment retained. However, a parent is required to separately disclose the total gain or loss and the portion of the gain or loss related to the retained noncontrolling investment in accordance with ASC 810-10-50-1B. To obtain the information necessary for disclosure, a second calculation of the portion related to the gain or loss on the retained noncontrolling investment is necessary. See Example BCG 5-14 and Example BCG 5-15 for an illustration of the calculation of the gain or loss on the retained noncontrolling interest.

It is also important to identify any gains or losses deferred in accumulated other comprehensive income attributable to the subsidiary. The cumulative amount deferred in other comprehensive income related to that subsidiary is considered part of the carrying amount of the subsidiary and is included in determining the gain or loss on the interest sold and the retained noncontrolling investment in accordance with ASC 810-10-40-4A. This includes the parent's and the NCI's share of gains or losses previously recognized in other comprehensive income.

Amounts recognized in equity (outside of accumulated other comprehensive income) related to changes in ownership interests that did not result in a change in control should not be included in determining the gain or loss on the interest sold and the retained noncontrolling investment. These amounts resulted from transactions among shareholders and are not directly attributable to the NCI.

The effect of applying the steps above when a subsidiary that is a business is partially owned prior to the loss of control is that the noncontrolling interests held by third parties are not revalued to fair value. As part of the deconsolidation of the subsidiary, the carrying value of the NCI's portion of the subsidiary's net assets is derecognized against the carrying amount of the NCI, with no gain or loss.

A subsidiary to be deconsolidated may have redeemable NCI that the reporting entity accounted for as mezzanine equity in accordance with the guidance described in BCG 6.2.1.4 and FG 7.4.3.2. If accretion of that mezzanine NCI was required, the accretion would have been reflected in equity and would not have impacted net income. Accordingly, the carrying amount of the NCI used for purposes of determining the gain or loss on deconsolidation should not include those accretion adjustments.

Rather, previously recorded accretion adjustments to the carrying amount of the NCI should be reversed prior to calculating the gain or loss on disposition by recording a credit to equity of the parent.

Typically, impairment tests for goodwill and long-lived assets (asset group) are needed when a parent expects that it will sell or lose control of a subsidiary. If the goodwill or long-lived asset group is impaired, the impairment loss should be recognized in earnings in accordance with ASC 350-20 and ASC 360-10-35, respectively.

Upon deconsolidation, the reporting entity should assess whether the deconsolidated subsidiary meets the criteria for discontinued operations and consider the applicability of the presentation and disclosure requirements for discontinued operations in accordance with ASC 205-20. See FSP 27 for additional information on discontinued operations.

Example BCG 5-14 and Example BCG 5-15 demonstrate the accounting for a change in interest when control is lost, assuming the transactions do not involve nonreciprocal transfers to owners.

EXAMPLE BCG 5-14

Accounting for changes in interest of a wholly-owned subsidiary that is a business if control is lost

Company A owns 100% of a subsidiary that is a business. Company A disposes of 60% of its interest in the subsidiary for \$360 million and loses control of the subsidiary. At the disposal date, the fair value of the retained noncontrolling investment is determined to be \$240 million. The carrying value of the identifiable net assets is \$500 million, including \$60 million of goodwill recorded from when the subsidiary was previously acquired. (For illustrative purposes, the tax consequences on the gain have been ignored.)

How should Company A account for the change in interest?

Analysis

Company A should record the following journal entry on the disposal date to record the 60% interest sold, the gain recognized on the 40% retained noncontrolling investment, and the derecognition of the subsidiary (in millions):

Dr. Cash	\$360	
Dr. Equity-method investment	\$240 ¹	
Cr. Net assets		\$500 ²
Cr. Gain on investment		\$100 ³

- ¹ Fair value of the 40% retained noncontrolling investment is recognized
- ² Deconsolidation of the subsidiary and removal of 100% of carrying value of the subsidiary's net assets, including an appropriately allocated portion of previously recorded goodwill (\$440 net assets excluding goodwill + \$60 goodwill)
- ³ Gain or loss on the interest sold and the retained noncontrolling investment is recognized in earnings, calculated as follows:

Fair value of consideration	\$360
Fair value of retained noncontrolling investment	240
Carrying value of NCI	n/a
	600
	600
Less: carrying value of former subsidiary's net assets (\$440 net assets excluding goodwill + \$60 goodwill)	(500)
	\$100
	\$100

The \$100 million gain on the interest sold and the retained noncontrolling investment would be recognized in earnings and disclosed in the financial statements. Additionally, Company A would need to disclose the portion of the gain or loss related to the remeasurement of the retained noncontrolling investment to fair value. This amount is calculated as follows (in millions):

Fair value of retained noncontrolling investment	\$240
Percentage retained of carrying value of subsidiary (((\$440 + \$60) × 40%)	(200)
	\$40
	\$40

EXAMPLE BCG 5-15

Accounting for changes in interest of a partially-owned subsidiary when control is lost

Company B owns 80% of a subsidiary that is a business. Company B disposes of 50% of the subsidiary for \$300 million and loses control of the subsidiary. Company B will deconsolidate the subsidiary and account for the remaining 30% interest as an equity-method investment. At the disposal date, the fair value of the retained noncontrolling investment is determined to be \$180 million. The carrying value of the identifiable net assets is \$440 million and there is no goodwill. The carrying value of the 20% noncontrolling interests held by third parties prior to the transaction is \$88 million. (For illustrative purposes, the tax consequences on the gain have been ignored.)

How should Company B reflect the change in interest?

Analysis

Company B would record the following journal entry on the disposal date to record the 50% interest sold, the gain recognized on the 30% retained noncontrolling investment, and the derecognition of the subsidiary (in millions):

Dr. Cash	\$300	
Dr. Equity-method investment	\$180 ¹	
Dr. NCI	\$88 ²	
Cr. Net assets		\$440
Cr. Gain on investment		\$128 ³

¹ Fair value of the 30% retained noncontrolling investment is recognized

² Derecognition of the carrying value of the NCI

³ Gain or loss on the interest sold and the retained noncontrolling investment is recognized in the income statement, calculated as follows:

Fair value of consideration	\$300
Fair value of retained noncontrolling investment	180
Carrying value of NCI	88
Subtotal	<u>568</u>
Less: carrying value of former subsidiary's net assets	<u>(440)</u>
Gain on interest sold and retained noncontrolling investment	<u>\$128</u>

The \$128 million gain on the interest sold and the retained noncontrolling investment would be recognized in earnings and disclosed in the financial statements. Additionally, Company B would need to disclose the portion of the gain or loss related to the remeasurement of the retained noncontrolling investment to fair value. This amount is calculated as follows (in millions):

Fair value of retained noncontrolling investment	\$180
Percentage retained of carrying value of subsidiary ($\$440 \times 30\%$)	<u>(132)</u>
Gain on retained noncontrolling investment	<u>\$48</u>

Question BCG 5-1

Is there a difference between (1) the gain recognized when an entity sells 100% of a consolidated subsidiary's shares (that is a business) to an equity-method investee and (2) the gain recognized when an entity sells shares of a consolidated subsidiary to an unrelated party but retains an equity interest in the former subsidiary?

PwC response

The two transactions are substantively similar, and the accounting result should be similar. This is best understood by analyzing the following two scenarios. Assume a parent company owns 30% of

Investee A and 100% of Subsidiary B and both entities are businesses. In one scenario, Parent sells 100% of Subsidiary B to Investee A. Investee A pays cash for 100% of Subsidiary B. Parent indirectly retains a 30% interest in Subsidiary B through its equity holding of Investee A. In another scenario, Parent sells 70% of Subsidiary B to an unrelated third party. In the first scenario, one could argue that a gain should be recognized on only the 70% interest in Subsidiary B that was not retained by Parent. However, even though Parent retains its 30% interest in Investee A, which now owns 100% of Subsidiary B, the Parent would recognize a gain or loss on the sale of the 100% interest sold in Subsidiary B, as there has been a change of control. In the second scenario, the Parent would recognize a gain or loss on the sale of the 70% interest sold, and a gain or loss on the remeasurement of the retained 30% noncontrolling investment in Subsidiary B. As a result, under both scenarios, the gain will be recognized upon the deconsolidation of a subsidiary in accordance with the guidance in ASC 810-10. Assuming similar facts and circumstances in the scenarios, an equal gain would result.

5.5.2 *Other interests retained when control is lost*

The retained noncontrolling investment includes the retained equity investment in the subsidiary upon deconsolidation. There may be other interests retained by the investor (parent) in the investee (subsidiary), such as a preferred share investment, debt investment, or other contractual arrangements (e.g., off-market contracts) that may need to be considered by the parent company in determining the amount of gain or loss to be recognized upon deconsolidation of the subsidiary. Example BCG 5-16 illustrates the guidance for determining the amount of gain or loss to be recognized upon the sale of a controlling interest in a subsidiary with an off-market contract.

EXAMPLE BCG 5-16

Determining the amount of gain or loss to be recognized upon the sale of a controlling interest in a subsidiary with an off-market contract

Company A owns 100% of Subsidiary B. Subsidiary B purchases electronic components from Company A under a four-year supply contract at fixed rates. The fixed rates are currently lower than what Subsidiary B would otherwise pay to a third party (i.e., below market rates). Company A sells 60% of its ownership in Subsidiary B to an unrelated third party one year after the commencement of the supply contract. The supply contract remains unchanged after the sale. Company A deconsolidates Subsidiary B on the sale date.

How should Company A determine the gain or loss to be recognized?

Analysis

In determining the amount of gain or loss upon deconsolidation of Subsidiary B, Company A should determine what portion of the consideration received from the buyer relates to compensation for Company A continuing to provide electronic components to its former Subsidiary B under its unfavorable supply contract, versus consideration for the sale of the 60% ownership in Subsidiary B. The amount ascribed to the below market supply contract should be recorded at fair value on the balance sheet. This reduces the consideration attributed to the deconsolidation of Subsidiary B and therefore reduces the gain recognized by Company A.

5.5.3 ***Nonreciprocal transfer to owners***

If a reporting entity loses control of a subsidiary that is a business through a pro rata nonreciprocal transfer to owners (i.e., a pro rata distribution of a business to owners in a spinoff), the guidance in ASC 810-10 for measuring the gain or loss does not apply to the transferred portion. Rather, the transferred portion is accounted for under ASC 845-10-30-10 and ASC 505-60. Under this guidance, the accounting for the distribution of nonmonetary assets to owners of an entity either (1) in a spinoff or other form of reorganization or liquidation or (2) in a plan that is in substance the rescission of a prior business combination is based on the recorded amount of the nonmonetary assets distributed (after reduction for any impairment). The transaction is recorded by the transferor within equity, and no gain or loss is recognized. This guidance is equally applicable to distributions to owners of an entity of a subsidiary or another investee entity that has been or is being consolidated as well as to distributions to shareholders of an investee that is a business that has been or is being accounted for under the equity method.

In some circumstances, the spinnor may not distribute all of the spinnee's shares to its shareholders, but instead retains an equity interest in the spinnee after the spinoff. The spinnor must first analyze whether it still controls the spinnee.

- If the spinnor determines it still controls the spinnee, the spinnor should continue to consolidate the spinnee under ASC 810 after the spinoff and would account for the change in interest as an equity transaction in accordance with ASC 810-10-45-23.
- If the spinnor determines it no longer controls the spinnee, the spinnor should account for the nonmonetary assets distributed to its owners using the guidance in the preceding paragraph. The spinnor's retained equity interest in the spinnee should be accounted for at an amount equal to the spinnor's proportionate share of the carrying amount of the spinnee's net assets. Subsequently, the retained equity interest in the spinnee would be accounted for in accordance with other applicable GAAP (e.g., ASC 323, *Investments – Equity Method and Joint Ventures*).

Other nonreciprocal transfers of nonmonetary assets to owners (e.g., a distribution that is not pro rata or does not represent a business or an equity method investment in a business) may 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. See PPE 6.3.2 and PPE 6.3.3 for additional guidance on a nonreciprocal transfer of assets that are not a business and a nonreciprocal transfer of assets in a split-off, respectively.

5.5.4 ***Multiple transactions that result in loss of control***

Sometimes a company may lose control of a subsidiary that is a business as a result of two or more transactions (e.g., sale of 40% of the subsidiary and a second sale of 20% of the subsidiary shortly thereafter). Circumstances sometimes indicate that multiple arrangements should be accounted for as a single transaction. In determining whether to account for arrangements as a single transaction, ASC 810-10-40-6 requires that the terms and conditions of the arrangements and their economic effects be considered. If multiple transactions resulting in a loss of control are considered separate transactions, then each transaction should be accounted for separately in accordance with its nature. The transactions that do not result in a loss of control are accounted for as equity transactions and any differences between the amount received and the carrying value of the NCI on these transactions should be recorded in equity and not in the income statement. If a transaction results in a loss of

control, it should be recognized in earnings, along with the related gain or loss on the final transaction (including the revalued amount of any retained noncontrolling investment).

Sometimes a company may determine that multiple transactions should be considered as a single transaction that resulted in a loss of control. In these cases, the gains and losses on all of the transactions (including the revaluation of any retained noncontrolling investment) should be recognized in earnings.

The existence of one or more of the following indicators in ASC 810-10-40-6 may signal that multiple arrangements should be treated as a single arrangement:

- The arrangements are entered into at the same time or in contemplation of each other.
- The arrangements form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

5.6 Disclosures (partial acquisitions and changes in NCI)

In accordance with ASC 810-10-50-1A(c), reporting entities are required to perform a reconciliation of the change in stockholders' equity, including the balances of noncontrolling interest. Additionally, companies are required to provide a supplemental schedule in the notes to the consolidated financial statements showing the effects of any transactions with the NCI on the equity attributable to the parent for each period that an income statement is presented in accordance with ASC 810-10-50-1A(d). See FSP 5.3.1 and FSP 18.3.1 for additional information.

ASC 805 requires specific disclosures for partial acquisitions and step acquisitions. See FSP 17.4.13 for additional information.

Chapter 6:
Noncontrolling interests—
updated September 2022

6.1 Overview: noncontrolling interests

As defined in ASC 810-10-20, noncontrolling interest (NCI) is the equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. NCI can be created in several different ways, including when a reporting entity acquires a controlling interest in a subsidiary and the sellers retain a portion of the equity. Alternatively, the reporting entity may sell an interest in a subsidiary to a third party while still maintaining control. See BCG 5 for a discussion of partial acquisitions and changes in NCI.

6.2 Classification of NCI

As detailed in ASC 810-10-45-17, only securities that represent an ownership interest, and are classified as equity for financial reporting purposes, are presented as NCI.

6.2.1 Securities with characteristics of debt and equity

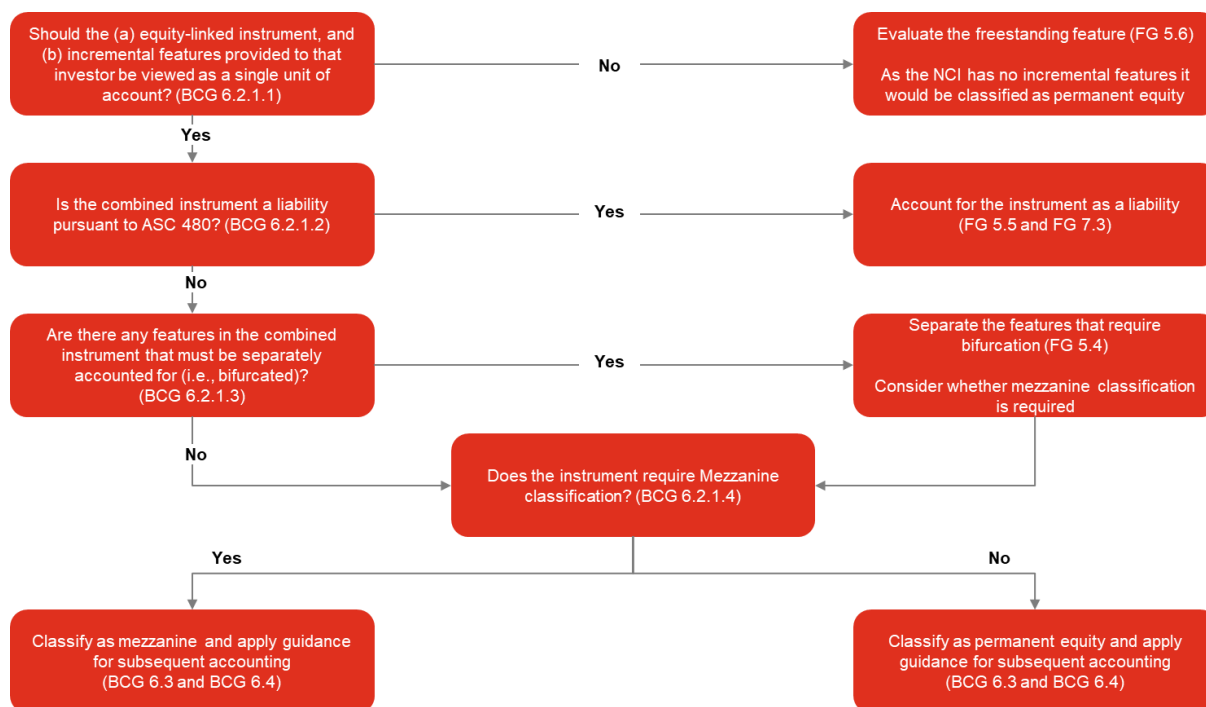
Entities may finance operations with securities that have characteristics of debt and equity, such as puttable stock, or stock with a fixed coupon. These securities, often referred to as equity-linked instruments, can be an attractive form of financing for issuers who benefit from a lower cash coupon or dividend. Investors also benefit, often through a minimum guaranteed return, more seniority, and potential appreciation of the stock. The inclusion of debt like characteristics, however, can mean the security must be classified as debt, precluding equity classification and NCI presentation. See FG 7.4.3.3 for discussion of preferred stock of a subsidiary accounted for as a liability.

Alternatively, if liability classification is not required, reporting entities may still be required to account for certain features (i.e., embedded derivatives), separate from the security. Finally, even if these securities qualify as NCI, they may require separate presentation as “mezzanine equity,” indicating that the reporting entity may need to settle them for cash or other assets. See BCG 6.2.1.4 for information on mezzanine equity.

Determining the appropriate balance sheet classification of equity-linked instruments can be difficult because various sections of accounting guidance must be considered in sequence. Figure BCG 6-1 provides a roadmap of the necessary steps.

Figure BCG 6-1

Roadmap to evaluating NCI with debt and equity features

**6.2.1.1 Unit of account for assessing NCI classification**

NCI often contains additional features that can affect the cash flows. For example, common stock may be issued with a put feature, offering the holder a residual interest in the entity along with the option to receive the return specified in the put option. When NCI has additional features, a reporting entity must determine whether the feature is freestanding or embedded in the NCI, as this can impact classification and subsequent measurement, which is further explained in FG 5.3.

In an acquisition, the buyer may provide the NCI holder incremental rights, such as the ability to force the controlling interest to redeem the NCI (i.e., a put option). The reporting entity would need to consider whether the put option is a separate (i.e., freestanding) financial instrument. When applying the guidance in FG 5.3, a reporting entity would often conclude the underlying shares and the incremental feature is a single unit of account (i.e., embedded) because (1) the incremental feature is issued concurrent with the newly created NCI, and (2) the feature cannot be legally detached, and if exercised, would require forfeiture of the outstanding shares.

In contrast, when a put option is issued separate from the shares in the subsidiary, it will often constitute its own distinct unit of account (i.e., freestanding). In such cases, the freestanding put should be separately evaluated in accordance with FG 5.6 to determine how to account for it. If equity classification is appropriate, these freestanding instruments will still be presented as NCI even though they are not outstanding shares. See BCG 6.2.2.

Example BCG 6-1 illustrates the analysis of whether a put right should be separately recorded.

EXAMPLE BCG 6-1

Analysis of put right

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

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

Should the put right be separately recorded?

Analysis

The put option is embedded in the NCI recorded in Parent Company A's financial statements because it does not meet either of the conditions of a freestanding financial instrument explained in FG 5.3:

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

6.2.1.2 ***Securities that require liability classification***

If an entity determines that the incremental features should be considered together with the underlying shares, the reporting entity must next determine whether the combined instrument should be classified as a liability. See FG 5.5 and FG 7.3 for a discussion of which instruments must be classified as liabilities.

In practice, mandatorily redeemable shares frequently meet the criteria for liability classification because they require settlement for a fixed amount at a fixed date. Similarly, a forward contract embedded in the outstanding shares would achieve the same economic outcome. That is, it will require the exchange of shares for cash at a predetermined date and amount.

Instruments deemed liabilities under the guidance in FG 5.5 and FG 7.3.1 are measured at fair value, and changes in fair value are reflected in earnings.

Liability classification is also required when the reporting entity enters into a purchased call and written put with the NCI holders, and the put and call have the same fixed exercise price and exercise date. This is further addressed in ASC 480-10-55-59 through ASC 480-10-55-63. That guidance would not be appropriate, however, if the purchased call and written put have (a) different exercise prices, (b) floating exercise prices, or (c) different exercise dates. In such situations, the NCI, along with the embedded put and call, should be evaluated in accordance with guidance described in BCG 6.2.1.3 and BCG 6.2.1.4.

Furthermore, if the NCI is considered a share-based payment award, the guidance in ASC 718 should be followed. For example, shares of a consolidated subsidiary issued to employees may be puttable

only upon completion of a defined service period. If the redemption price is based on a formula, the guidance in ASC 718-10-25-9(a) may result in treatment of the arrangement as a liability-classified award. See SC 3.3.3 for further discussion of repurchase features in stock-based compensation awards.

6.2.1.3 Embedded features in an NCI that require bifurcation

If the NCI is not a liability, a reporting entity must evaluate whether any features embedded in the instrument must be separately accounted for as a derivative, referred to as bifurcation. Features that commonly need to be considered include put and call options, conversion options, and required dividend payments.

Bifurcation is required if all the criteria detailed in ASC 815-15-25-1 are met, as described in FG 5.4. In practice, there are several reasons why bifurcation would not be required.

Bifurcation is only required if a feature meets the definition of a derivative in ASC 815-10-15-83, as described in FG 5.4.2 and DH 2. Puts and calls embedded in the NCI of a private company generally do not meet the definition of a derivative as they typically do not meet the “net settlement” requirement. This is because the shares are not readily convertible to cash as there is no public market for them. Consequently, they would not need to be separately accounted for.

Bifurcation would also only be required if the feature introduces economics that are different than those in the host contract (e.g., a fixed return embedded in an equity instrument). For this analysis, the economics of the host contract are considered, and whether the host is more akin to debt or equity. This is a highly judgmental analysis and is further explained in FG 5.4.1 and FG 7.3.2. If it is determined that both the feature and the host in question have similar economics, then bifurcation would not be required. An example of this might be a conversion option into common stock that is embedded in perpetual preferred stock when the preferred stock is deemed to have economics that most closely resemble that of an equity instrument.

Finally, an embedded feature that meets the definition of a derivative does not have to be separated if it qualifies for a scope exception from the derivative guidance. One such scope exception is for certain contracts involving a reporting entity’s own equity (see ASC 815-10-15-74(a)). Conversion options embedded in preferred shares may meet this exception, as further discussed in FG 5.4.3.

If bifurcation is required, the total proceeds should be allocated as described in BCG 6.3.1. A reporting entity would still need to consider whether the shares (i.e., the host contract) should be accounted for as permanent NCI or mezzanine NCI.

6.2.1.4 NCI that requires mezzanine classification

Even if an NCI is not classified as a liability, the reporting entity must still consider whether it should be presented as mezzanine or permanent equity, as described in ASC 480-10-S99-3A. Mezzanine equity is presented on the balance sheet after liabilities and before stockholders’ equity, informing the reader that the holder may demand cash or other assets for the shares at a future date. Mezzanine classification would only be appropriate if cash settlement is not certain or required, as explained in FG 7.3.4 in the context of preferred stock.

In determining whether mezzanine classification is appropriate, a reporting entity should also consider features that were bifurcated. For example, if the reporting entity determined that bifurcation was required for the put feature in puttable NCI, the reporting entity may still need to classify the NCI

as mezzanine equity if the holder may tender the shares to the reporting entity and demand cash or other assets (i.e., gross settlement).

In addition to “plain-vanilla” put options embedded in the NCI that would cause the NCI to be mezzanine classified, we often see reporting entities issue shares that are contingently puttable if certain events occur, and therefore, require mezzanine classification. Examples include shares that are contingently puttable either upon a change of control, a violation of covenants, or in the event the reporting entity does not take certain actions by a specified date.

The requirements for mezzanine classification are included in ASC 480-10-S99-3A, which codifies guidance issued by the SEC. Accordingly, if the reporting entity is a private company, application of the guidance would not be required. Notwithstanding, as noted in FSP 5.6.3.1, mezzanine classification is strongly encouraged for private companies, especially in those circumstances when there is a strong likelihood that the reporting entity might settle the NCI for cash.

6.2.2 *Equity-classified instruments that are not shares as NCI*

Securities that qualify for equity classification, but are not shares, are still presented as NCI. Examples include written call options, warrants, and employee stock options. See further discussion in BCG 5.4.1 and BCG 5.4.2. FG 5.6 explains the process for determining whether these instruments qualify for equity classification.

6.2.3 *Whether to include indirect interests in NCI*

A reporting entity may be required to present interests it holds in a subsidiary indirectly as part of the reporting entity’s controlling interest and not NCI as noted in the definition of NCI.

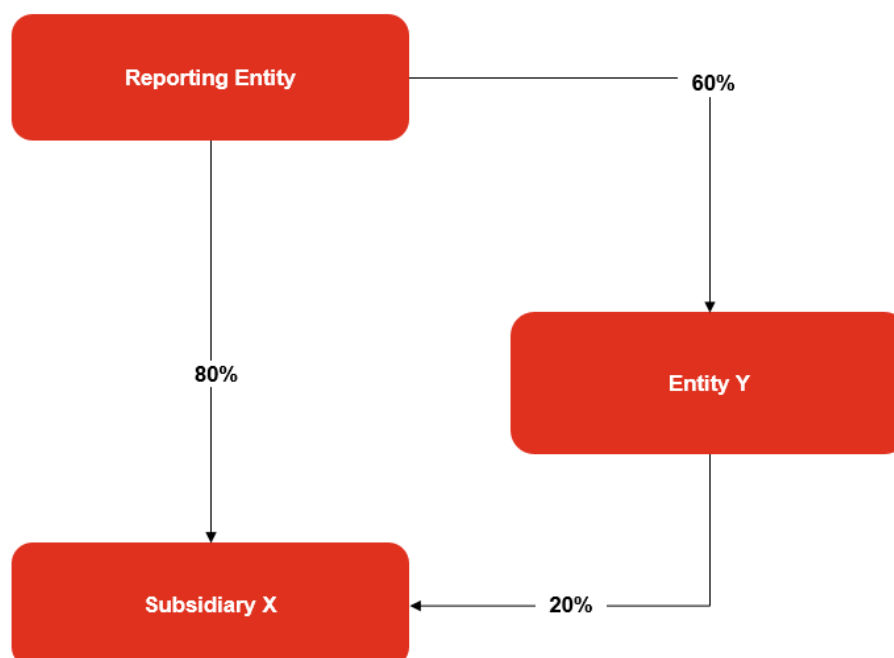
Excerpt from ASC Master Glossary

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.

Interest held indirectly through a consolidated entity

A reporting entity may hold a controlling interest in a subsidiary directly and may also hold an interest in the same subsidiary indirectly through another consolidated entity. To determine the total controlling interest, the reporting entity should combine the entire interest held indirectly through the consolidated entity with the direct interest. This is illustrated in Figure BCG 6-2. To determine its controlling interest in Subsidiary X, Reporting Entity would combine the 20% indirect interest held through consolidated Entity Y with its 80% direct interest in Subsidiary X, for a total controlling interest of 100% in Subsidiary X. Reporting Entity would reflect the 40% interest held by third parties in Entity Y (which includes Entity Y’s 20% share of Subsidiary X) as noncontrolling interest in Reporting Entity’s consolidated financial statements. This will effectively reflect 8% (40% of 20%) of Subsidiary X as part of the overall NCI balance.

Figure BCG 6-2
Interest held indirectly through a consolidated entity



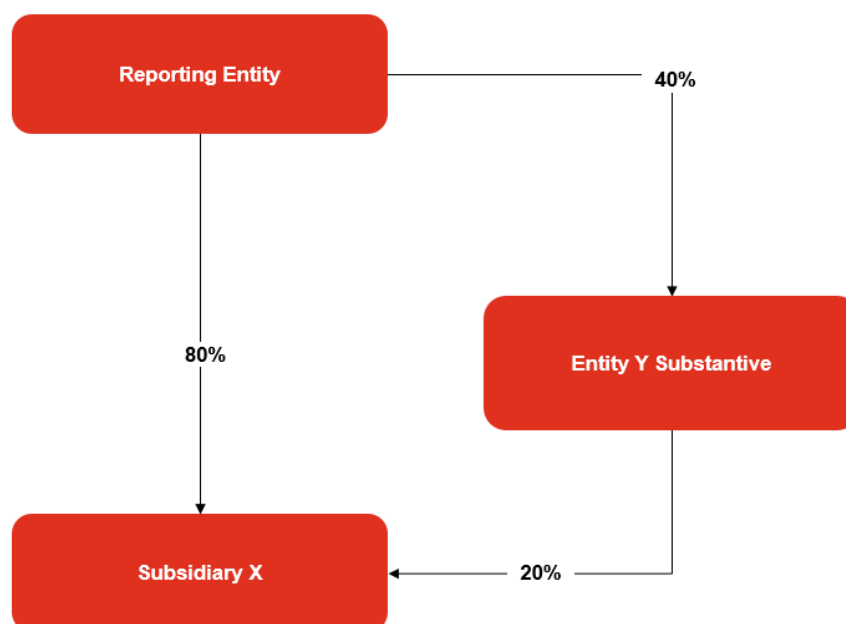
Interest held indirectly through a substantive nonconsolidated entity

When an indirect interest is held through a substantive nonconsolidated entity, we believe it would be inappropriate to combine the indirect interest with the direct interest. The rationale is that the reporting entity does not control the indirectly held portion, and accordingly, that interest would behave more like a noncontrolling interest than an extension of the reporting entity. Accordingly, the indirectly held interest would be considered NCI.

Figure BCG 6-3 illustrates this scenario. Reporting Entity has an 80% direct interest in Subsidiary X. It also has an indirect interest in Subsidiary X through a substantive nonconsolidated entity, Entity Y. In determining its controlling interest, Reporting Entity includes only the 80% direct interest. The remaining 20% interest in Subsidiary X held by Entity Y would be viewed by Reporting Entity as NCI of Subsidiary X, and not included in the Reporting Entity's controlling interest.

Figure BCG 6-3

Interest held indirectly through a substantive nonconsolidated entity

**6.3 Initial recognition and measurement of NCI**

In a business combination, both permanent and mezzanine classified NCI should be measured and recognized by the acquirer at fair value on the acquisition date as required by ASC 805-20-30-1.

6.3.1 Initial measurement of NCI

In cases when NCI represents the seller's retained interest in an acquired subsidiary, NCI is generally viewed from an accounting perspective as a new instrument, as the nature of the shares change with the change in control.

If NCI is issued to NCI holders in conjunction with a liability that is marked to market, such as a derivative, consideration should first be allocated to the mark to market instrument based on its fair value and the residual should be allocated to the NCI. The requirement to first allocate value to the mark to market instrument eliminates the risk of an immediate mark to market adjustment after the allocation.

If the NCI holders concurrently obtained other financial instruments that are not marked to market, such as debt or equity instruments, the allocation to each instrument should be based on their relative fair value.

6.3.2 Initial recognition of NCI

If NCI is created as part of a business combination, where the reporting entity gained control over an acquiree while the seller retained a portion of the acquiree's equity, the NCI would be recognized at

fair value, as described in BCG 5.3.1. This is the case whether the NCI is in the form of common stock or preferred stock, and whether it is redeemable or non-redeemable.

If non-redeemable or redeemable NCI is created through the sale of preferred stock to a third party (e.g., not in a business combination), the preferred stock NCI would generally be recorded at its issuance date fair value in accordance with the guidance in FG 7.4 and ASC 480-10-S99-3A (12).

If non-redeemable NCI is created through the sale of common stock to a third party (e.g., not in a business combination), ASC 810-10-45-23 specifies that NCI is measured initially based on its proportionate ownership interest in the carrying amount of the subsidiary. Any difference between the fair value of the consideration received and the NCI recognized would be reflected in APIC, as illustrated in Example BCG 5-6. As noted above, when preferred stock is issued to a third party, the initial carrying amount is the fair value of the consideration received, as described in FG 7.4, and APIC is not adjusted.

Non-redeemable NCI is (1) reported as part of equity of the consolidated group, (2) recorded separate from the parent's interests, and (3) clearly identified and labelled (e.g., NCI in subsidiaries) to distinguish it from other components of the parent's equity. The presentation of NCI is further discussed in FSP 2.5.

If redeemable NCI is created through the sale of common stock to a third party and will be classified as mezzanine, or temporary, equity as discussed in BCG 6.2.1.4, questions arise as to whether it should be initially recorded following the guidance in ASC 810 or ASC 480-10-S99. Specifically, ASC 480-10-S99 states that the initial amount presented in temporary equity should be the initial carrying amount of the noncontrolling interest pursuant to ASC 805-20-30-1, which in a business combination is its acquisition-date fair value.

We believe that if the fair value of common stock NCI (i.e., the consideration received) exceeds the proportionate interest in the carrying amount of the subsidiary (i.e., the ASC 810 amount), and the fair value of the common stock is less than the calculated redemption amount of the NCI, the NCI should be initially recorded at its fair value. The amount should be accreted to its redemption value, as appropriate, as described in BCG 6.4.2.

Example BCG 6-2 illustrates the initial carrying amount of redeemable common stock NCI resulting from a sale of the common stock of a subsidiary.

EXAMPLE BCG 6-2

Sale of redeemable shares in a business

Company A has a wholly-owned subsidiary, Company B. Company A sells a 20% interest in the common shares of Company B to outside investors for \$200 million. Company A maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is \$600 million.

Embedded in the 20% interest is a put option that gives investors the right to put the interest to Company A after 3 years for \$250 million. It was determined that the put should not be separately accounted for and that NCI should be classified as mezzanine equity.

What is the initial carrying amount of the redeemable common stock NCI?

Analysis

\$200 million. The fair value of the shares (i.e., the consideration received) is greater than the proportionate interest in the carrying amount of the subsidiary, which is \$120 million (\$600 million × 20%). Additionally, it is less than the redemption amount of the instrument (i.e., \$250 million).

The journal entry recorded on the issuance date for the 20% interest sold would be as follows (in millions):

Dr. Cash	\$200	
Cr. NCI - mezzanine equity		\$200

If, at the issuance date of the redeemable common stock NCI, the fair value is greater than the calculated redemption amount, and the calculated redemption amount is greater than the proportionate ownership interest in the carrying amount of the subsidiary (i.e., the amount based on ASC 810), we believe the NCI should be recorded at the calculated redemption amount. Any difference between the redemption amount and the fair value) should be reflected in APIC.

Similarly, if at the issuance date of the redeemable common stock NCI, the fair value is greater than the proportionate ownership interest in the carrying amount of the subsidiary, and that amount is greater than the calculated redemption amount, we believe the NCI should be recorded at its proportionate interest in the carrying amount of the subsidiary. Any difference between this amount and the fair value should be reflected in APIC. No decrement to the lower redemption amount would be recorded.

If, at the issuance date of the redeemable common stock NCI, the fair value is less than the proportionate ownership interest in the carrying amount of the subsidiary, we believe the NCI should be recorded at its proportionate interest in the carrying amount of the subsidiary, and the difference should be charged to APIC. If the calculated redemption amount is greater than the proportionate interest in the carrying amount of the subsidiary, the reporting entity should follow the accretion guidance in ASC 480-10-S99-3A(15), ASC 480-10-S99-3A(22), and BCG 6.4.2.

If redeemable common stock NCI is initially recognized at an amount greater than its proportionate ownership interest under ASC 810, that initial recognition should not be considered a deemed dividend, and therefore should not be viewed as an adjustment impacting the parent's share of the subsidiary's net income or its earnings per share.

Redeemable NCI classified as mezzanine equity is presented after liabilities and before stockholders' equity on the balance sheet. Mezzanine equity should be separate from the stockholders' equity accounts that are classified as permanent equity.

6.4 Subsequent measurement of NCI

Each reporting period, a reporting entity should attribute net income and comprehensive income of a consolidated subsidiary to the controlling interest and NCI, as described in BCG 6.4.1. If the NCI is classified as mezzanine equity, the reporting entity would have to consider additional requirements described in BCG 6.4.2.

6.4.1 *Attribution of net income and comprehensive income*

An NCI should be allocated its share of net income or loss, and its respective share of each component of other comprehensive income, in accordance with ASC 810-10-45-20. The presentation of allocated net income for an NCI is discussed in FSP 3.8.7. The presentation of other comprehensive income is discussed in FSP 4.4.1.

The accounting guidance does not specify a particular method for attributing earnings between the controlling interest and the NCI. However, the attribution method should be reasonable and appropriate given the circumstances (FAS 160.B39).

If there are contractual arrangements that determine the attribution of earnings, such as a profit sharing agreement, the attribution specified by the arrangement should be considered if it is substantive. For example, the parties may have a contractual arrangement specifying a 50/50 split of the earnings, in which case 50% of the earnings should be allocated to the controlling interest and 50% to the NCI. If there are no such contractual arrangements, the relative ownership interests in the entity should be used. For example, if the reporting entity has a 60% controlling interest of a subsidiary and the NCI has 40%, then 60% of the earnings should be allocated to the reporting entity and 40% to the NCI.

In some instances, agreements may designate splits that differ for purposes of (a) financial reporting, (b) tax, (c) ongoing distributions from operations, and (d) distributions upon liquidation. Furthermore, these splits may change with the passage of time or the occurrence of specified events. In such circumstances, it may be appropriate to apply the hypothetical liquidation at book value (HLBV) method of accounting described in EM 4.1.4 if the splits are considered substantive.

The allocation of income to noncontrolling interest in the form of preferred stock is discussed in FG 7.4.3.3.

6.4.1.1 *Attribution of amounts in excess of the NCI balance*

NCI is considered part of the equity of the consolidated group that participates in both the risk and rewards of ownership in a subsidiary. Accordingly, absent explicit agreements that designate a different allocation of losses, losses should continue to be attributed to the NCI even if it results in a debit balance in the NCI. Similarly, distributions in excess of the carrying amount of the NCI would also cause the NCI to have a debit balance.

ASC 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.

Example BCG 6-3 illustrates the attribution of amounts in excess of the NCI to the NCI.

EXAMPLE BCG 6-3

Attribution of amounts in excess of the NCI balance

Company X has an 80% common stock controlling interest in Subsidiary A. Subsidiary A has a diverse real estate portfolio, with a carrying value of \$100 million, that appreciated significantly since the subsidiary was acquired. Subsidiary A refinances the existing secured loan of \$70 million with a new loan of \$120 million. Total equity of Subsidiary A is \$30 million, and NCI represents 20% or \$6 million.

Upon refinancing, Subsidiary A generates excess cash of \$50 million (\$120 million - \$70 million) which it distributes. NCI receives its proportional interest which is \$10 million (\$50 million x 20%).

Should the company adjust NCI to a debit balance?

Analysis

Yes. Distributions to NCI holders are charged against the NCI balance. The NCI should reflect a debit balance of \$4 million (\$6 million - \$10 million) after the distribution.

6.4.1.2 Equity-classified instruments that are not shares

As noted in BCG 6.2.2, the NCI guidance applies to all equity-classified instruments, including those that are not outstanding shares.

Holders of these instruments generally do not directly participate in the profits or loss of the subsidiary. Accordingly, during the period prior to exercise or expiration, no portion of the subsidiary's profit or loss would be attributed to this component of NCI. BCG 5.4.1 and BCG 5.4.2 address the accounting upon exercise or expiration of these types of instruments.

6.4.1.3 Legacy acquisitions (prior to adoption of current guidance)

The guidance that was eventually codified in ASC 805 was adopted by calendar year end entities on January 1, 2009. For certain assets acquired under legacy acquisition guidance, amortization expense should not be attributed to the controlling interest and NCI in proportion to their interests.

Under pre-2009 guidance, only the portion of acquired assets that were attributable to the acquirer was “stepped-up” to a new basis. Accordingly, when a seller retained an interest in the acquired subsidiary, the new carrying basis of acquired assets and liabilities only partially reflected the acquisition date fair value (a “mixed-basis”). For example, if a reporting entity acquired 80% of a subsidiary in a single transaction, the intangible assets that it recognized in the acquisition would likely have been recorded at 80% of their fair value. This is because a carryover basis of zero would be used for the 20% interest not acquired, as the acquired intangible assets were previously not recognized. This issue is most pronounced with assets, such as intangibles, that may not have had any basis prior to the acquisition.

When allocating amortization expense for intangible assets that were previously unrecognized, the full amount should be allocated to the parent's interest in accordance with FAS 160.B38. A reporting entity should apply the same guidance for other assets, such as buildings, that were acquired in a legacy acquisition and have a “mixed-basis.”

6.4.2 **Subsequent accounting for a mezzanine classified NCI**

The subsequent accounting for mezzanine classified NCI depends on several factors, including whether the NCI is currently redeemable.

If the mezzanine classified NCI is currently redeemable, the NCI carrying amount should be adjusted to its maximum redemption amount as of the balance sheet based on the guidance in ASC 480-10-S99-3A(15) and FG 7.4.3.2 (subject to the discussion in BCG 6.4.2.1 on limitations of reversals of mezzanine adjustments).

If the mezzanine classified NCI is not currently redeemable, the NCI carrying amount is not adjusted for the redemption feature if it is not currently probable that the NCI instrument will become redeemable at the option of the holder. However, when the holder's ability to redeem a mezzanine classified NCI (see BCG 6.2.1.4) is probable, the NCI must be accreted to its redemption amount. The required accretion will ensure that NCI is reported at its redemption value by the date the issuer could be required to redeem it. As further described in FG 7.4.3.2, a reporting entity may either accrete these changes over the periods prior to the earliest redemption date or recognize them immediately as they occur. ASC 480-10-S99-3A(22) notes that consistent with ASC 810-10-45-23, an adjustment to the carrying amount of NCI does not impact net income or comprehensive income in the consolidated financial statements. Rather, such adjustments are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital).

The process of adjusting NCI to its redemption value (the "Mezzanine Adjustment") should be performed after attribution of the subsidiary's net income or loss pursuant to ASC 810, *Consolidation* (see BCG 6.4.1). The carrying amount of NCI will equal the higher of the amount resulting from application of ASC 810 or the amount resulting from the Mezzanine Adjustment.

Example BCG 6-4 illustrates an adjustment to the carrying value of redeemable equity securities.

EXAMPLE BCG 6-4

Adjustment to the carrying value of redeemable equity securities

Parent Company A acquires 80% of the common shares of Subsidiary from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary. As part of the acquisition, Parent Company A and Company Z enter into an agreement that allows Company Z to put its equity interest in Subsidiary, in its entirety, to Parent Company A based on a formula at a future specified date. Parent Company A recognizes NCI at its acquisition date fair value of \$100 million.

Parent Company A concludes that the put option is embedded in the NCI, and the NCI should be presented as mezzanine equity because Parent Company A may be required to redeem it at a future date.

At the end of the first year, Subsidiary records income of \$50 million. Income attributable to the NCI is \$10 million ($\$50 \text{ million} \times 20\%$). The formula-based redemption amount is calculated as \$117 million.

Parent Company A elected to recognize changes in the redemption amount immediately as they occur.

What is the carrying value of the mezzanine equity at the end of Year 1?

Analysis

\$117 million. Parent Company A would first allocate \$10 million to the NCI to reflect its proportionate interest in the income of Subsidiary. This would result in a carrying amount of \$110 million (\$100 million + \$10 million). Parent Company A would then adjust the NCI by \$7 million (\$117 million redemption amount - \$110 million carrying amount) to reflect the higher redemption amount, with the offset to equity.

6.4.2.1 Reversals of Mezzanine Adjustments

A reporting entity should reverse previous accretion of mezzanine classified instruments to reflect a decline in redemption value of the instrument. However, a reversal should only be recognized to the extent of prior accretions (as detailed in ASC 480-10-S99-3A(16(e))).

We believe that the carrying amount should also not be lower than the amount that would have otherwise been reported pursuant to ASC 810. Therefore, each reporting period, a reporting entity should:

- Identify the portion of the NCI carrying amount from the prior period that is attributable to ASC 810, and adjust it for the current period income or loss attributable to the NCI, and
- Calculate the current year's Mezzanine Adjustment, while ensuring that a reversal, if any, is not larger than the accretion already taken.

To ensure the correct offset for each adjusting entry, a reporting entity should track the components of NCI and follow the order of the operations described above. As illustrated in Example BCG 6-5, if the basis of NCI increases due to the attribution of subsidiary income, a prior year Mezzanine Adjustment may be reversed even though the redemption price did not decrease. Example BCG 6-6 illustrates the full reversal of a prior Mezzanine Adjustment that was made to redeemable NCI.

EXAMPLE BCG 6-5**Partial reversal of a prior Mezzanine Adjustment for redeemable NCI**

Parent Company acquires 80% of the common shares of Subsidiary from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary. As part of the acquisition, Parent Company and Company Z enter into an agreement that allows Company Z to put its equity interest in Subsidiary, in its entirety, to Parent Company based on a formula at a future specified date. Parent Company recognizes NCI at its acquisition date fair value of \$100 million.

Parent Company concludes that the put option is embedded in the NCI, and the NCI should be presented as mezzanine equity because Parent Company may be required to redeem it at a future date.

At the end of the first year, Subsidiary records income of \$50 million. Income attributable to the NCI is \$10 million (\$50 million × 20%). The formula-based redemption amount is calculated as \$117 million. Parent Company first allocates \$10 million to the NCI to reflect its proportionate interest in the income of Subsidiary. This results in a carrying amount of \$110 million (\$100 million + \$10 million).

As Parent Company elected to recognize changes in the redemption amount immediately as they occur, it would then adjust the NCI by \$7 million (\$117 million redemption amount - \$110 million carrying amount) with the offset to equity so that the ultimate carrying amount of the NCI is \$117 million.

In the subsequent year, Subsidiary has net income of \$25 million. Accordingly, net income attributable to the NCI would be \$5 million (\$25 million x 20%). The formula-based redemption amount is calculated and determined to still be \$117 million.

What is the carrying value of the mezzanine equity at the end of Year 2?

Analysis

The carrying amount is \$117 million; however, Parent Company will need to reverse \$5 million of the prior Mezzanine Adjustment.

At the end of Year 1, the NCI balance resulting from the attribution of Subsidiary's income was \$110 million. After attribution of Year 2's income, the carrying amount would be \$115 million (\$110 million + \$5 million). Accordingly, there is a \$2 million difference between (a) the \$115 carrying amount and (b) the \$117 redemption amount. While the mezzanine equity ultimately should be reported on the balance sheet at \$117 million, Parent Company had a previous Mezzanine Adjustment of \$7 million. Therefore, to ensure that the NCI reflects the correct balance, it will need to reverse \$5 million (\$7 million - \$2 million) of the prior Mezzanine Adjustment.

EXAMPLE BCG 6-6

Full reversal of a prior Mezzanine Adjustment made to redeemable NCI

Parent Company acquires 80% of the common shares of Subsidiary from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary. As part of the acquisition, Parent Company and Company Z enter into an agreement that allows Company Z to put its equity interest in Subsidiary, in its entirety, to Parent Company based on a formula at a future specified date. Parent Company recognizes NCI at its acquisition date fair value of \$100 million.

Parent Company concludes that the put option is embedded in the NCI, and the NCI should be presented as mezzanine equity because Parent Company may be required to redeem it at a future date.

At the end of the first year, Subsidiary records income of \$50 million. Income attributable to the NCI is \$10 million (\$50 million × 20%). The formula-based redemption amount is calculated as \$117 million. Parent Company first allocates \$10 million to the NCI to reflect its proportionate interest in the income of Subsidiary. This results in a carrying amount of \$110 million (\$100 million + \$10 million).

As Parent Company elected to recognize changes in the redemption amount immediately as they occur, it would then adjust the NCI by \$7 million (\$117 million redemption amount - \$110 million carrying amount) with the offset to equity so that the ultimate carrying amount of the NCI is \$117 million.

In the subsequent year, Subsidiary has a net loss of \$30 million. Accordingly, net loss attributable to the NCI would be \$6 million ($\$30 \times 20\%$). The formula-based redemption amount is calculated and determined to be \$102 million.

What is the carrying value of the mezzanine equity at the end of Year 2?

Analysis

The carrying amount is \$104 million. At the end of Year 1, the NCI balance resulting from the attribution of Subsidiary's income was \$110 million. After attribution of the Year 2 loss, the carrying amount would be \$104 million ($\$110 \text{ million} - \6 million). As the formula-based redemption amount (\$102 million) is less than the carrying amount, the entire prior Mezzanine Adjustment of \$7 million should be reversed.

6.4.2.2 *EPS considerations related to mezzanine classified NCI*

Changes to the carrying amount of mezzanine classified NCI are intended to capture the incremental value the NCI holder may ultimately be entitled to. Specifically, the NCI holder may be entitled to receive consideration that is greater than its proportionate share of the subsidiary, for example upon its exercise of a put option.

Accordingly, for purposes of calculating earnings per share, changes in the carrying amount of mezzanine equity may be viewed as a deemed dividend, and may impact the calculation of the numerator, as further described in FSP 7.4.1.2.

FSP 7.4.1.2 explains that if the NCI is common stock and the redemption amount is other than fair value (e.g., a formula amount), a reporting entity has the option to reflect as a deemed dividend either (a) the entire change in redemption amount or (b) only the amount by which the redemption amount exceeds fair value. The rationale is that the change in redemption value attributable to changes in the fair value of the NCI does not provide the NCI holder with any value that is incremental to what other common stockholders are entitled to. As noted in FSP 7.4.1.2, if the NCI is preferred stock, the entire change in the redemption amount should be reflected as a deemed dividend in the calculation of income available to the parent company common stockholders.

In practice, redemption formulas often do not approximate fair value (e.g., a formula based on an EBITDA multiple), and accordingly, reporting entities that wish to elect alternative (b) must calculate the difference between the redemption formula and fair value. While electing alternative (b) may result in a smaller EPS impact, it is also more difficult operationally, as the reporting entity must determine the fair value of the NCI each reporting period.

Example BCG 6-7 illustrates the impact of a redeemable NCI security on earnings per share.

EXAMPLE BCG 6-7

Impact of a redeemable NCI security on earnings per share

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

in its entirety, to Parent Company based on a formula at a future specified date. Parent Company recognizes NCI at its acquisition date fair value of \$100 million.

Parent Company concludes that the put option is embedded in the NCI, and the NCI should be presented as mezzanine equity because Parent Company may be required to redeem it at a future date.

At the end of the first year, Subsidiary records income of \$50 million. Income attributable to the NCI is \$10 million ($\$50 \text{ million} \times 20\%$). The formula-based redemption amount is calculated as \$117 million. Parent Company first allocates \$10 million to the NCI to reflect its proportionate interest in the income of Subsidiary. This results in a carrying amount of \$110 million ($\$100 \text{ million} + \10 million).

As Parent Company elected to recognize changes in the redemption amount immediately as they occur, it would then adjust the NCI by \$7 million ($\$117 \text{ million redemption amount} - \$110 \text{ million carrying amount}$) with the offset to equity so that the ultimate carrying amount of the NCI is \$117 million.

It is determined at the end of the first year that the fair value of the NCI is \$115 million. Furthermore, Parent Company elects to recognize a deemed dividend only to the extent the redemption amount exceeds fair value.

What is the impact on the income attributable to the parent, or income available to common stockholders of the parent, at the end of the first year?

Analysis

The basic EPS numerator would be reduced by \$2 million ($\$117 \text{ million redemption price} - \$115 \text{ million fair value}$). While the Mezzanine Adjustment is \$7 million, all common shareholders would benefit due to an increase in their share value. Only the excess over the fair value would be deemed a dividend impacting earnings per share.

6.4.2.3 *NCI that no longer requires mezzanine classification*

A reporting entity may determine that mezzanine classification is no longer appropriate. This may occur if the put option lapses, or the reporting entity changes the terms of the instrument. Such changes should be accounted for as a modification rather than an extinguishment, as described in FG 7.8.

The reporting entity would reclassify the NCI from mezzanine to permanent equity on the date of the event that caused the reclassification. Prior financial statements should not be adjusted. Additionally, the reporting entity should not reverse any adjustments to the carrying amount of the equity instrument (see ASC 480-10-S99-3A(18)).

If the reporting entity determines it is appropriate to deconsolidate a subsidiary with mezzanine classified NCI, it should reverse prior accretion, as described in BCG 5.5.1. Previously accreted amounts should not impact the amount of the gain or loss recorded upon deconsolidation.

See BCG 5.4 for a description of the accounting if the NCI holder exercises its put option, or the reporting entity repurchases the NCI.

***Chapter 7:
Common control
transactions—updated
February 2023***

7.1 *Common control transactions*

Common control transactions occur frequently, particularly in the context of reorganizations, spinoffs, and initial public offerings. Combinations between entities that are under common control are excluded from the scope of the business combinations guidance in ASC 805. ASC 805-50-15-6 describes various examples of transfers and exchanges between entities that are under the control of the same parent.

Common control transactions are generally accounted for by the receiving entity based on the nature of the transactions. For example, transactions involving the transfer of an asset (such as an unoccupied building) are accounted for by the receiving entity at the carrying value of the asset transferred on a prospective basis. Conversely, transactions involving the transfer of a business ordinarily will result in a change in reporting entity for the receiving entity and require retrospective combination of the entities for all periods presented using the historical cost basis of the parent. Whether a transfer of net assets results in a change in reporting entity will depend on whether the nature of the net assets is more similar to a group of assets or a business. Additionally, transactions involving the routine transfer of inventory or the transfer of financial assets may be accounted for at fair value. See BCG 7.1.2 for further information.

There is no specific US GAAP guidance on how the transferring entity should account for the transfer of a business or an asset in a common control transaction. The transferring entity in a transaction involving entities under common control may be required to prepare its own separate financial statements. In these circumstances, additional complexities may arise in relation to the nature and the basis of the transfer. See BCG 7.1.4 for further information.

Transfers among entities with a high degree of common ownership, but with no single party controlling the entities, are not common control transactions, and are separately discussed in BCG 7.1.1.3.

7.1.1 *Assessing whether common control exists*

In ASC 805, “control” has the same meaning as “controlling financial interest” in ASC 810-10-15-8. A “controlling financial interest” is generally defined as ownership of a majority voting interest by one entity, directly or indirectly, of more than 50% of the outstanding voting shares of another entity, with certain exceptions (e.g., bankruptcy). While majority voting ownership interests are the most common form of control, control may also be established through other means, such as variable interests under the Variable Interest Entities Subsections of ASC 810-10 or contractual and other legal arrangements. US GAAP does not define the term “common control.” However, ASC 805-50-15-6 provides examples of the types of transactions that qualify as common control transactions.

ASC 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. This transaction 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.

An assessment of whether common control exists is based on all of the facts and circumstances surrounding the relationships between the parties (both direct and indirect). If consolidated financial statements were prepared by a parent entity, generally, the entities that were consolidated are under common control.

7.1.1.1 Common control and control groups

There is no definition of common control in the Accounting Standards Codification. The Emerging Issues Task Force attempted to define common control in EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141* (EITF 02-5), but did not reach a consensus. Therefore, in the absence of definitive guidance issued by the FASB, it is helpful to consider the SEC staff's conclusions expressed during the deliberations in EITF 02-5 that common control exists between (or among) separate entities in the following situations:

- An individual or enterprise holds more than 50% of the voting ownership interest of each entity.
- A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.
- Immediate family members (married couples and their children, but not their grandchildren) hold more than 50% of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert). Entities may be owned in varying combinations among living siblings and their children. Those situations require careful consideration regarding the substance of the ownership and voting relationships.

Due to the lack of other authoritative guidance, the SEC staff's guidance is widely applied by public and private companies, although the FASB has indicated in paragraph BC19 in the Basis for Conclusions of ASU 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, that a broader interpretation (such as considering grandparents and grandchildren together when evaluating common control) may be supportable for private companies. Judgment is required to determine whether common control exists in situations other than those described above.

Two examples from a 1997 SEC staff speech illustrate the existence of common control through a control group:

- Two brothers own a 60% controlling interest in a public company. Their father owns 100% of two other companies that provide services to the company that is controlled by the two brothers. If these three companies merged into a single entity, would the brothers and the father constitute a control group, thus permitting historical cost accounting for the interests owned by the father and two brothers? The SEC staff indicated that, absent evidence to the contrary, it would not object to the assertion that the immediate family is a control group.
- One person has ownership in three entities: 60% in two, and 45% in the third. In the third entity, the 45% shareholder has an agreement with the entity's employee owners that stipulates that the 45% shareholder must repurchase the employees' shares if they are terminated or leave the company voluntarily. In addition, the 45% shareholder has the ability to cause a termination of the employee owners. The question is whether these three entities are under common control. The SEC staff believes that for the third entity to be under common control, the employee owners would have to give the 45% shareholder sufficient voting proxies to ensure the shareholders act and vote in concert.

Example BCG 7-1 provides additional guidance related to a transaction when common management may exist.

EXAMPLE BCG 7-1

Sale between two real estate investment trusts (REIT) with a common manager

Company A, a public REIT, sells its 25% interest in a real estate property to Company B, which is also a REIT. Company A and Company B are not entities under common control, but they are managed by the same third party. The common manager does not control either Company A or Company B through the management agreements.

Does the sale represent a transaction between entities under common control?

Analysis

Company A and Company B are not entities under common control, but rather are entities with common management. The existence of a common manager in and of itself would not result in the transaction being accounted for as a transaction under common control that would preclude recognition of a real estate sales transaction and related gain or loss on the sale by Company A.

7.1.1.2 **Consolidation under the VIE model (common control)**

In addition to voting ownership interests, control may be established through the ownership of variable interests that result in consolidation by a primary beneficiary under the Variable Interest Entities subsections of ASC 810-10. ASC 805-50-15-6A indicates that the guidance in the Transactions between Entities under Common Control Subsections (ASC 805-50) does not apply to the initial measurement by a primary beneficiary of a VIE if the primary beneficiary and the VIE are under common control. However, the guidance in ASC 810 for such circumstances is similar to the common control guidance in ASC 805-50.

ASC 810-10-30-1 describes a primary beneficiary's accounting for a VIE under common control.

ASC 810-10-30-1

If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and the noncontrolling interest of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).

ASC 810-10-30-1 requires that there be no remeasurement of a VIE's assets and liabilities upon consolidation if the primary beneficiary and VIE are under common control. For example, assume Company A and Company B are under the common control of Company XYZ. An agreement is entered into between Company A and Company B that results in Company B obtaining a variable interest in Company A. After performing an analysis under the Variable Interest Entities Subsections of ASC 810-10, Company A is determined to be a VIE and Company B is identified as the primary beneficiary. Following the guidance in ASC 810-10-30-1, the net assets of Company A would be recorded by Company B at the carrying amounts in Company XYZ's financial statements. In this case, Company B's financial statements and financial information presented for prior years should be retrospectively adjusted in accordance with the guidance in BCG 7.1.3.2.

A reporting entity that is a private company is not required to apply the VIE guidance to legal entities under common control (including common control leasing arrangements) if the parent and the legal entities being evaluated for consolidation are not public business entities. Refer to CG 2.3.5.

7.1.1.3 **Entities with a high degree of common ownership**

A high degree of common ownership exists when multiple shareholders hold similar ownership interests in multiple entities, but no one shareholder controls the entities. Transfers among entities that have a high degree of common ownership are not common control transactions. However, such transfers may be accounted for in a manner similar to a common control transaction if the transfers lack economic substance. For example, a transaction in which the shareholders have identical ownership interests before and after the transaction generally is considered to lack economic substance.

The SEC staff has historically looked to the guidance provided in FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations* (FTB 85-5), to evaluate whether a transaction lacked economic substance. In an assessment of an exchange between a parent and minority shareholder in one of the parent's partially owned subsidiaries, paragraph 6 states that if the

minority interest does not change and in substance, the only assets of the combined entity are those of the partially owned subsidiary prior to the exchange, a change in ownership has not taken place. In this scenario, the transaction would be accounted for based on the carrying amounts of the partially owned subsidiary's assets and liabilities.

The SEC staff has stated that if the ownership percentages and interests are not, in substance, the same before and after the transaction, a substantive transaction occurred, and the staff would object to accounting similar to a transaction under common control. Transfers of businesses that have been determined to have economic substance should be accounted for using the acquisition method.

FTB 85-5 was superseded by the issuance of ASC 805. However, we believe the underlying guidance contained in paragraph 6 continues to be relevant until the SEC staff indicates otherwise. That is, we believe one should evaluate whether a transfer among entities with a high degree of common ownership lacks economic substance when determining the appropriate accounting.

Questions arise as to whether a small change in ownership percentages can be considered a substantive transaction. There is no bright line in making such a determination. We are aware that the SEC staff has evaluated situations when the minority-ownership percentage changed by a relatively small amount, yet concluded that there was a substantive economic change in ownership interests, which precluded historical cost accounting. In assessing changes in ownership, consideration should be given to all interests outstanding on a fully diluted basis. Other economic factors (beyond ownership percentages) may indicate a transaction has economic substance.

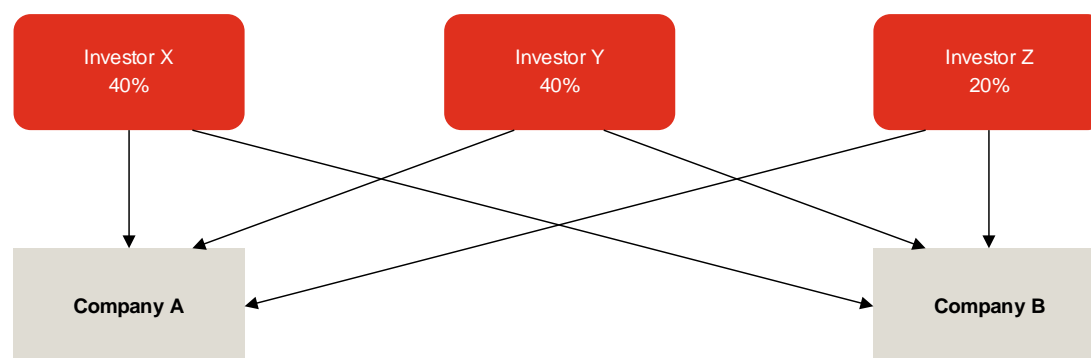
Example BCG 7-2 illustrates a transaction that lacks economic substance between entities with a high degree of common ownership.

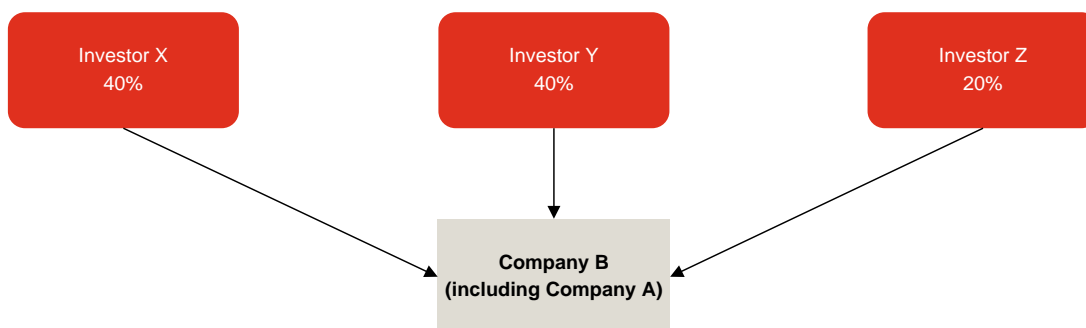
EXAMPLE BCG 7-2

Transfer between entities with a high degree of common ownership that lacks economic substance

Company A and Company B are each owned 40% by Investor X, 40% by Investor Y, and 20% by Investor Z. Company A and Company B are each considered a business under ASC 805. On December 31, 20X1, Company A is merged with and into Company B. Each of the investor's ownership interests in the merged entity is the same before and after the transaction.

Before



After

How should the transfer be recorded in Company B's financial statements?

Analysis

Although no single investor controls Company A and Company B, each investor's ownership interest in the underlying net assets in the combined entity is the same before and after the transaction. As a result, the transaction is deemed to lack economic substance, and Company B would generally record the assets and liabilities of Company A at the carrying amounts recorded in Company A's financial statements in accordance with the guidance contained in ASC 805-50. See BCG 7.1.3.2 for further information.

The investors should consider any basis differences between the carrying amount of their equity method investments in Company A and their proportionate interests in the equity of Company A as included in Company B's financial statements. See EM 3.3.1 for additional information on the accounting for basis differences.

7.1.1.4 Up-C structures

Certain companies that are pass-through entities for tax purposes (e.g., partnerships or certain limited liability companies) may contemplate a public offering using an umbrella partnership C corporation ("Up-C") structure. In this structure, the existing equity holders of a pass-through entity amend the existing entity's governance structure to enable a newly formed corporation to have a controlling financial interest in the entity. Concurrently, the equity holders of the pass-through entity receive noneconomic voting shares (e.g., Class B common stock) of the corporation for each share or unit held in the existing entity, while retaining their economic interest in the pass-through entity.

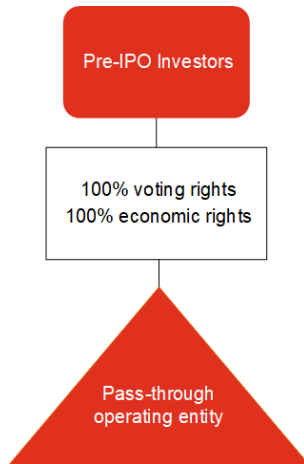
Subsequent to the reorganization, the newly formed corporation will issue common shares with both economics and voting rights (e.g., Class A common stock) to public shareholders in the public offering. These transactions allow the pass-through entity's equity holders to retain the tax benefits of the pass-through entity while also providing a path to future liquidity as the equity holders are given the right to exchange their partnership (or similar) interests in the entity into common stock of the publicly traded corporation.

When Up-C IPOs are structured such that the owners of the operating company retain control of the operations through ownership of a majority of the voting rights in the publicly traded company, the transaction may involve a high degree of common ownership and therefore be accounted for in a manner similar to a common control transaction. Refer to BCG 7.1.1.3 for more information.

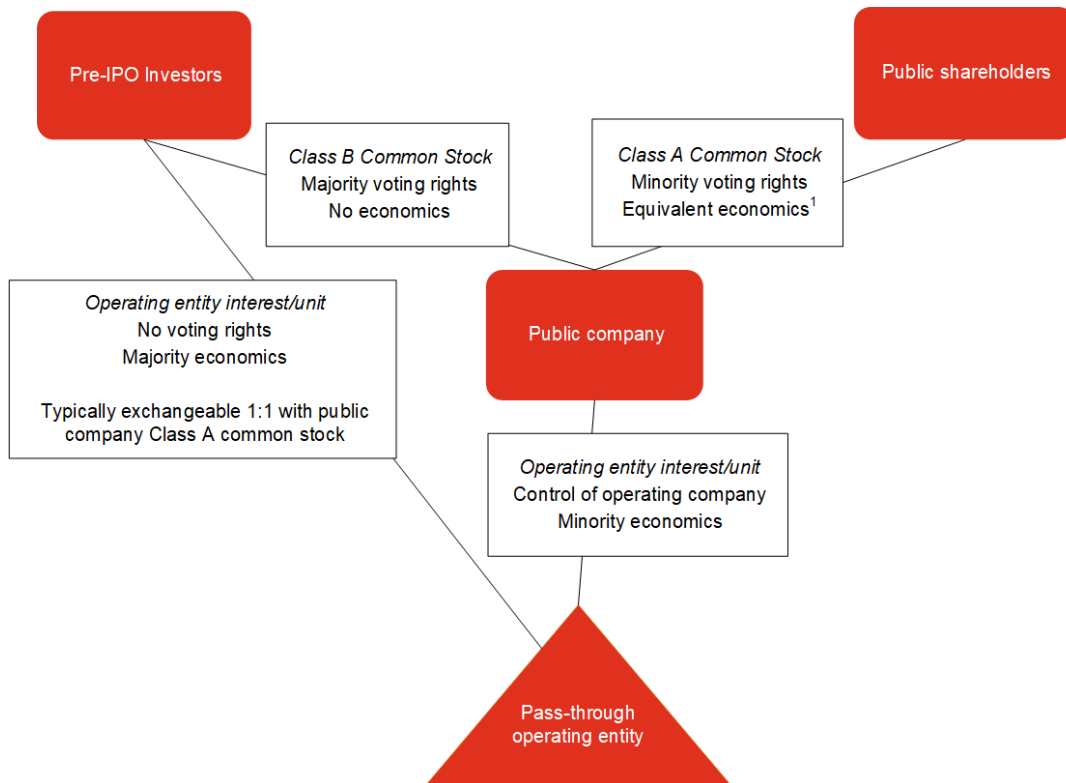
Figure BCG 7-1 provides a simplified organizational structure for an Up-C transaction pre-IPO and post-IPO:

Figure BCG 7-1
Up-C organizational structure

Pre-IPO



Post-IPO



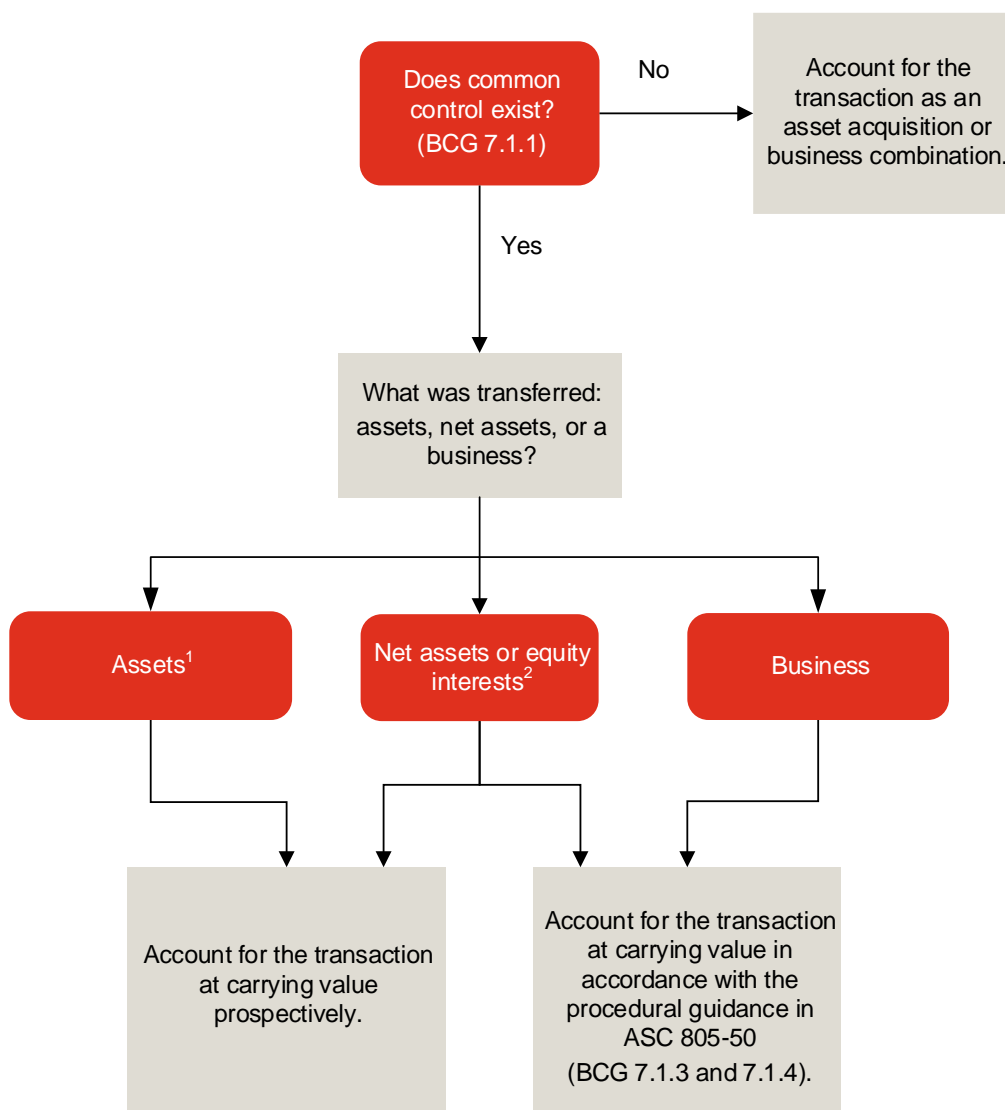
¹ The economics of each share of Class A common stock represents the same proportional interest in the underlying business as a common unit of the pass-through operating entity.

7.1.2 Nature of the transfer (common control)

The accounting for common control transactions is based on the nature of what is transferred or exchanged as part of the transaction. Figure BCG 7-2 provides a decision tree which may help determine how the transaction should be measured and presented for financial reporting purposes.

Figure BCG 7-2

Accounting for common control transactions



¹ When nonrecurring transactions (e.g., transfers of long-lived assets) involving entities under common control occur, any nonfinancial assets are recorded at the parent's historical carrying values in such assets by the receiving entity. However, for recurring transactions for which valuation is not in question, such as routine inventory transfers, the exchange price is normally used regardless of whether a common control relationship exists. Depending on the nature of the transaction, nonrecurring transfers of financial assets may be at fair value (i.e., qualify for sale accounting) or at historical cost at the subsidiary level, by the receiving entity. See BCG 7.1.2.1 for more information on transfers of financial assets involving entities under common control.

² As discussed further below, the determination of whether to account for the transaction prospectively or retrospectively will depend on whether the nature of the net assets or equity interests is more similar to assets or a business.

ASC 805-50-05-5 states that some transfers of net assets or exchanges of shares between entities under common control result in a change in reporting entity. Transfers of a business or net assets between entities under common control that result in a change in reporting entity require retrospective combination of the entities for all periods presented as if the combination had been in effect since the inception of common control. See BCG 7.1.3.2 for further information. Transfers of assets are accounted for prospectively.

The ASC Master Glossary defines a change in reporting entity.

ASC Master Glossary

Change in the reporting entity: A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to the following:

- a. Presenting consolidated or combined financial statements in place of financial statements of individual entities
- b. Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented
- c. Changing the entities included in combined financial statements.

Neither a business combination accounted for by the acquisition method nor the consolidation of a VIE pursuant to Topic 810 is a change in reporting entity.

There is no specific guidance on differentiating asset transfers from net asset transfers. In practice, transfers of businesses are usually considered to be net asset transfers and non-business transfers as asset transfers. However, judgment must be applied in determining whether a transaction constitutes an asset transfer (that would not result in a change in reporting entity), or a transfer of net assets (that would result in a change in reporting entity). Some factors that may be helpful in making the determination include:

- Determining whether the assets transferred constitute a business under ASC 805
- Determining whether the assets transferred constitute an asset group as defined in ASC 360-10
- Making a qualitative assessment of the characteristics of the assets transferred in conjunction with the characteristics of a business described in Article 11 of Regulation S-X; see FSP 17.4.16.2 for further information

This list is not intended to be all inclusive, and all facts and circumstances of each transfer should be considered in determining whether the transfer constitutes the transfer of an asset or the transfer of net assets.

Sometimes a new parent company may be added to an existing company (or consolidated group of companies) by setting up a new holding company (see BCG 2.3.1 for additional information on “NewCos”). The shareholders of the existing company exchange their shares for shares in the new company in proportion to their existing ownership interests (i.e., share for share exchange). In such cases, there is no change in the substance of the reporting entity. Therefore, absent basis differences

between a controlling owner and the parent company, the consolidated financial statements of the new company should reflect the accounting of the previous company (or existing consolidated group), except that the legal capital (i.e., issued and outstanding capital stock or membership interests) would reflect the capital of the new parent company.

Another type of transaction between entities under common control is a downstream merger, when a partially owned subsidiary exchanges its common shares for the outstanding voting common shares of its parent. The end result is that the consolidated net assets are owned by a single stockholder group that includes both the former shareholders of the parent and the former shareholders of the noncontrolling interest in the subsidiary. A downstream merger is accounted for as if the parent acquired the shares of the subsidiary, regardless of the legal form of the transfer. Consistent with a reverse merger, there is no change in basis for the assets and liabilities. The shareholders' equity of the surviving entity will reflect that of the former parent, giving effect to the acquisition of the noncontrolling interest in accordance with ASC 810-10-45-23.

7.1.2.1 **Transfers of financial assets (common control)**

ASC 860-10-55-78 indicates that a transfer of a financial asset between subsidiaries of a common parent would be accounted for as a sale in the transferring subsidiary's standalone financial statements if all the conditions of ASC 860-10-40-5 are met and the transferee subsidiary is not consolidated in the transferring entity's standalone financial statements. This guidance does not apply to transfers of financial assets between a parent company and its subsidiaries. This guidance also does not apply to the transfer of nonfinancial assets, or the shares or net assets of a subsidiary that are not principally financial assets, between entities under common control. Rather, those transactions should generally be recorded at historical cost by the receiving subsidiary as a common control transaction. Example BCG 7-3 illustrates the accounting for transactions involving the transfer of financial assets between subsidiaries of a common parent.

EXAMPLE BCG 7-3

Transfer of a financial asset between subsidiaries of a common parent

Company A and Company B are entities under common control, with Parent owning 100% of both companies. Company A holds debt securities accounted for as available-for-sale under ASC 320-10. The fair value of the debt securities is \$1 million with a cost basis of \$800,000 at December 31, 20X1. Company A recorded the \$200,000 unrealized gain in these marketable securities in other comprehensive income (this example ignores tax effects). On December 31, 20X1, Company A transfers the marketable securities to Company B. Company A does not consolidate Company B into its separate-entity financial statements.

How should Company A record the transfer?

Analysis

Since debt securities are financial assets and Company A does not consolidate Company B, Company A would apply ASC 860-10-55-78 to this transaction. If Company A determines that this transaction qualifies as a sale in accordance with ASC 860-10-40-5, then Company A would account for the transfer of the debt securities at their fair value and record a gain of \$200,000 in its financial statements. Parent, however, would not recognize a gain.

7.1.3 **Accounting by the receiving entity (common control)**

This section provides guidance on the accounting and reporting of the entity that receives net assets or equity interests from an entity that is under common control.

7.1.3.1 **Basis of transfer (common control)**

When accounting for a transfer of assets or exchange of shares between entities under common control, the receiving entity should recognize the assets and liabilities transferred at the historical cost of the parent of the entities under common control in accordance with ASC 805-50-30-5. This may be referred to as use of the ultimate parent's basis. Use of the ultimate parent's basis is important as the transferring entity's carrying values sometimes differ from the parent's basis because pushdown accounting has not been applied.

Example BCG 7-4, Example BCG 7-5, Example BCG 7-6, Example BCG 7-7, and Example BCG 7-8 provide additional guidance for determining the proper basis at which to record transfers in common control transactions.

EXAMPLE BCG 7-4

Accounting by the receiving subsidiary

Parent owns 100% of both Company A and Company B. Parent will contribute its ownership interest in Company B to Company A. Parent's basis in Company B is \$200 in its consolidated financial statements. The carrying amount of Company B's assets and liabilities in its standalone financial statements is \$150 because Parent did not push down its basis to Company B's standalone financial statements.

How should the transfer be recorded in Company A's consolidated financial statements?

Analysis

The transaction represents a transaction between entities under common control. Pursuant to ASC 805-50-30-5, the parent's basis in Company B (i.e., \$200) should be reflected in Company A's consolidated financial statements upon the transfer.

EXAMPLE BCG 7-5

Parent sells division to partially owned subsidiary

Company A owns 80% of Company B. Company A plans to sell one of its divisions to Company B with a book value of \$150 million and an estimated fair value of \$250 million for \$250 million in cash.

How should Company B record the transaction?

Analysis

This is a transaction between entities under common control because Company A controls Company B. Company B should record its investment in the division at the parent's basis of \$150 million, and the excess paid over the parent's basis of the transferred division of \$100 million should be charged to equity as a deemed dividend.

EXAMPLE BCG 7-6

Subsidiary sells its wholly owned subsidiary to another subsidiary of its parent

Company A and Company B are controlled by the same corporate parent, Company P. Company A sells one of its wholly owned subsidiaries, Company C, to Company B for \$115 million in cash. The fair value of Company C, as determined by an independent third party, is \$115 million and its book value is \$100 million. There is no basis difference between Company A's carrying value of its investment in Company C and the underlying equity of Company C. Further, there is no basis difference between Company P's carrying value of its investment in Company A and the underlying equity of Company A.

How should Company B (receiving entity) account for the transaction?

Analysis

This is a transaction between entities under common control. Even though the fair value of Company C has been determined by an independent third party, ASC 805-50-30-5 indicates that assets and liabilities transferred between entities under common control should be accounted for at the parent's historical cost. Company B should record its investment in Company C at the parent's basis of \$100 million, and the excess paid over the parent's basis in Company C of \$15 million should be charged to equity as a deemed dividend.

EXAMPLE BCG 7-7

Parent transfers acquired entity to newly formed subsidiary

Parent acquired Company A for \$7 million. Company A was then transferred to a newly formed subsidiary of Parent, Company B, for consideration of \$1 million in cash and a \$8 million note. The initial capitalization of Company B was \$1 million.

How should Company B record the transaction?

Analysis

Company B should record the net assets of Company A at Parent's basis of \$7 million. Accordingly, the financial statements of Company B should reflect the net assets of Company A, a note payable to the parent of \$8 million, and a deemed dividend of \$2 million resulting in a net shareholder's deficit of \$1 million.

EXAMPLE BCG 7-8

Property sold to subsidiary, and then sold to a third party

Company A agrees to sell a building with a book value of \$20 million and a fair value of \$35 million to a third party. Immediately prior to consummation of the sale, Company A sells the building to its subsidiary, Subsidiary B, for \$20 million and the subsidiary sells the building to the third party for \$35 million.

How should Subsidiary B record the additional sale proceeds?

Analysis

Subsidiary B should record the additional \$15 million sales proceeds as a contribution to capital. In substance, since the subsidiary did not previously hold the building as an operating asset, the transaction may be viewed as a dividend distribution of \$20 million from Subsidiary B to Company A with a concurrent capital contribution of \$35 million from Company A to Subsidiary B. However, the gain on sale of \$15 million would be credited to income in Company A's consolidated financial statements.

7.1.3.2 Presenting a change in reporting entity (common control)

If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are effectively considered to be those of a different reporting entity. The change in reporting entity requires retrospective combination of the entities for all periods presented as if the combination had been in effect since inception of common control in accordance with ASC 250-10-45-21. The following guidance should be applied when preparing financial statements and related disclosures for the receiving entity:

ASC 805-50-45-2

The financial statements of the receiving entity should report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intra-entity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intra-entity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible.

ASC 805-50-45-3

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities need not be eliminated. However, paragraph 805-50-50-2 requires disclosure.

ASC 805-50-45-4

Similarly, the receiving entity shall present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

ASC 805-50-45-5

Financial statements and financial information presented for prior years also shall be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries shall indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years shall only be adjusted for periods during which the entities were under common control.

ASC 805-50-50-3

The notes to the financial statements of the receiving entity shall disclose the following for the period in which the transfer of assets and liabilities or exchange of equity interests occurred:

- a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests
- b. The method of accounting for the transfer of net assets or exchange of equity interests.

ASC 805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

When there is a change in reporting entity, companies may need to determine a predecessor entity in certain common control transactions as discussed in BCG 7.1.3.3.

7.1.3.3 *Determining the receiving entity (common control)—updated September 2023*

Similar to the concept in the reverse acquisition guidance, the legal receiving entity may not be deemed the receiving entity for accounting purposes in a common control transaction. When both entities were under common control during the entire reporting period and both entities reflected the parent's basis, it is not necessary to determine which entity is the receiving entity because doing so has no impact on the retrospectively adjusted financial statements. Determination of the receiving entity is necessary when one or more of the combining entities does not reflect the parent's basis as the assets and liabilities of the transferred entity should be recognized by the receiving entity at the ultimate parent's basis. See Example BCG 7-4.

When the combining entities have not been under common control for the entire period presented, the receiving entity for accounting purposes should be determined from the perspective of the parent company. As the parent controls the form of the transaction, different accounting should not result solely based on the legal form of the transaction. Thus, the entity that first came under control of the parent is often presented as the accounting receiving entity regardless of the legal form of the transaction.

Example BCG 7-9 illustrates how to determine the receiving entity in a common control transaction.

EXAMPLE BCG 7-9**Determining the receiving entity in a common control transaction**

Parent has two wholly-owned subsidiaries: Subsidiary A, which was acquired in 20X1, and Subsidiary B, which was acquired in 20X2. In 20X3, Subsidiary A is merged with and into Subsidiary B, and Subsidiary B is the surviving entity. Subsidiary A and Subsidiary B represent 20% and 80%, respectively, of the total net assets of the combined company. Parent's basis has not been pushed down into the separate accounts of Subsidiary A or Subsidiary B and therefore, basis differences exist between Parent and each subsidiary.

What entity is the receiving entity for accounting purposes?

Analysis

Subsidiary A is considered the receiving entity as it was the entity that first came under control of Parent (in 20X1). Subsidiary A's assets would continue to be reflected at Subsidiary A's historical cost in the financial statements of the combined entity. Subsidiary B's net assets, however, should be reflected at Parent's basis.

Because the application of pushdown accounting is an optional election for each acquired company within its separate financial statements, Subsidiary A could elect to apply pushdown accounting for comparability. However, as Subsidiary A had not initially applied pushdown accounting, such an election in this subsequent period would be considered a change in accounting principle in accordance with ASC 250, which requires assessment that the change is preferable. If it were to make this election, Subsidiary A would retrospectively adjust its reporting basis as of the date of the change-in-control event (i.e., when it was acquired in 20X1). See BCG 10.1.5 for additional information.

For purposes of SEC reporting, Regulation S-X requires financial statements for the registrant and its predecessor(s). Often, the receiving entity for accounting purposes is also the predecessor for SEC reporting purposes. However, this is not always the case.

The term predecessor is defined in Section 1170 of the Division of Corporation Finance's Financial Reporting Manual. However, this guidance is not always sufficiently helpful to determine which entities should be considered the predecessor in initial registration statements. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member commented that when determining a predecessor entity, factors to consider may include the size of the entities, the relative fair value of the entities, the ongoing management structure, and the order in which the entities were acquired. While not specific to common control transactions, this speech indicates that the predecessor entity determination should be made based on the specific facts and circumstances. No one factor is determinative.

Example BCG 7-10 illustrates how to determine the predecessor entity for SEC reporting and the financial statement presentation for the merged entity.

EXAMPLE BCG 7-10

Determining the predecessor entity for SEC reporting

Parent has two wholly owned subsidiaries: Subsidiary A, which was acquired on July 1, 20X1, and Subsidiary B, which was acquired on October 1, 20X2. On March 31, 20X3, Subsidiary A is merged with and into Subsidiary B, and Subsidiary B is the surviving entity. Subsidiary A and Subsidiary B represent 20% and 80%, respectively, of the total net assets of the combined company. There are no basis differences between Parent and Subsidiary A or Subsidiary B (i.e., both subsidiaries elected pushdown accounting at the time of their respective acquisitions).

The combined entity is preparing financial statements for SEC reporting purposes. For SEC reporting purposes, which entity should be presented as the predecessor to the combined company? How should the financial statements be presented for the merged entity?

Analysis

For SEC reporting purposes, although Parent obtained control of Subsidiary A first, it may be appropriate for Subsidiary B to be considered the predecessor entity after considering each of the following factors:

- The relative size of the entities;
- The relative fair value of the entities;
- The ongoing management structure; and

The order in which the entities were acquired.

If Subsidiary B is considered the predecessor, the year ended December 31, 20X1 and the period from January 1, 20X2 to September 30, 20X2 would reflect the operations of Subsidiary B on a historical cost basis prior to its acquisition by Parent. As Subsidiary B elected pushdown accounting, a blackline would separate the periods before and after its acquisition by Parent on October 1, 20X2 to highlight the new basis of accounting resulting from this change in control.

The successor period from October 1 through December 31, 20X2 and the year ended December 31, 20X3 would reflect the operations of the combined entity (i.e., the operations of Subsidiary A and Subsidiary B) as October 1, 20X2 is the earliest date on which both subsidiaries were under common control. As the receiving entity, Subsidiary B would recognize the assets and liabilities of Subsidiary A (the transferred entity) based on Parent's acquisition accounting basis. The use of Parent's basis is required by ASC 805-50-30-5 regardless of whether Subsidiary A elected pushdown accounting in its standalone financial statements.

The receipt of Subsidiary A by Subsidiary B does not itself trigger blackline presentation. This is because from Subsidiary B's perspective, the transaction is a common control merger in which it is considered the receiving entity as of the date when common control was achieved (i.e., October 1, 20X2). Therefore, if Subsidiary B had not elected pushdown accounting, the financial statements would not include a blackline, but rather would reflect the historical cost basis of Subsidiary B for all periods, and the acquisition of Subsidiary A on October 1, 20X2 as a business combination.

Subsidiary A's standalone financial statements may be required under Regulation S-X Rule 3-05.

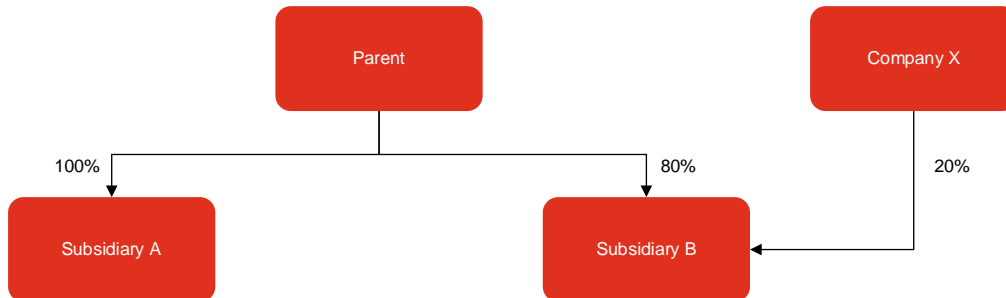
7.1.3.4 Noncontrolling interest in a common control transaction

The accounting for any noncontrolling interest should follow the guidance in ASC 810-10 if one or more entities in a common control transaction are partially owned by the parent. While noncontrolling interest is recorded at fair value at the acquisition date in a business combination under ASC 805, in a common control transaction, by definition, there is no change in control. Under ASC 810-10, changes in the parent's ownership interest while it retains a controlling financial interest in its subsidiary are accounted for as equity transactions. The carrying amount of the noncontrolling interest should be adjusted to reflect the change in the noncontrolling shareholders' ownership interest.

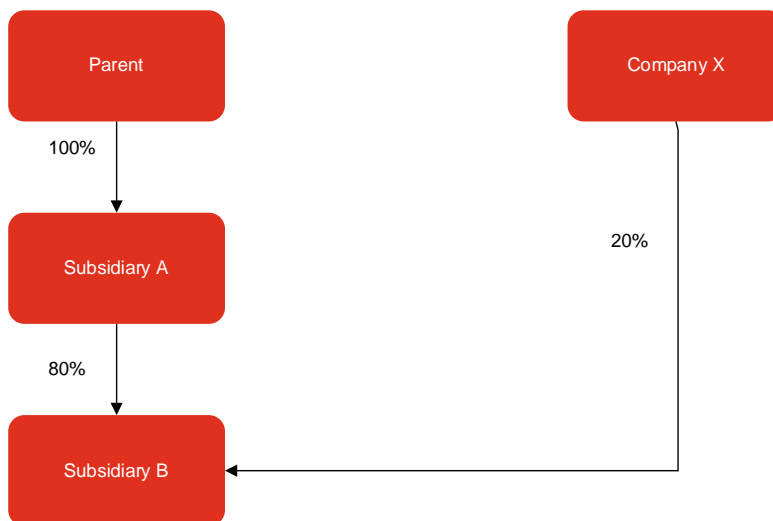
Example BCG 7-11 illustrates the accounting for the noncontrolling interest in a common control transaction.

EXAMPLE BCG 7-11**Acquisition of a noncontrolling interest in a common control transaction**

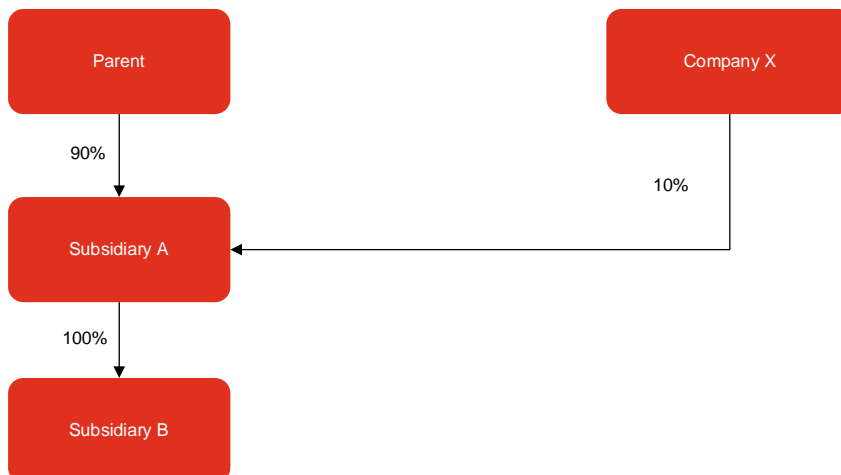
Parent owns 100% of Subsidiary A and 80% of Subsidiary B. Company X owns 20% of Subsidiary B.



Parent transfers its investment in Subsidiary B to Subsidiary A in a common control transaction.



In conjunction with the transaction, Company X exchanges its 20% interest in Subsidiary B for a 10% interest in Subsidiary A.



Also assume the following additional facts:

	Fair value	Net book value
Subsidiary A	\$500	\$200
Subsidiary B	\$500	\$300

- Parent's basis in 100% of Subsidiary A is \$200.
- Parent's basis in 80% of Subsidiary B is \$240.
- In Parent's financial statements, Company X's noncontrolling interest in Subsidiary B is \$60.
- Fair value of 10% of Subsidiary A and Subsidiary B combined is \$100.

How should the transaction be recorded in the financial statements of Parent and Subsidiary A?

Analysis

Parent's contribution of Subsidiary B to Subsidiary A – Parent's financial statements

The transfer by Parent of its investment in Subsidiary B to Subsidiary A is a common control transaction and would be recorded at Parent's carrying amount of \$240. The transaction would have no impact on Parent's consolidated financial statements.

Subsidiary A's acquisition of Company X's noncontrolling interest in Subsidiary B in exchange for a 10% noncontrolling interest in subsidiary A – Parent's financial statements

Subsidiary A acquires Company X's noncontrolling interest in Subsidiary B in exchange for a 10% noncontrolling interest in Subsidiary A. Under ASC 810-10, the transaction is accounted for as an equity transaction with the noncontrolling interest in the consolidated financial statements of Parent and would be recorded as follows:

NCI—subsidiary B	\$60 ¹	
Equity/APIC—parent		\$10 ²
NCI—subsidiary A		\$50 ³

¹ Elimination of Company X's noncontrolling interest in Subsidiary B.

² The net increase in Parent's equity in the consolidated financial statements as a result of the transaction with the noncontrolling interest is calculated as follows:

	Net book value	20% NCI in Subsidiary B	10% NCI in Subsidiary A	Total adjustment
Subsidiary A	\$200	—	\$20	\$20
Subsidiary B	\$300	\$(60)	30	(30)
Adjustment to Parent's APIC		\$(60)	\$50	\$(10)

The effect of the \$60 reduction in the noncontrolling interest in Subsidiary B and \$50 increase in the noncontrolling interest in Subsidiary A results in a net \$10 increase in Parent's equity in the consolidated financial statements. The changes in the carrying value of the noncontrolling interests are accounted for through equity/APIC. The noncontrolling interest is only recorded at fair value at the date of a business combination.

³ Recording of the new noncontrolling interest in Subsidiary A (consolidated net book value of \$500 × 10%).

Other Considerations – Parent's financial statements

If Company X did not participate in the exchange (i.e., Company X maintained its 20% interest in Subsidiary B), the transaction would simply be accounted for as a transfer of Parent's investment in Subsidiary B to Subsidiary A at Parent's historical cost.

Recasting of historical financial statements – Subsidiary A

The common control transfer of Subsidiary B to Subsidiary A represents a change in reporting entity for Subsidiary A. Subsidiary A would recast its historical financial information. The periods prior to the transfer would be adjusted to include the results of Subsidiary B with a 20% noncontrolling interest, reflecting the ownership interest of Company X. On the date of transfer, and as a result of the exchange of Company X's 20% ownership in Subsidiary B for a 10% ownership in Subsidiary A, Subsidiary A would eliminate the noncontrolling interest in its financial statements prospectively.

See BCG 5 and BCG 6 for information and additional illustrative examples on how to account for transactions between a parent company and the noncontrolling interest.

7.1.3.5 Goodwill and reporting unit assessment (common control)

When an entity prepares financial statements for entities under common control following the guidance in ASC 805-50, it must consider goodwill impairment testing. A frequent question is whether the historical annual goodwill impairment tests should be performed assuming the transferred entity was integrated into the combined entity's reporting units at the inception of common control or if the

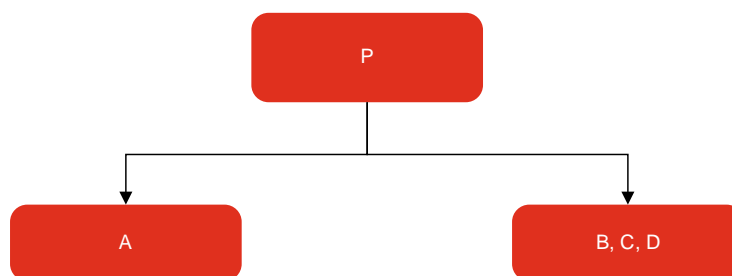
transferred entity is its own separate reporting unit. While there is no specific guidance, two alternative approaches have developed in practice.

The first approach is based on an interpretation of the guidance in ASC 805-50 that indicates the new reporting entity's financial statements should result in financial reporting similar to the pooling-of-interest method. Under this premise, the combined entity should reassess its historical reporting units for goodwill impairment testing as if the transferred entity actually had been transferred at the inception of common control. This method requires management of the new reporting entity to make assumptions about how the financial reporting of the entity would have been structured and managed in historical periods, which may not reflect how the entities were actually managed during those periods.

The alternative view is that the entities being combined should utilize the historical reporting unit structures of each of the combined entities. In the event the transferred entity, the receiving entity, or both did not have stand-alone reporting requirements, the entity (the transferring entity, the receiving entity, or both) would be treated as its own reporting unit for historical goodwill impairment testing purposes. At the time of the common control transaction, the reporting entity would need to reassess the reporting units for testing goodwill impairment going forward. To the extent any changes are made to the reporting units (e.g., the formerly separate entities treated as separate reporting units for historical goodwill testing do not remain separate reporting units), the reporting entity would need to reassign goodwill in accordance with ASC 350-20-35-45. See BCG 9.4.4 for additional information on reassigning goodwill when the reporting entity's reporting unit structure changes.

Under either approach, the amount of goodwill associated with the transferred entity should be determined consistent with the guidance in CO 4.2.7.

To illustrate both alternatives, assume Parent Company P has four wholly owned subsidiaries: A, B, C, and D. Subsidiary A comprises a single reporting unit and subsidiaries B, C, and D comprise a second single reporting unit.



Subsidiary A previously prepared stand-alone financial statements and it constituted a single reporting unit for goodwill impairment testing purposes. On December 31, 20X1, Parent Company P transfers its interest in Subsidiary B to Subsidiary A in a common control transaction, resulting in a change in reporting entity.

Under the first approach, management of Subsidiary A would be required to determine how the combined operations of Subsidiary A and Subsidiary B would have been managed had the operations of Subsidiary B been transferred at the beginning of the earliest reporting period.

Under the second alternative, the historical single reporting unit of Subsidiary A would remain unchanged and the operations of Subsidiary B would have been treated as a second stand-alone

reporting unit prior to the actual transfer date. As noted above, any changes to the reporting unit structure at the time of the common control transaction would result in a reassignment of goodwill.

Regardless of the method used, the consolidated financial statements of Parent Company P will account for this change in reporting structure prospectively. Goodwill should be reassigned to the affected reporting units by using a relative fair value approach. See BCG 9.4.4 for further information.

7.1.3.6 *Deferred taxes (common control)*

The guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50 does not specifically address the accounting for the deferred tax consequences that may result from a transfer of net assets or the exchange of equity interests between entities under common control. Although such a transaction is not a pooling-of-interests, we believe the historical guidance in FAS 109, paragraphs 270-272, which addresses the income tax accounting effects of a pooling-of-interests transaction, should be applied by analogy. See TX 10.10 for further information.

7.1.3.7 *Last-In, First-Out (LIFO) inventories (common control)*

In a nontaxable transfer of net assets or exchange of equity interests between entities under common control, any LIFO inventories of the entities are carried over at the historical LIFO basis and with the same LIFO layers for financial reporting and for tax purposes. In a taxable transfer or exchange, LIFO inventories of the entities are carried over at the same historical LIFO basis and with the same LIFO layers for financial reporting purposes. However, for income tax purposes, the LIFO inventories of one of the entities are stepped up and considered purchases of the current year. Deferred taxes arising from differences in the financial reporting and income tax bases of LIFO inventories resulting from a taxable transfer or exchange should be credited to contributed capital.

7.1.3.8 *Conforming accounting policies (common control)*

Subsidiaries of a common parent generally have similar accounting policies; however, US GAAP does not require them to be the same. Therefore, in a common control transaction, the receiving entity and the transferring entity may have differing accounting policies. For instance, one entity may apply last-in, first-out for inventory while the other uses a different method for similar types of inventory. ASC 805-50-30-6 describes the accounting when this occurs.

ASC 805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method should be applied retrospectively, and financial statements presented for prior periods should be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

If the receiving entity's method is not preferable, the receiving entity may account for the transferred assets and liabilities under the transferring entity's existing accounting method. Alternatively, if either the transferring entity or receiving entity were to change its accounting policy, it must be preferable.

7.1.4 ***Accounting by the transferring entity (common control)***

This section provides guidance on the accounting and reporting of the entity that contributes net assets or equity interests to an entity that is under common control.

ASC 805-50-05-5 indicates that certain common control transactions are changes in the reporting entity and provides accounting guidance for the entity that receives the net assets. However, ASC 805 is silent regarding the accounting by the entity that contributes the net assets or equity interests.

In situations where the contribution or sale transaction is to one of the transferring entity's wholly owned subsidiaries, the consolidated financial statements of the transferring entity will not be affected, except in certain cases for tax effects associated with an intra-entity sale or transfer of subsidiary stock. Otherwise, any differences between the proceeds received and the book value of the disposal group would be eliminated in consolidation, and no gain or loss would be recognized. In contrast, the financial statements of the transferring entity will be impacted by a contribution or sale to another party under common control that is not a subsidiary of the transferring entity (e.g., a fellow subsidiary under a common parent). A transfer of long-lived assets between entities under common control would generally be accounted for at carrying value prospectively. Any difference between the proceeds received by the transferring entity and the book value of the assets would be recognized as an equity transaction. For those transactions that constitute a transfer of net assets (e.g., a business), two methods of accounting by the transferring entity have developed in practice. Regardless of the method used, the consolidated financial statements of the common parent will not be affected.

In the first method, similar financial reporting for the receiving entity is applied to the transferring entity. This method is often referred to as a "de-pooling." In a de-pooling, the assets, liabilities, and related operations of the transferred business are retrospectively removed from the financial statements of the transferring entity at their historical carrying values.

Under the second approach, the transferring entity reports the transfer as a disposal pursuant to ASC 360-10. The guidance in ASC 360-10-45-15 indicates that the disposal group of long-lived assets that are to be disposed of other than by sale should continue to be classified as held and used until the disposal date. Specifically, ASC 360-10-40-4 states that if a long-lived asset is to be disposed of in an exchange or a distribution to owners in a spin-off, and if that exchange or distribution is to be accounted for based on the recorded amount of the nonmonetary asset relinquished, the asset should continue to be accounted for as held and used until it is exchanged or distributed. Any difference between the proceeds received by the transferring entity and the book value of the disposal group (after impairment included in earnings, if any) would be recognized as a capital transaction and no gain or loss would be recorded.

If the disposal group qualifies as a component of the transferring entity, it should be assessed for discontinued operations reporting on the disposal date. For more information on the criteria for reporting discontinued operations, refer to FSP 27.

The SEC staff has issued Staff Accounting Bulletin (SAB) Topic 5-Z.7, *Miscellaneous Accounting, Accounting and Disclosure Regarding Discontinued Operations, Accounting for the Spin-off of a Subsidiary* (codified in ASC 505-60-S99-1), which addresses accounting for the spin-off of a subsidiary. While this topic is not written in the context of a change in reporting entity that results from a common control transaction, entities should consider this guidance in determining the appropriate accounting by the transferring entity in a common control transaction. The topic provides a number of stringent criteria, all of which must be met to "de-pool" a transferred business

retroactively from its historical financial reporting periods. The SEC staff often challenges a company's assertion that all the requirements of the SAB topic have been met. Therefore, the transferring entity will more frequently reflect the contribution as a disposal under ASC 360-10. Although this guidance is specific to public companies, we believe the underlying concepts are applicable to private companies as well.

Example BCG 7-12 illustrates the accounting for a common control transfer in the transferring entity's separate financial statements.

EXAMPLE BCG 7-12

Subsidiary sells its wholly owned subsidiary to a sister subsidiary that is owned by the same parent

Company A and Company B are controlled by the same corporate parent, Parent Company P. Company A is required to prepare separate financial statements for statutory reporting purposes. Company A sells one of its wholly owned subsidiaries, Company C, to Company B for \$115 million in cash, which is determined to be its fair value. Company C meets the definition of a business. The book value of Company C is \$130 million. There is no basis difference between Company A's carrying value of its investment in Company C and the underlying equity of Company C. Further, there is no basis difference between Parent Company P's carrying value of its investment in Company A and the underlying equity of Company A.

How should Company A record the transaction?

Analysis

The transaction represents a transfer of net assets between entities under common control. Company A would continue to account for the assets of Company C as held and used until Company C is distributed to Company B. On the date of the distribution to Company B, Company A should consider recognizing an impairment loss of \$15 million based on the difference between the fair value and the book value of Company C. Any difference between the proceeds received by Company A and the book value of Company C (after impairment, if any) would be recognized as an equity transaction and no gain or loss would be recorded. Additionally, since Company C qualifies as a component of Company A, it should be assessed for discontinued operations reporting on the date of the distribution.

7.1.4.1 Allocation of contributed entity goodwill (common control)

In certain circumstances, the transferred entity may constitute a business and comprise a portion of a larger reporting unit at the parent-company level. In addition, the parent company may not have previously pushed down goodwill related to the contributed entity for stand-alone reporting purposes. In the transferring entity's separate financial statements, the transferring entity needs to determine the appropriate method to allocate goodwill to the disposal group based on the specific facts and circumstances.

The transferring entity would generally apply the guidance prescribed in ASC 350-20-40-1 through ASC 350-20-40-3. That guidance requires that goodwill of the reporting unit be allocated to the transferred entity based on the relative fair values of the retained portion of the reporting unit and the transferred entity on the date of the transfer.

Alternatively, in the limited circumstances described in ASC 350-20-40-4 through ASC 350-20-40-6, the transferring entity would apply the historical cost approach described in ASC 350-20-40-4 in its separate financial statements. Under this approach, the transferring entity would allocate to the transferred entity the specifically identified original goodwill value of that business from the original acquisition that generated such goodwill.

See BCG 9.10 for additional information on factors to consider when determining the level of integration of an acquired business and any related goodwill into a reporting unit after its acquisition.

Under either method, the transferring entity is required to subsequently test the remaining goodwill for impairment in accordance with ASC 350. Additionally, regardless of the allocation method, the receiving entity will record goodwill based on the parent's historical cost in the contributed entity in accordance with paragraph ASC 805-50-30-5. As a result, there may not be symmetry between the goodwill allocated to the transferred entity by the transferring entity and the goodwill recorded by the receiving entity.

7.1.4.2 Transfers to owners (common control)

Under ASC 845-10-20, a nonreciprocal transfer is a transfer of assets or services in one direction, either from an entity to its owners or to another entity, or from owners or another entity to the entity. A transfer of assets to owners of an entity could be in the form of a pro rata spinoff (see PPE 6.3.2) or a non-pro rata split-off (see PPE 6.3.3).

Chapter 8:
Accounting for indefinite-lived
intangible assets—updated
June 2023

8.1 Overview: indefinite-lived intangible assets

This chapter discusses the accounting for indefinite-lived intangible assets, including how to determine if an intangible asset is indefinite-lived and how to assess such assets for impairment.

Related content

- Presentation and disclosure guidance related to indefinite-lived intangible assets is included in FSP 8.8. Additionally, for private companies, see FSP 8.10.1.
- The initial accounting for intangible assets acquired in a business combination or an asset acquisition is addressed in BCG 4 and PPE 2, respectively.
- The accounting for finite-lived intangible assets, including how to determine their useful lives and method of amortization, is included in PPE 4. How to assess, calculate, and record impairments on finite-lived intangible assets is included in PPE 5.
- Guidance on the initial recognition and measurement of goodwill is included in BCG 2.6.
- Accounting for goodwill post acquisition is addressed in BCG 9.
- Guidance on the derecognition of nonfinancial assets (which includes intangible assets) is included in PPE 6.

8.2 Accounting for indefinite-lived intangible assets

The useful life of an intangible asset should be considered indefinite if no legal, regulatory, contractual, competitive, economic, or other factors limit its useful life to the reporting entity. The term indefinite, however, does not mean infinite or indeterminate, as described in ASC 350-30-35-4.

All factors that are pertinent to whether an intangible asset has an indefinite life should indicate that there is no foreseeable limit to the period over which the asset is expected to contribute to the reporting entity's cash flows. All available evidence should be considered and based on historical and projected trends in demand, competition, technological change, and other economic factors affecting the entity and its industry.

It may be difficult to support an indefinite life, except for certain classes of intangible assets (e.g., Federal Communications Commission licenses and trade names). For example, it would be rare for a customer-related intangible asset to have an indefinite life due to the frequency of customer turnover and changes in relationships. In considering whether an intangible asset has an indefinite life, it may be important to consider how an entity determines the fair value of an intangible asset and assesses that asset for impairment (e.g., a forecasted deterioration in annual cash flows may be inconsistent with an indefinite useful life determination).

Indefinite-lived intangible assets should be reassessed each reporting period to determine whether events or circumstances continue to support an indefinite useful life in accordance with ASC 350-30-35-16. See BCG 8.2.1 for further information on the accounting considerations when an asset that is not being amortized is subsequently determined to have a finite useful life.

Example BCG 8-1 and Example BCG 8-2 illustrate the determination of useful lives.

EXAMPLE BCG 8-1

Intangible asset determined to have an indefinite life

As part of ABC Company's purchase of XYZ Company, ABC recognizes an intangible asset related to XYZ's registered trademark, which is used to distinguish a leading consumer product. The trademark has a remaining legal life of seven years, but is renewable every 10 years for minimal cost. ABC intends to continuously renew the trademark and evidence supports its ability to do so. Analysis of the product life cycle provides evidence that the trademarked product will generate cash flows for ABC for an indefinite period of time.

What useful life should be assigned to the trademark?

Analysis

The trademark may have an indefinite useful life because it is expected to contribute to cash flows indefinitely and the associated costs of renewal are not significant. Therefore, the trademark would not be amortized until its useful life is no longer indefinite. However, the trademark would need to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired in accordance with ASC 350-30-35-18.

EXAMPLE BCG 8-2

Intangible asset determined to have a finite life

As part of Entity B's acquisition of Entity M, Entity B recognizes an intangible asset related to Brand K, a brand known for its association with the production of an economic alternative to carbon-based fuel. Management of Entity B has committed significant resources in support of Brand K and continued improvement of the underlying technology. There is significant competition in this technological area and therefore the technology is subject to constant change and improvement. Brand K does not have an established pattern of surviving changes in the underlying technology.

What factors should be considered by Entity B in determining the useful life that should be assigned to the brand?

Analysis

Since the technology is subject to constant change and improvement, a significant discovery may make previously cutting-edge technology obsolete, resulting in reduced utilization of the brand. Additionally, there is no evidence to support an assertion that Brand K would continue to exist beyond the life of the current underlying technology. These factors would likely make it difficult to conclude that the entity would benefit economically from the brand indefinitely. On the other hand, if Brand K had an established pattern of surviving changes in the underlying technology, Entity B may have been able to support Brand K having an indefinite life.

8.2.1 Reclassifying intangible assets to/from indefinite-lived

As described in ASC 350-30-35-17, when a reporting entity subsequently determines that an indefinite-lived intangible asset has a finite useful life, the reporting entity should test the asset for impairment as an indefinite-lived intangible asset prior to commencing amortization. The intangible asset should then be amortized prospectively over its estimated useful life and accounted for the same

as other intangible assets subject to amortization (including applying the impairment provisions of ASC 360-10). Conversely, as described in ASC 350-30-35-10, if a finite-lived intangible asset is subsequently determined to have an indefinite life, the entity should cease amortizing the asset and test it for impairment as an indefinite-lived intangible asset. Reclassification from a finite-lived intangible asset may result in an impairment charge as the first step in the ASC 360-10 finite-lived intangible asset impairment test, the recoverability test, is performed on an undiscounted basis. The recoverability of the asset using the undiscounted cash flow approach is not considered when assessing the indefinite-lived intangible asset for impairment, which instead compares the fair value of the asset with its carrying amount (see BCG 8.3). In accordance with ASC 350-30-35-11, any resulting impairment loss would be considered a change in accounting estimate, and thus would be presented in the income statement consistent with other impairment losses. While the reclassification of an indefinite-lived intangible asset to a finite-lived intangible asset may occur as a result of changes in circumstances, the reclassification of a finite-lived intangible asset to an indefinite-lived intangible asset is expected to be rare.

8.2.2 *Renewable intangible assets (postacquisition)*

Under ASC 350-30-55-1C, an entity should consider its own historical experience in renewing or extending similar arrangements when developing its assumptions about renewals or extensions used to determine the useful life of an intangible asset. For example, an entity in the television broadcasting business may acquire broadcast licenses. The license may have a stated term but is expected to be renewed indefinitely consistent with past experience. In this case, the entity may conclude that the broadcast license is indefinite lived. In the absence of that experience, an entity should consider the assumptions that market-participants would use about renewals or extensions (consistent with the highest and best use of the asset by market-participants), adjusted for the entity-specific factors in ASC 350-30-35-3.

In some instances, finite-lived intangible assets, such as customer relationships, may be valued using long-term, or even perpetual cash flows. This does not imply that the asset has an indefinite life.

8.2.3 *Reacquired rights (intangible assets postacquisition)*

An entity may, as part of a business combination, reacquire a right it had previously granted to the acquiree to use the acquirer's recognized or unrecognized intangible assets. It is rare that such rights would have an indefinite life. See BCG 2.5.6 for further information on reacquired rights and BCG 2.5.6.1 for further detail on the determination of the value and useful life of reacquired rights.

8.2.4 *Intangible assets used in R&D (postacquisition)*

As discussed in BCG 4.3.4.1, ASC 805 requires the recognition of both tangible and intangible research and development assets acquired in a business combination. This applies even if the intangible assets do not have an alternative future use. After initial recognition, tangible research and development assets are accounted for in accordance with their nature. On the other hand, in-process research and development intangible assets (IPR&D) should be considered indefinite-lived until the abandonment or completion of the associated research and development efforts, as described in ASC 350-30-35-17A. If abandoned, the assets are expensed in the period of abandonment. Impairment of acquired IPR&D intangible assets immediately after being acquired in a business combination is possible, but rare.

If the research and development activities are completed, the acquiring entity would make a determination of the useful lives and methods of amortization of those assets. Refer to BCG 8.2.1 for impairment considerations when reclassifying an indefinite-lived intangible asset. Research and

development expenditures that are incurred after the acquisition, including those for completing the research and development activities related to the acquired intangible research and development assets, are generally expensed as incurred.

Subsequent to a business combination, ASC 350 provides that acquired-in-process research and development intangible assets should not be amortized; instead, they would be subject to an impairment assessment, at least annually in accordance with ASC 350-30-35-18 through ASC 350-30-35-20. See BCG 8.3 for further information on impairment of intangible assets with indefinite useful lives. Further, if these intangible assets are temporarily idled, they should not be accounted for as abandoned, consistent with ASC 360-10-35-49.

This requirement makes it necessary for companies to track capitalized research and development projects for impairment testing purposes. As projects evolve (for instance, multiple projects are combined), such tracking will be necessary for companies to properly test for impairment and determine the point of completion or abandonment of a project. Furthermore, costs incurred after the acquisition related to acquired research and development intangible assets will likely be relevant in performing the impairment testing as they may impact the fair value of the assets.

The AICPA IPR&D Guide provides a best practices publication addressing the financial reporting and emerging practice issues companies are dealing with in regard to research and development assets acquired in a business combination or an asset acquisition. Research and development intangible assets acquired or costs incurred outside of a business combination should be expensed, unless there is an alternative future use, in accordance with ASC 730-10-25-1. See PPE 2 for further information on research and development assets acquired outside of a business combination.

8.2.4.1 *Enabling technology (intangible assets postacquisition)*

Enabling technology is defined in the IPR&D Guide as follows:

Partial definition from IPR&D 6.51

Enabling technology: ...the underlying technology that has value through its continued use or reuse across many products or product families (product family represents many generations of a singular product).

Examples of enabling technology provided in the IPR&D Guide include a portfolio of patents, a software object library, or an underlying form of drug delivery technology. If enabling technology meets the criteria for recognition as an intangible asset, it could be a separate unit of accounting if it does not share the useful life, growth, risk, and profitability of the products in which it is used. The IPR&D Guide indicates that enabling technology is not expected to significantly contribute to the amount of recognized goodwill; rather, if enabling technology does not meet the criteria for separate recognition, the value of enabling technology would be subsumed into other asset categories, such as IPR&D or specific developed technology intangible assets.

8.3 *Impairment of indefinite-lived intangible assets*

Developments and events after a business combination or an asset acquisition may result in a material and sustained decrease in the value of intangible assets, potentially leading to impairment. As defined in ASC 360-10, impairment exists when the carrying amount of an asset (or asset group) exceeds its

fair value. ASC 350 addresses impairment of indefinite-lived intangible assets. An indefinite-lived intangible asset is considered impaired when the asset's carrying amount is greater than its fair value.

The carrying amount of indefinite-lived intangible assets should be tested for impairment prior to testing long-lived assets or goodwill for impairment. Refer to PPE 5.2.2 and PPE 5.3.2 for further discussion regarding the order of impairment testing when the asset group is held and used and held for sale, respectively.

ASC 350 does not prescribe when to perform the annual impairment test for indefinite-lived intangible assets. Similar to goodwill impairment testing, current practice is to perform the test at the same time each year. Any change in the testing date for an indefinite-lived intangible asset should not result in more than one year elapsing between impairment tests, nor should such a change be made to avoid recognizing an impairment loss. Different indefinite-lived intangible assets may be tested for impairment at different times of the year.

Unlike a change in an annual goodwill impairment test date, the SEC staff has stated that a preferability letter is not required if a registrant changes its impairment test date for indefinite-lived assets. This is because ASC 350 does not specifically require the test to be performed at the same time each year.

In accordance with ASC 350-30-45-2, an impairment loss that an entity recognizes for an indefinite-lived intangible asset should be reported as a component of income from continuing operations before income taxes or discontinued operations, as appropriate. We believe the impairment loss should be included in the subtotal "income from operations," if presented. See FSP 8.8 for additional information. After an impairment loss is recognized, the adjusted carrying amount of the indefinite-lived intangible asset will become its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited in accordance with ASC 350-30-35-20.

8.3.1 Indefinite-lived intangible asset impairment test

ASC 350 allows an entity to first assess qualitative factors to determine whether events and circumstances indicate that it is more likely than not (that is, a likelihood of more than 50%) that an indefinite-lived intangible asset is impaired (i.e., the asset's carrying amount exceeds its fair value). If it is more likely than not that the asset is impaired, the entity must calculate the fair value of the asset and record an impairment charge if the carrying amount exceeds fair value. If an entity concludes that it is not more likely than not that the asset is impaired, no further action is required.

Question BCG 8-1

Does the option to apply the qualitative assessment change how an entity determines whether they need to perform an event-driven interim impairment test?

PwC response

No. An indefinite-lived intangible asset should be tested for impairment between annual tests ("interim tests") if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. If such events or changes have occurred, a quantitative assessment is required. Refer to BCG 8.3.1.1 for examples of events and circumstances that could trigger the need for an interim impairment test.

8.3.1.1 **Qualitative impairment: indefinite-lived intangible asset**

In evaluating whether a quantitative test is necessary, an entity should consider the totality of all relevant events or circumstances that could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. ASC 350-30-35-18B provides examples of such events and circumstances.

ASC 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.

These examples are not all-inclusive. An entity should consider other relevant events and circumstances. For example, a sustained decrease in the entity's share price should not be ignored as changes in share price may be a relevant indicator when testing an asset that is critical to an entity's operating and financial performance, such as a certain trade name, distribution right, or license. In addition to the adverse factors, an entity should consider any positive or mitigating events and

circumstances, including the difference between the asset's fair value and carrying amount if determined from its most recent fair value calculation (i.e., "cushion"), as well as any changes to the carrying amount of the asset.

Entities should place more weight on those events and circumstances that most significantly affect an indefinite-lived intangible asset's fair value. None of the individual examples of events and circumstances are intended to represent stand-alone triggering events that would necessarily require an entity to calculate the fair value of an indefinite-lived intangible asset. Similarly, the existence of positive and mitigating events and circumstances would not represent a rebuttable presumption that an entity should not perform the quantitative impairment test.

If an entity determines that it is not more likely than not that the indefinite-lived intangible asset is impaired, management should document its conclusion and the events and circumstances taken into consideration to reach that conclusion.

8.3.1.2 Qualitative impairment: selecting intangible assets

An entity can choose to perform the qualitative assessment on none, some, or all of its indefinite-lived intangible assets. An entity can bypass the qualitative assessment for any asset in any period and proceed directly to the quantitative impairment test. It can choose to return to a qualitative assessment in any subsequent period. The selection of assets on which to perform the qualitative assessment is not an accounting policy decision that needs to be followed consistently. Therefore, an entity should tailor its use of the qualitative assessment based on each asset's specific facts and circumstances.

In some cases, a qualitative assessment may not provide sufficient support to conclude that there is no impairment. In other cases, the qualitative assessment may not be cost effective compared to performing the quantitative impairment test. For example, an entity that already has an efficient and robust process in place for determining the fair value of its assets may prefer to bypass the qualitative assessment and proceed directly to the quantitative impairment test rather than implement additional processes and internal controls for performing the qualitative assessment.

The qualitative assessment is generally effective when there is significant cushion based on a recent fair value measurement and no significant adverse changes have since occurred. See BCG 8.3.1.3 for further information on considering the results of prior fair value measurements in the qualitative assessment. Conversely, a qualitative assessment alone may not be cost effective or efficient for an asset whose fair value approximated its carrying amount in a recent fair value calculation. The lack of cushion in this situation results in the fair value inputs being highly sensitive to adverse factors, such as changes in actual and forecasted cash flows, tax rates, and discount rates. It may also be difficult to apply the qualitative impairment test to IPR&D assets since, given the nature of the assets, they are subject to frequent and significant changes in fair value.

Question BCG 8-2

How should management support its conclusion as a result of a qualitative assessment of its indefinite-lived intangible assets?

PwC response

In most cases, a robust process with supporting documentation will be needed to support an entity's conclusion that the quantitative impairment test is not necessary. Generally, entities that plan to use the qualitative assessment should consider developing a comprehensive process to:

- Determine which factors are the key drivers of the significant inputs of each asset's fair value and monitor changes in those factors.
- Identify the internal and external sources of information needed to monitor the relevant factors for each asset. Consider whether analyst and other external information are consistent with management's assessment of events and circumstances that could affect the significant inputs used in calculating an asset's fair value.
- Consider the amount of "cushion" from the most recent fair value calculation and evaluate both positive and adverse events and circumstances since that analysis. Underperformance relative to budget or prior expectations may suggest a quantitative impairment test is warranted.
- Monitor changes in other market-based metrics that could affect the significant inputs used in calculating an asset's fair value, including changes in the discount rate.
- Evaluate and weigh the impact of adverse and mitigating factors based on the extent those factors affect the comparison between fair value and carrying amount.

Management should document the results of its qualitative assessment, including the basis for its conclusion. Generally, the more analysis needed to assert that no further testing is necessary, the greater the extent of documentation that should be prepared. Management should also consider if, and how frequently, a quantitative impairment test should be performed for the purpose of "refreshing" the baseline valuation. See BCG 8.3.1.4 for additional information.

Question BCG 8-3

How much cushion between an indefinite-lived intangible asset's fair value and its carrying amount would allow an entity to consider a qualitative impairment test?

PwC response

There are no bright lines. The test is qualitative and should consider all facts and circumstances impacting the asset's fair value, including the length of time elapsed since the last fair value calculation, the impact of adverse and mitigating or positive qualitative factors, as well as current year changes in the asset's carrying amount. All else being equal, an asset with a significant cushion is more likely to allow an entity to start with a qualitative assessment than an asset with little or no cushion.

8.3.1.3 *Results of prior intangible asset fair value measurements*

When testing an indefinite-lived intangible asset for impairment, the amount of cushion, if any, between the fair value and the carrying amount of the asset from a prior fair value measurement is a critical factor when considering a current period qualitative assessment. However, an entity should not look solely at the amount of cushion from a recent fair value measurement to determine whether to perform a qualitative assessment. An entity must first determine whether the assumptions and projections underlying the previous fair value measurement are still reasonable in the current period. For example, using the multi-period excess earnings method of valuation (see FV 7.3.4.1), an entity's actual results for the current year combined with updated forecasts may differ from the forecasts used in the valuation model. The significance of the differences may indicate that the projections used for the last fair value calculation were too aggressive and that less weight should be given to the apparent cushion from the prior valuation. Conversely, more weight would likely be given to a prior cushion amount when actual results are consistent with or more favorable than results used in the recent fair value calculation projections.

8.3.1.4 *Periodically refresh indefinite-lived asset's fair value*

Entities should consider periodically "refreshing" an indefinite-lived intangible asset's fair value calculation. The more time that has elapsed since a recent fair value calculation, the more difficult it may be to support a conclusion based solely on a qualitative assessment. The frequency with which an entity refreshes its fair value calculation for an asset will depend on a variety of factors, including how much cushion existed in the last fair value calculation, the current operating environment, the current market environment for similar assets and any changes in carrying amount of an asset.

Question BCG 8-4

How many years can an entity use a previously-measured fair value of an indefinite-lived intangible asset as a basis for assessing the extent of cushion between an asset's fair value and its carrying amount?

PwC response

There are no bright lines. The appropriate length of time between quantitative measurements of the fair value of an asset is a matter of judgment. Some entities may establish a policy requiring assets' fair values to be reassessed periodically. Even with such a policy, an entity may still need to determine an asset's fair value more frequently than the policy requires if events and circumstances indicate that a quantitative impairment test is appropriate.

8.3.2 *Quantitative impairment: indefinite-lived intangible assets*

If an entity bypasses the qualitative assessment or determines from its qualitative assessment that an indefinite-lived intangible asset is more likely than not impaired, a quantitative impairment test should be performed. The quantitative impairment test compares the fair value of an indefinite-lived intangible asset with the asset's carrying amount. If the fair value of the indefinite-lived intangible asset is less than the carrying amount, an impairment loss should be recognized in an amount equal to the difference in accordance with ASC 350-30-35-19.

8.3.2.1 Unit of accounting for indefinite-lived intangible assets—updated May 2024

Generally, the unit of accounting for the impairment test of separately recorded indefinite-lived intangible assets is the individual indefinite-lived intangible asset. However, some reporting entities may acquire indefinite-lived intangible assets in separate transactions, but collectively use the individual assets in a manner that suggests they represent one asset. For example, an entity may acquire FCC licenses in separate transactions to assemble nationwide cell service coverage. ASC 350-30-35-21 through ASC 350-30-35-28 addresses the circumstances under which separately recorded indefinite-lived intangible assets should be combined into a single unit of accounting for purposes of impairment testing.

Under ASC 350-30-35-21 through ASC-350-30-35-28, separately recorded indefinite-lived intangible assets, whether acquired or internally developed, should be combined into a single unit of accounting for impairment testing if those assets are operated as a single asset and, as such, are essentially inseparable from one another. However, the unit of accounting cannot represent a group of indefinite-lived intangible assets that collectively constitute a business. Further, the unit of accounting should include only indefinite-lived intangible assets and cannot be tested in combination with long-lived assets or goodwill.

Determining whether two or more indefinite-lived intangible assets are essentially inseparable is a matter of judgment that depends upon the relevant facts and circumstances. Figure BCG 8-1 provides a list of indicators from ASC 350-30-35-23 and ASC 350-30-35-24 that an entity should consider in making a determination about whether to combine intangible assets for impairment testing purposes. None of the indicators should be considered presumptive or determinative.

Figure BCG 8-1

Indicators to consider when determining whether to combine indefinite-lived intangible assets for impairment testing

Combined	Not combined
The intangible assets were acquired to construct or enhance a single asset (i.e., they will be used together).	Each intangible asset generates cash flows independent of any other intangible asset (as would be the case for an intangible asset licensed to another entity for its exclusive use).
Had the intangible assets been acquired in the same acquisition, they would have been recorded as one asset.	If sold, each intangible asset would likely be sold separately. A past practice of selling similar assets separately is evidence, indicating that combining assets as a single unit of accounting may not be appropriate.
The intangible assets as a group represent the highest and best use of the assets (e.g., they yield the highest price if sold as a group).	The entity has adopted or is considering a plan to dispose of one or more intangible assets separately.
The marketing or branding strategy provides evidence that the intangible assets are complementary as that term is used in ASC 805-20-55-18.	The intangible assets are used exclusively by different ASC 360-10 asset groups.

Combined	Not combined
	The economic or other factors that might limit the useful economic life of one of the intangible assets would not similarly limit the useful economic lives of other intangible assets combined in the unit of accounting.

If it is determined that indefinite-lived intangible assets that were previously tested for impairment separately can now be combined into a single unit of accounting, those assets should be tested separately for impairment prior to being combined.

The unit of accounting is determined from the reporting entity's perspective based on the indicators above. A consolidated entity's unit of accounting may include indefinite-lived intangible assets that are recorded in the separate financial statements of the entity's consolidated subsidiaries. As a result, an impairment loss that is recognized in the consolidated financial statements may differ from the sum of the impairment losses, if any, that are recognized in the separate financial statements of the entity's subsidiaries.

Example BCG 8-3 illustrates the determination of the unit of accounting for trade names.

EXAMPLE BCG 8-3

Unit of accounting – trade names

Company A acquired Company B, an international fragrance manufacturer. Company B has four legal entities. Each legal entity owns the registered trade name of Company B used in that country. In acquisition accounting, Company A recorded four trade name assets because separate financial statements are prepared for each legal entity. The trade name assets have an indefinite life and the value is expected to be recovered from the worldwide sales of Company B's fragrances.

What is the appropriate unit of accounting for the acquired trade names?

Analysis

Company A should combine the four trade name assets into a single unit of accounting for purposes of impairment testing because the four trade name assets were acquired in the same business combination, the worldwide marketing of the fragrances utilizes the same trade name and the four registered trade names would likely be sold together. Further, if there was not a requirement to prepare separate financial statements for each legal entity, the trade names would have been recorded as a single asset.

Unit of accounting: intangible assets used in research and development

The determination of the appropriate unit of accounting will impact the postacquisition accounting for IPR&D, including impairment assessments and the determination of amortization periods and/or useful lives. Determining the appropriate unit of accounting for valuing and recognizing intangible assets used in research and development activities may be especially complex when such activities may ultimately benefit various jurisdictions and/or versions of a product.

One common approach is to record separate “jurisdictional” assets for a research and development activity that will benefit various jurisdictions or versions, while another approach is to record a single “global” asset. The AICPA IPR&D Guide (IPR&D 2.21) provides factors to consider in making this determination, as outlined below.

Jurisdictional asset

- The nature and costs of the activities to develop the project are not substantially the same.
- The risks of further development of the project are not substantially the same.
- The amount and timing of benefits expected from the developed assets and the expected economic life of those assets are not substantially the same.
- Based on historical experience and current intent, once completed, the product (if transferred) would not be transferred as a single asset.
- The manner in which the product will be advertised and sold will not be substantially the same.

Global asset

- The development of the project will occur centrally and the company only intends to incur a small portion of development costs to obtain approvals in future jurisdictions.
- Based on historical experience (or expectations), the risks of further development of the IPR&D project are substantially the same.
- The amount and timing of benefits expected from the developed assets and the expected economic life of the developed assets are substantially the same.
- Based on historical experience and current intentions, once completed, the product (if ever transferred) would be transferred in one worldwide arrangement.
- Advertising and selling costs will be managed from the perspective of a global brand, not the individual jurisdictions where the product is sold.

None of these factors are individually determinative, and the assessment should be based on the facts and circumstances specific to each situation.

Example BCG 8-4 illustrates making a determination of whether acquired in-process research and development should be measured and recognized as a single asset or multiple assets.

EXAMPLE BCG 8-4

Unit of accounting – IPR&D

Company C acquired Company D, which is accounted for as a business combination. At the acquisition date, Company D was pursuing completion of an in-process research and development (IPR&D) project that, if successful, would result in a drug for which Company C would seek regulatory approval in the United States and Japan. This research and development project is in the later stages of development but is not yet complete. The nature of the activities and costs necessary to successfully develop the drug and obtain regulatory approval in the two jurisdictions are not substantially the

same. If approved, the respective patent lives are expected to be different as well. In addition, Company C intends to manage advertising and selling costs separately in both countries. Lastly, Company C has determined that any future sale of the in-process research and development assets would likely involve two different buyers.

What is the unit of accounting for the acquired IPR&D?

Analysis

The acquired IPR&D project would likely be recorded as two separate “jurisdictional” in-process research and development assets. While there may be other factors to consider, Company C’s assessment may lead it to believe that the development risks, the nature of the remaining activity and costs, the risk of not obtaining regulatory approval, and expected patent lives for the acquired in-process research and development are not substantially the same in both countries. Finally, Company C intends to manage the drug separately, including separate advertising and selling costs in each country.

8.3.2.2 Portion of intangible removed from single unit of account

As described in ASC 350-30-35-21 through ASC 350-30-35-28, separately recorded indefinite-lived intangible assets, whether acquired or internally developed, should be combined into a single unit of accounting for impairment testing if those assets are operated as a single asset and are essentially inseparable from one another. An indefinite-lived intangible asset previously combined with one or more indefinite-lived intangible asset as a single unit of account may be separated or removed from the single unit of account as a result of a disposition, a reassessment of the unit of account, or an indefinite-lived intangible asset being reclassified as a finite-lived intangible asset.

When an indefinite-lived intangible asset is removed from a single unit of account consisting of two or more indefinite-lived intangible assets, and the single unit of account was previously impaired, a reporting entity should remove the indefinite-lived intangible asset from the single unit of account after considering the impact of the impairment charge. In the absence of guidance specific to indefinite-lived intangible assets, we believe a reporting entity may apply the guidance in ASC 360-10-35-28 by analogy.

Excerpt from ASC 360-10-35-28

An impairment loss for an asset group shall reduce only the carrying amounts of a long-lived asset or assets of the group. The loss shall be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort.

In applying this guidance by analogy, an indefinite-lived intangible asset removed from a single unit of account would be based on the historical carrying amount of the indefinite-lived intangible asset when it was initially included in the single unit of account, less a pro-rata allocation of the impairment loss previously recorded. Given the lack of prescriptive guidance, other reasonable and supportable methodologies may be applied.

8.4 Digital assets—updated February 2024

Digital assets (even those that can function as a medium of exchange) likely do not meet the definition of cash as they are not legal tender. Digital assets also may not meet the definition of a financial asset as they do not include an obligation to deliver cash or another financial instrument. However, given that intangible assets are defined as assets that lack physical substance, many digital assets meet this definition. When a digital asset is determined to meet the definition of an intangible asset, it should follow the guidance in ASC 350. Given the nature of many digital assets, they will usually have indefinite useful lives.

See PwC's *Crypto assets* guide (CA) for the relevant accounting and reporting considerations related to digital assets.

New guidance

In December 2023, the FASB issued ASU 2023-08, *Intangibles — Goodwill and Other — Crypto Assets (Subtopic 350-60): Accounting for and Disclosure of Crypto Assets*. If crypto assets that meet the definition of an intangible asset also meet all of the additional criteria in ASC 350-60-15-1, ASU 2023-08 indicates that reporting entities should follow the accounting guidance in ASC 350-60 for the subsequent measurement, presentation, and disclosure of those crypto assets. This guidance requires all entities holding in-scope crypto assets to subsequently measure those in-scope crypto assets at fair value, with the remeasurement recorded in net income. See CA 1.1, CA 2.4 through CA 2.4.2 and CA 5.4 through CA 5.4.2 for accounting considerations related to crypto assets in the scope of ASC 350-60.

***Chapter 9:
Accounting for goodwill post
acquisition—updated May
2024***

9.1 Overview: accounting for goodwill post acquisition

This chapter discusses the subsequent accounting for goodwill post acquisition, including how to test goodwill for impairment.

Related content

- Guidance on the initial recognition and measurement of goodwill is included in BCG 2.6.
- Presentation and disclosure guidance related to goodwill is included in FSP 8.9. Additionally, for private companies, see FSP 8.10.2 and FSP 8.10.3.

Generally, the acquirer in a business combination is willing to pay more for a business than the sum of the fair values of the individual assets and liabilities because of other inherent value associated with an assembled business. In addition, synergies and other benefits that are expected from combining the activities of the acquirer and acquiree are often drivers for paying an amount greater than the fair value of the underlying assets and liabilities. The resulting excess of the aggregate of (1) the consideration transferred, as measured in accordance with ASC 805-30-30-7, which generally requires the use of acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree, over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with ASC 805, is recognized as goodwill. This chapter addresses the accounting for goodwill after an acquisition.

Under ASC 350-20, goodwill is not amortized. Rather, an entity's goodwill is subject to periodic impairment testing. ASC 350-20 requires that an entity assign its goodwill to reporting units and test each reporting unit's goodwill for impairment at least on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

An entity is permitted to first assess qualitative factors to determine whether a quantitative goodwill impairment test is necessary. Further testing is only required if the entity determines, based on the qualitative assessment, that it is more likely than not that a reporting unit's fair value is less than its carrying amount, including goodwill. Otherwise, no further impairment testing is required. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to the quantitative goodwill impairment test. This would not preclude the entity from performing the qualitative assessment in any subsequent period.

When an entity bypasses the qualitative assessment or determines based on the qualitative assessment that further testing is necessary, a quantitative goodwill impairment test is performed to measure an impairment loss, if any. To perform the quantitative goodwill impairment test, an entity must:

- Identify its reporting units
- Assign assets and liabilities to its reporting units
- Assign all goodwill to one or more of its reporting units
- Determine the fair value of those reporting units to which goodwill has been assigned

Under ASC 350-20, a goodwill impairment loss is measured as the amount by which a reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. Once a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill will be its new accounting basis. In accordance with ASC 350-20-35-13, a previously recognized goodwill impairment loss cannot be reversed.

The above summarizes the process for a public entity testing goodwill for impairment. However, a private company/not-for-profit (NFP) entity may make an accounting policy election for certain accounting alternatives related to goodwill. See BCG 9.11 for discussion of the goodwill accounting alternatives for private companies/NFP entities.

9.2 Identifying reporting units

The unit of accounting for goodwill is at a level of the entity referred to as a reporting unit. Goodwill is assigned to specific reporting units for purposes of the annual or interim impairment assessment and, therefore, identification of an entity's reporting units is the cornerstone of goodwill impairment testing.

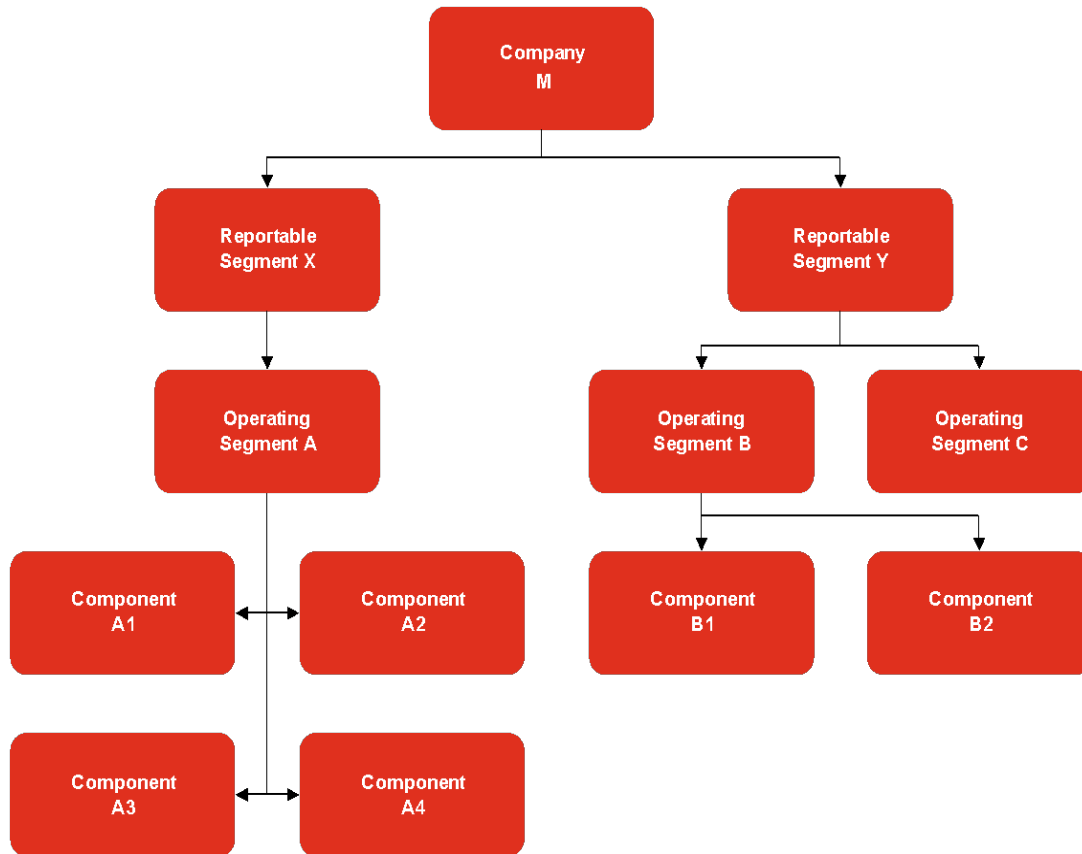
A reporting unit is the same as, or one level below, an operating segment as defined in ASC 280-10-50-1. Therefore, although ASC 280-10 may allow for the aggregation of operating segments into reportable segments based on similar economic characteristics, an entity's reportable segments are not relevant in the determination of its reporting units.

One level below an operating segment is referred to as a component. A component of an operating segment is required to be identified as a reporting unit if the component is a business (as defined in ASC 805) for which discrete financial information is available and segment management regularly reviews the operating results.

Once components are identified, an entity would consider whether any components of an operating segment should be aggregated into one or more reporting units based on whether the components have similar economic characteristics.

Figure BCG 9-1 shows a company's reporting structure used to determine its reporting units and will be referred to throughout this section.

Figure BCG 9-1
Reporting structure used to determine reporting units



9.2.1 *Operating segments: starting point for reporting units*

Operating segments, not reportable segments, are the basis for the determination of reporting units. ASC 280-10-50-1 defines an operating segment as a portion of an enterprise:

- That 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 enterprise)
- Whose operating results are regularly reviewed by the enterprise's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance
- For which discrete financial information is available

For example, using the reporting structure of Company M in Figure BCG 9-1, reportable segments X and Y are not relevant to the determination of reporting units. Instead, the determination should begin with operating segments A, B, and C. It is important not to confuse reportable segments with operating segments because this may result in the misapplication of ASC 350-20 and improper goodwill impairment testing.

Entities that are not required to report segment information (e.g., nonpublic entities) are nonetheless required to determine their reporting units and test goodwill for impairment at the reporting unit level in accordance with ASC 350-20-35-38, unless they are eligible to and elect the accounting alternatives described in BCG 9.11. Those entities therefore must still apply the guidance in ASC 280-10 to determine their operating segments for purposes of establishing their reporting units. See FSP 25 for further guidance on determining operating segments.

9.2.2 *Reporting unit may be operating segment or one level below*

Whether an operating segment should be further divided into components is based on the entity's internal reporting structure (i.e., its management organization and its financial resource allocation and reporting), which is consistent with the determination of operating segments. For this reason, reporting units may vary significantly from organization to organization and are generally not comparable, even among competitors. Determining reporting units is a matter of judgment based on entity-specific facts and circumstances.

A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and is regularly reviewed by segment management. Segment management is not intended to be equivalent to the CODM, as defined in ASC 280-10. Instead, segment management usually reports to the CODM. For instance, in Figure BCG 9-1, Company M's possible reporting units would be components A1 through A4, B1 and B2, and operating segment C, before considering whether any components should be aggregated.

Two or more components of an operating segment, which would qualify as reporting units on their own, should be aggregated and deemed a single reporting unit if the components have similar economic characteristics.

ASC 350-20 does not specifically address situations when one or more components of an operating segment qualify as a reporting unit (or reporting units) while the remaining portion of the reporting unit does not qualify (e.g., the remaining portion does not meet the definition of a business). In establishing the reporting unit(s) of such an operating segment, an entity will need to apply judgment to determine how the remaining elements that do not qualify as a component should be considered, keeping in mind that all of an entity's goodwill must be assigned to its reporting units.

9.2.3 *Criteria to be a reporting unit*

For a component of an operating segment to be a reporting unit, it must be a business (as defined in ASC 805) for which discrete financial information is available. The term discrete financial information, for purposes of determining if a component is a reporting unit, has the same meaning as when used to determine operating segments under ASC 280-10. ASC 350-20-55-4 states that such financial information can consist of as little as operating information (e.g., revenues and gross margins), provided that the CODM (segment management for reporting units) regularly reviews the operating results of the business. Furthermore, it is not necessary for an entity to have assigned assets and liabilities at the component level to conclude that a component may constitute a reporting unit (i.e., a balance sheet is not required to qualify as a component).

9.2.4 *Aggregation of reporting units*

ASC 350-20-35-35 requires that two or more components of an operating segment that have similar economic characteristics be aggregated into a single reporting unit. For purposes of evaluating

economic characteristics of a component of an operating segment, the following criteria for aggregating operating segments in ASC 280-10-50-11 should be considered:

- Similar financial performance (such as similar long-term average gross margins)
- The nature of the products and services
- The nature of the production processes
- The type or class of customer for the products and services
- The methods used to distribute the products or provide the services
- If applicable, the nature of the regulatory environment

ASC 350-20-55 provides implementation guidance, stating that while all of the factors in ASC 280-10 need to be considered, the FASB did not intend that every factor be met to demonstrate the economic similarity of the components. Furthermore, ASC 350-20-55-7 provides a list of other factors that an entity should consider in determining economic similarity.

ASC 350-20-55-7

In determining whether the components of an operating segment have similar economic characteristics, all of the factors in paragraph 280-10-50-11 should be considered. However, every factor need not be met in order for two components to be considered economically similar. In addition, the determination of whether two components are economically similar need not be limited to consideration of the factors described in that paragraph. In determining whether components should be combined into one reporting unit based on their economic similarities, factors that should be considered in addition to those in that paragraph include but are not limited to, the following:

- a. The manner in which an entity operates its business or nonprofit activity and the nature of those operations
- b. Whether goodwill is recoverable from the separate operations of each component business (or nonprofit activity) or from two or more component businesses (or nonprofit activities) working in concert (which might be the case if the components are economically interdependent)
- c. The extent to which the component businesses (or nonprofit activities) share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- d. Whether the components support and benefit from common research and development projects.

The fact that a component extensively shares assets and other resources with other components of the operating segment may be an indication that the component either is not a business or nonprofit activity or it may be economically similar to those other components.

Assessing whether two or more components of an operating segment have similar economic characteristics is a matter of judgment that depends on specific facts and circumstances. The assessment should be more qualitative than quantitative. This is a notable difference from assessing the economic similarities of operating segments for aggregation into a reportable segment where

quantitative measures may be more important. Additionally, ASC 350-20 requires that components be aggregated into a single reporting unit if the criteria are met; this contrasts with the guidance for segments in ASC 280-10-50-11, for which aggregation of two or more operating segments into a single segment is optional but not required.

9.2.5 ***Components may not be aggregated across operating segments***

Components that share similar economic characteristics but are part of different operating segments may not be combined into a single reporting unit. This is of notable significance for entities whose operating segments are organized on a geographic basis. Such organizations are precluded from aggregating components in different geographic operating segments, even if they are economically similar. For example, in Figure BCG 9-1, components A1 and B1 could not be combined into a single reporting unit, even if they have similar economic characteristics, because they are part of different operating segments.

9.2.6 ***Periodic reassessment of reporting units***

As discussed in BCG 9.4.4, an entity may need to reassign goodwill to reporting units when the entity's reporting structure changes. However, ASC 350-20 does not specifically address whether an entity should periodically reassess the economic similarity of the components of its operating segments to determine whether aggregation or disaggregation of components continues to be appropriate when determining its reporting units. Generally, significant changes in the economic characteristics of components or reorganization of an entity's reporting structure may result in a reassessment of the affected operating segment and its components to determine whether reporting units need to be redefined. When such a reassessment leads an entity to redefine previously determined reporting units, goodwill should be reassigned to the reporting units affected using the relative fair value approach, based on the fair values of the affected reporting units as of the date of the reassessment, in accordance with ASC 350-20-35-45. See BCG 9.4.4.

9.2.7 ***Determining reporting units***

Figure BCG 9-2 provides a summary of the various reporting levels that may exist within an entity and how the reporting levels are used in determining an entity's reporting units.

Figure BCG 9-2

Reportable segment versus operating segment versus component

Term and definition	Use in determining reporting units
Reportable segment	
<ul style="list-style-type: none"> □ The reporting level that is disclosed for financial reporting purposes. □ Operating segments may be aggregated into one or more reportable segments if they meet specified criteria. □ An operating segment could be a reportable segment if an entity does not aggregate its operating segments for reporting purposes. 	<ul style="list-style-type: none"> □ Not applicable unless a reportable segment is an operating segment. Reporting units must be at the operating segment level or one level below the operating segment.

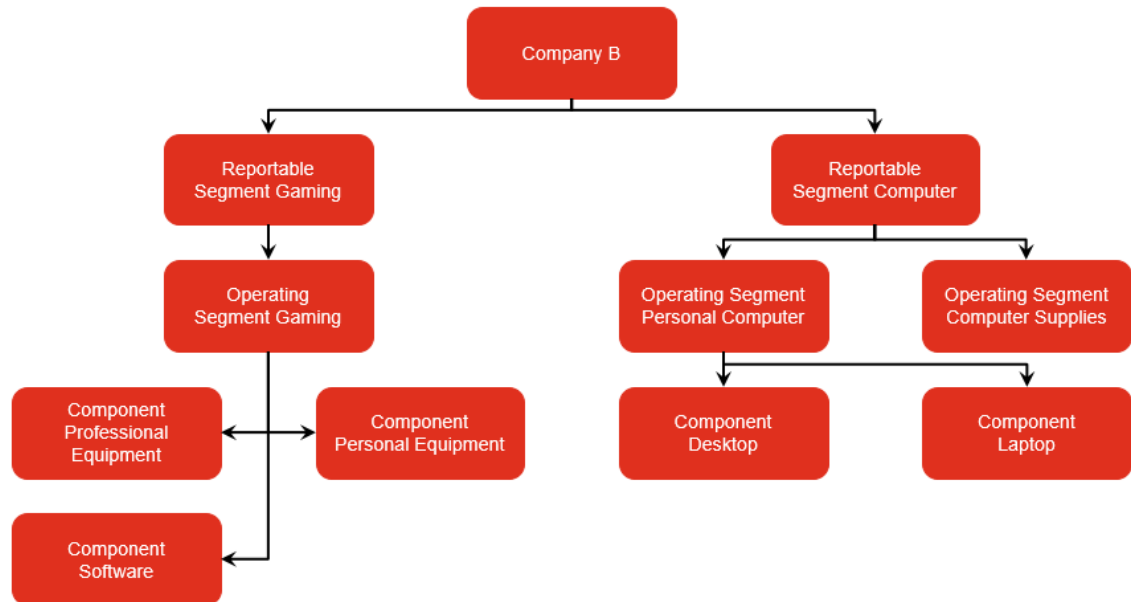
Term and definition	Use in determining reporting units
Operating Segment	
<ul style="list-style-type: none"> □ Engages in business activities from which it may recognize revenues and incur expenses. □ Discrete financial information is available. □ Operating results are regularly reviewed by the CODM to allocate resources and assess performance. 	<p>An operating segment will be a reporting unit if:</p> <ul style="list-style-type: none"> □ All of its components have similar economic characteristics. □ None of its components is a reporting unit. □ It comprises a single component. <p>Note: Unlike a component, as described below, an operating segment need not constitute a business to be deemed a reporting unit.</p>
Component	
<ul style="list-style-type: none"> □ One level below an operating segment. 	<p>A component may be a reporting unit if:</p> <ul style="list-style-type: none"> □ The component constitutes a business for which discrete financial information is available. □ Segment management regularly reviews the component's operating results. <p>However, components of an operating segment should be aggregated into a single reporting unit if they have similar economic characteristics, as defined by ASC 350-20-55.</p>

Example BCG 9-1 provides an example of the identification of reporting units.

EXAMPLE BCG 9-1

Identification of reporting units

Company B manufactures, markets, and sells electronic equipment, including computers and gaming equipment for professional (e.g., casinos and gaming halls) and personal use. Company B's CEO has been identified as the CODM and, on a monthly basis, receives, among other information, divisional income and cash flow statements for each operating segment, as well as sales on a product line basis. Based on the organizational structure of the company and information used to assess performance and allocate resources, management identified the following structure:



For segment reporting, Company B reports “Gaming” as a reportable segment and aggregates its two computer-related operating segments into a reportable segment “Computer.” Two of the three operating segments have various components that are businesses for which discrete financial information is available, and segment management regularly reviews the operating results of the businesses. The components “Personal Equipment,” “Software,” and “Desktop” have similar economic characteristics based on the nature of the products and the types of customers. Company B will have at least three reporting units (operating segments “Gaming,” “Personal Computer,” and “Computer Supplies”), and might have as many as six reporting units (five components and the operating segment “Computer Supplies”).

How many reporting units should Company B identify?

Analysis

Upon analyzing the economic characteristics of the identified components, Company B would likely conclude that:

- Component “Professional Equipment” is not economically similar to the components “Personal Equipment” and “Software,” so this component would be a separate reporting unit
- Components “Personal Equipment” and “Software” of the Gaming operating segment should be aggregated into a single reporting unit because they have similar economic characteristics
- The economic similarities between the “Desktop” and “Laptop” components of “Personal Computer” are not sufficient for them to be aggregated so these components would be separate reporting units
- The “Personal Equipment” and “Software” components share very similar economic characteristics with the “Desktop” component. Despite these similarities, the “Desktop” component must be treated separately because it resides in a different operating segment than components “Personal Equipment” and “Software”

- Operating segment “Computer Supplies” is a reporting unit because it does not have individual components

Company B would therefore identify five reporting units: “Professional Equipment,” “Personal Equipment and Software,” “Desktop,” “Laptop,” and “Computer Supplies.”

9.3 *Assigning assets and liabilities to reporting units*

To apply the provisions of the goodwill impairment test (as further discussed in BCG 9.6 and BCG 9.8), an entity needs to assign the appropriate assets and liabilities to the respective reporting units. Assets and liabilities are required to be assigned to a reporting unit if both of the following criteria in ASC 350-20-35-39 are met:

- The asset will be employed in or the liability relates to the operations of a reporting unit.
- The asset or liability will be considered in determining the fair value of the reporting unit.

Assigning assets and liabilities to reporting units inherently involves judgment. The objective of the assignment of identifiable assets and liabilities to a reporting unit is to achieve symmetry (i.e., an “apples to apples” comparison) between the assets and liabilities that are assigned to the reporting unit and the net assets that are considered in the determination of a reporting unit’s fair value. To achieve this symmetry, it is critical for the entity to (1) understand the factors behind and drivers of a reporting unit’s fair value, and (2) employ a methodology for assigning assets and liabilities to a reporting unit that is reasonable, supportable, and consistent with how it determines the reporting unit’s fair value.

A reporting unit should be assigned all of the assets and liabilities necessary to operate as a business because it is those net assets that will generate the cash flows used to determine the fair value of the reporting unit. However, the assignment of assets and liabilities does not need to result in a full balance sheet for an operating segment or component to qualify as a separate reporting unit. An operating segment does not need to constitute a business to be a reporting unit. Once an entity has established an appropriate methodology for assigning assets and liabilities to a reporting unit, it should be applied consistently from period to period.

The process of assigning assets and liabilities to reporting units is only for the purpose of impairment testing and the resulting information is usually not reflected in the actual ledgers or financial statements of the entity. Such information is usually maintained on separate detailed schedules as part of the accounting records that support the financial statement balances and conclusions reached as a result of impairment testing.

9.3.1 *Assigning assets/liabilities of multiple reporting units*

Some assets or liabilities may be employed in or relate to the operations of multiple reporting units. This may include intangible assets, such as trade names, technology, patents, and customer lists; tangible assets, such as shared manufacturing facilities; or liabilities, such as debt and pension obligations for active employees. In developing a reasonable and supportable methodology to assign such assets and liabilities to reporting units, an entity may consider the relative benefit received by the different reporting units or the relative fair values of the different reporting units. Other criteria may

include specific measurable relationships. In the case of some pension items, for example, a pro rata assignment based on payroll expense might be used.

An entity's methodology to assign to reporting units those assets and liabilities that are employed in multiple reporting units should be consistent and established in tandem with how the entity determines the reporting units' fair values. An entity normally should base its determination of a reporting unit's fair value on assumptions that market participants would use to estimate fair value. These assumptions include the likely structure of a sale of that reporting unit, and whether (and, if so, how) an asset employed in multiple reporting units would be included in the transaction. If the asset would not be included in the sale but its continued use would be necessary to maximize the value of the reporting unit, the cash flow projections used to estimate the fair value of the reporting unit may need to include a cash outflow representing the payment at fair value for the continued use of the asset (similar to a rental or usage fee). This would be the case even if the entity does not presently have intercompany charges for the usage across reporting units.

Conversely, if the asset is included in the reporting unit, it may be necessary to include cash inflows as payments at fair value from the entity's other reporting units that use the asset. The objective is to ensure that the approach to assigning assets and liabilities to reporting units is consistent with how the fair value of the reporting unit is determined. Otherwise, an entity may determine inappropriately that it has or does not have a goodwill impairment loss based on its quantitative goodwill impairment test.

Question BCG 9-1

If a company has multiple reporting units, how should pension assets and liabilities be attributed to its reporting units?

PwC response

The objective is to ensure that the approach of assigning assets and liabilities to reporting units is consistent with how the fair value of the reporting unit would be determined. In making this assessment, it is necessary to understand the assumptions a market participant would make in determining the fair value of the reporting unit and whether it is likely that the pension asset or liability would be included in a transaction to sell the reporting unit. The allocation of pension expense to reporting units does not automatically mean that pension assets and liabilities should also be attributed to reporting units. For example, if a reporting unit participates in a multi-employer plan, pension expense would be allocated to the reporting unit; however, no pension asset or liability would be attributed to the reporting unit as a pension asset or liability would not transfer to an acquirer in a sale of the reporting unit.

Example BCG 9-2 illustrates a method for assigning the carrying amount of an intangible asset employed in multiple reporting units.

EXAMPLE BCG 9-2

Assignment of an intangible asset employed in multiple reporting units

A parent company owns an acquired trade name that is used by several of its reporting units. The parent company is determining the appropriate assignment of the trade name's recorded amount to the reporting units that use the name (i.e., the trade name is maintained at the parent company level

but the trade name benefits multiple reporting units). The parent company may not sell that trade name if the parent company were to sell only one of the reporting units to a market participant. Rather, in exchange for a royalty on future product sales, the parent company might grant an acquirer the right to continue using the trade name. The parent company has determined that the assignment should be driven by the assumptions applied in establishing the fair value of the reporting units.

How should the value of the trade name employed in multiple reporting units be assigned to each reporting unit?

Analysis

It is likely that an estimate of the reporting unit's fair value would be based on the assumption that the trade name will be licensed to the acquirer instead of sold. Therefore, the parent company generally would not assign a portion of the trade name's carrying amount to the reporting unit. Instead, a royalty at fair value would be imputed as a cash outflow of the reporting unit that uses the trade name for purposes of determining the reporting unit's fair value. Further, assuming the trade name is not a corporate asset but is assigned to another reporting unit, that reporting unit would impute royalty income as a cash inflow from the reporting unit using the trade name.

In certain circumstances, depending on the facts, there may be other methods to performing this assignment, such as assigning based on the relative fair values of the reporting units or benefits received by the reporting units. In determining whether the carrying amount of an asset that is used in multiple reporting units should be assigned to one or more reporting units, an entity will need to evaluate the relevant facts and circumstances in light of how the fair values of its reporting units are being estimated.

9.3.2 *Assigning corporate assets and liabilities*

Assets and liabilities that an entity considers part of its corporate-level assets and liabilities should be assigned to a specific reporting unit if the criteria discussed in BCG 9.3 are met. When corporate-level assets and liabilities relate to several or all of the entity's reporting units, they are usually not assigned to specific reporting units. Pursuant to the guidance of ASC 350-20, not all assets and liabilities of an entity need to be assigned to specific reporting units. However, if corporate items are included and reflected in the fair value of a reporting unit, they may need to be assigned to that unit. This may include balances arising from pension plans, taxes, and general debt obligations. In instances where a reporting unit benefits from the corporate items, but such items are not assigned to the reporting unit, the determination of the reporting unit's fair value should consider the fair value of the use of the corporate-level assets and liabilities.

9.3.3 *Segment reporting interaction with reporting units' assets*

ASC 280-10-50-20 through ASC 280-10-50-29 provides that an entity must include in its segment disclosures those assets that are included in the measure of a segment's assets, as used by the CODM. ASC 350-20 does not affect ASC 280 and does not require that all of the assets that an entity assigns to reporting units for purposes of goodwill impairment testing be reflected in an entity's reported segment assets. Thus, an entity should report its segment assets in accordance with the guidance in ASC 280 (see FSP 25.7 for additional information on segment disclosures). In addition to the required segment disclosures in ASC 280, an entity is required by ASC 350-20-50-1 to disclose the carrying amount of goodwill for each of its reportable segments and provide a detailed reconciliation of the

changes in those amounts for each period. See FSP 8.9.1 for additional information on the goodwill reconciliation disclosure.

9.3.4 “Full” allocation for entities with a single reporting unit

Generally, an entity is not required to assign all of its assets and liabilities to its reporting units. However, for entities that are narrowly focused in their operations and that identify only one operating segment and one reporting unit, it is difficult to assert that any corporate assets or liabilities were not involved with the single reporting unit’s operations. In that case, all of the entity’s assets and liabilities would be included in that reporting unit for the purpose of goodwill impairment testing.

9.3.5 Guidance for specific balance sheet components

Assets and liabilities should be assigned to a reporting unit if (1) the asset will be employed in, or the liability relates to, the operations of a reporting unit, and (2) the asset or liability will be considered in determining the fair value of the reporting unit as discussed in ASC 350-20-35-39. The following are considerations for assigning specific assets or liabilities to a reporting unit:

- Working capital: Companies generally include a working capital balance in the valuation of their reporting units. When comparing a reporting unit’s carrying amount to its fair value, it is important to understand the working capital assumptions used in the fair value measurement to ensure they are consistent with the entity’s assignment of working capital to the reporting unit when determining its carrying amount. Similarly, intercompany accounts may reflect the working capital of a reporting unit and need to be considered when determining the fair value and carrying amount of a reporting unit.
- Cash/cash equivalents: Entities may maintain cash that is not related to a specific reporting unit as a corporate asset. Generally, corporate-level cash would not be assigned to an entity’s reporting units. On the other hand, an entity would assign cash to the related reporting unit if the entity considered the cash in determining the fair value of the unit. Because the carrying amount of cash and cash equivalents would be expected to approximate fair value, its assignment to reporting units generally would not have an impact on the goodwill impairment test as long as it had been appropriately considered in the fair value of the reporting unit.
- Investments: Determining whether investments in debt and equity securities (including equity method investments) should be assigned to and included in the carrying amount of reporting units may be challenging. Investments maintained at a corporate level generally would not be employed in the operations of a reporting unit and therefore would not be assigned to reporting units. In some cases, however, investments may be an integral part of the operations of a reporting unit. In those cases, if an entity demonstrates that its investments would likely be transferred to a market participant if the reporting unit were to be sold, it may be appropriate to assign investments to the reporting unit and consider them in determining the reporting unit’s fair value.
- Debt: An entity should assign debt to the reporting unit if that debt relates directly to the operations of the unit and is likely to be transferred to a market participant if the reporting unit were to be sold. For example, debt issued to construct a manufacturing plant and secured by the plant would typically be assigned to the reporting unit that includes the plant because the debt is specific to the plant and would likely be assumed by an acquirer of the reporting unit. Similarly, for leases accounted for by a lessee under ASC 842, *Leases*, if the leased asset is employed in the operations of a reporting unit, both the right-of-use asset and the lease liability should be assigned

- to the reporting unit. On the other hand, an entity would not typically assign general corporate debt to its reporting units. An entity should evaluate intercompany debt to determine if it should be treated in a manner similar to external debt.
- Contingent consideration: Determining whether a contingent consideration obligation or asset should be assigned to and included in the carrying amount of reporting units may be challenging. If the reporting unit is obligated to pay contingent consideration or the right to receive contingent consideration is held by the reporting unit, the contingent consideration generally would be assigned to that reporting unit. It would also be appropriate to include contingent consideration obligations or assets in a reporting unit's carrying amount if an acquiring market participant would assume that obligation or asset, similar to the guidance on intangible assets such as trade names in BCG 9.3.1.
 - Deferred taxes other than for net operating losses (NOLs) and other carryforwards: The deferred taxes originating from temporary differences related to the reporting unit's assets and liabilities should be included in the carrying amount of the reporting unit, regardless of whether the fair value of the reporting unit is determined by assuming it would be sold in either a taxable or nontaxable transaction following the guidance in ASC 350-20-35-7. (See Question BCG 9-2.)
 - Deferred taxes arising from NOLs and other carryforwards: ASC 350-20 does not specifically address whether deferred tax assets arising from NOL and other carryforwards, which are not related to particular assets or liabilities of a reporting unit, should be assigned to a reporting unit. However, entities should apply the criteria in ASC 350-20-35-39. That is, as the NOL and other carryforwards could be used by the reporting unit, they should be assigned to a reporting unit if they were included in determining the fair value of the reporting unit. For example, if the reporting unit is a separate legal entity and the assumption used in determining the fair value of the reporting unit was that it would be sold in a nontaxable transaction in which the carryforwards would transfer to the buyer, then the deferred tax assets from the carryforwards generated by that entity should be assigned to the reporting unit in determining the reporting unit's carrying value. (See Example BCG 9-3 and Example BCG 9-4.)
 - Cumulative translation adjustments: Under ASC 830, *Foreign Currency Matters*, an entity records a cumulative translation adjustment (CTA) as part of its accumulated other comprehensive income when it translates the financial statements of a foreign subsidiary that has a functional currency that differs from the entity's reporting currency. When testing the goodwill of a reporting unit for impairment, the question arises as to whether the carrying value of the reporting unit should include the CTA associated with the reporting unit. The carrying amount of the reporting unit should include assets and liabilities at their currently translated amounts in accordance with ASC 350-20-35-39A. (See Example BCG 9-5).
 - Although ASC 830-30-40-1 and ASC 830-30-45-13 only address the treatment of CTA, we believe that the treatment of other amounts in accumulated other comprehensive income (e.g., unrealized gains or losses on debt investments classified as available for sale, unrealized employee benefit plan gains or losses) should analogize to this guidance. Refer to PPE 5.3.3.4 for further details.

Question BCG 9-2

If a company has a valuation allowance on deferred tax assets and files a consolidated tax return, should the valuation allowance be assigned to its reporting units in the quantitative goodwill impairment test?

PwC response

If a company files a consolidated tax return and has established a valuation allowance against its deferred tax assets at the consolidated level, it should attribute the valuation allowance to each reporting unit based on the deferred tax assets and liabilities assigned to each reporting unit. It would not be appropriate for the company to evaluate each reporting unit on a “separate” return basis and thereby assess the need for a valuation allowance for each individual reporting unit.

Example BCG 9-3 and Example BCG 9-4 consider whether deferred tax assets arising from NOL and credit carryforwards should be assigned to a reporting unit.

EXAMPLE BCG 9-3

Assignment of deferred tax assets arising from NOL and credit carryforwards to a reporting unit

Assume that one of Company A’s reporting units is a separate legal entity, Sub X. Sub X has generated NOL and tax credit carryforwards for which Company A has recognized deferred tax assets. No valuation allowance is deemed necessary because Sub X is expected to generate future taxable income sufficient to realize the carryforward benefits. Company A believes that it would be feasible to sell the shares of Sub X in a nontaxable transaction, which would allow the transfer of Sub X’s NOL and tax credit carryforwards. In addition, Company A believes that market participants would base their estimates of the fair value of Sub X on a nontaxable transaction, and Company A has determined that it would receive the highest economic value if it were to sell Sub X in a nontaxable transaction.

Should the deferred tax assets arising from NOL and tax credit carryforwards be assigned to the reporting unit Sub X?

Analysis

In this fact pattern, the deferred tax assets related to Sub X’s NOL and tax credit carryforwards meet the criteria in ASC 350-20-35-39 as the deferred tax assets will be employed in the operations of the reporting unit and were considered in determining the fair value of the reporting unit. Therefore, the deferred tax assets should be included in the carrying amount of the reporting unit.

EXAMPLE BCG 9-4

No assignment of deferred tax assets arising from NOL and credit carryforwards to a reporting unit

Assume that Company B has NOL and tax credit carryforwards for which it has recognized deferred tax assets. Company B’s NOL and tax credit carryforwards can only be used at the consolidated level because Company B’s reporting units are not separate legal entities and none of those reporting units could be sold in a nontaxable transaction. Therefore, in determining the fair value of its reporting units, Company B assumes that its reporting units would be sold in taxable transactions that do not

provide for the transfer of tax attributes, such as NOLs and tax credit carryforwards, to a market participant acquirer.

Should Company B assign its deferred tax assets arising from its NOL and tax credit carryforwards to its reporting units?

Analysis

In this fact pattern, Company B should not assign the deferred tax assets for the NOL and credit carryforwards to its reporting units because they were not considered in determining the fair value of the reporting unit, and thus do not meet the criteria in ASC 350-20-35-39.

Example BCG 9-5 provides an example of how a company would consider CTA when determining the carrying amount of a reporting unit.

EXAMPLE BCG 9-5

Consideration of CTA in determining the carrying amount of a reporting unit

Assume that a foreign subsidiary that is a reporting unit has the following balances after currency translation by its US parent company (in millions):

	Dr/(Cr)
Total assets (including goodwill of \$300)	\$1,000
Total liabilities	(750)
Total net assets	\$250
Paid-in capital and retained earnings	\$(200)
Cumulative translation adjustment	(50)
Total equity	\$(250)

What would be the carrying amount of the reporting unit used for goodwill impairment testing?

Analysis

The carrying amount of this reporting unit for purposes of the quantitative goodwill impairment test would be \$250 million, which represents the net assets of the reporting unit at their currently translated amounts. In accordance with ASC 350-20-35-39A, foreign currency translation adjustments (in this example, \$50 million) would not be allocated to the reporting unit from the entity's accumulated other comprehensive income.

9.4 *Assigning all recorded goodwill to one or more reporting units*

All goodwill that is acquired in a business combination must be assigned to one or more reporting units as of the acquisition date. Goodwill is assigned to the reporting units that are expected to benefit from the business combination, regardless of whether other assets or liabilities of the acquired entity are also assigned to those reporting units. An entity's methodology for determining the amount of acquired goodwill to assign to a reporting unit should be reasonable, supportable, and applied in a consistent manner in accordance with ASC 350-20-35-41. ASC 350-20-35-42 through ASC 350-20-35-43 describes two approaches an entity might follow when assigning goodwill to reporting units: an acquisition method approach and a "with-and-without" approach. The use of any approach to assigning goodwill is dependent on facts and circumstances.

In the simplest of acquisitions, a new reporting unit will be created in connection with an acquisition, and the assets and liabilities of the acquired entity will be assigned to the new reporting unit. If no synergies with other existing reporting units are expected from the acquisition, all the goodwill arising from the acquisition would be assigned to the new reporting unit.

Many times, though, the specific assets and liabilities of an acquired entity will be assigned to one or more of the acquiring entity's existing reporting units and, perhaps, new reporting units that are created in connection with the acquisition. If the assets and liabilities that are assigned to reporting units constitute businesses, the goodwill arising from the acquisition may be assigned to the reporting units based on the excess of the fair values of the individual businesses acquired over the fair value of the sum of the individual assets acquired and liabilities assumed that are assigned to the reporting units. This is considered an acquisition method approach.

In some business combinations, synergies may be expected to be realized by existing reporting units that are not assigned any of the acquired assets or assumed liabilities. When synergies are expected in one or more of the entity's other reporting units, the entity may assign goodwill to the reporting units expecting to benefit from the synergies using a with-and-without approach. The with-and-without approach generally considers the difference between the fair value of the existing reporting unit before and after the acquisition in determining the amount of goodwill to assign to that reporting unit.

Example BCG 9-6 and Example BCG 9-7 illustrate the acquisition method approach and with-and-without approach, respectively, for purposes of assigning goodwill to reporting units.

EXAMPLE BCG 9-6

Acquisition method approach

Company X acquires Company Y for \$1,500. The fair value of the identifiable net assets acquired is \$1,000. Company X assigns the identifiable net assets of the acquired entity with fair values of \$200 and \$800 to new Reporting Units A and B, respectively. The net assets assigned represent businesses whose fair values are \$500 and \$1,000, respectively. No other reporting units are expected to benefit from acquisition-related synergies.

How should goodwill be assigned to Reporting Units A and B?

Analysis

Goodwill should be assigned to Reporting Units A and B as follows:

	Reporting Unit A	Reporting Unit B	Total acquisition
Fair value of acquired businesses	\$500	\$1,000	\$1,500
Fair value of identifiable net assets assigned to reporting units (excluding goodwill)	(200)	(800)	(1,000)
Goodwill assigned	\$300	\$200	\$500

EXAMPLE BCG 9-7*With-and-without approach*

Company X acquires Company Y for \$1,500. The fair value of the identifiable net assets acquired is \$1,000. The acquiring entity includes the entire acquired business in a new reporting unit—Reporting Unit D. Although existing Reporting Unit C has not been assigned any of the acquired assets or assumed liabilities, the acquiring entity expects Reporting Unit C to benefit from synergies related to the acquisition (e.g., Reporting Unit C is expected to realize higher sales of its products because of access to the acquired entity's distribution channels). Prior to the acquisition, the fair value of Reporting Unit C was \$1,900. After the acquisition, the fair value of Reporting Unit C is \$2,000.

How should goodwill be assigned to Reporting Units C and D?

Analysis

Goodwill should be assigned to Reporting Units C and D as follows:

	Reporting Unit C	Reporting Unit D	Total acquisition
Fair value of acquired entity			\$1,500
Fair value of identifiable net assets (excluding goodwill)		\$1,000	(1,000)
Fair value of unit C with acquisition	\$2,000		
Fair value of unit C without acquisition	(1,900)		
Goodwill assigned	\$100	\$400	\$500

The application of this approach must reflect a reasonable assignment among the reporting units.

Although it is expected that most entities will use one of the approaches noted above to assign goodwill upon an acquisition, an entity may also employ other methods when assigning goodwill to its reporting units, provided that the attribution methodology is reasonable, supportable, and does not result in the immediate impairment of goodwill. See BCG 9.9.2 for further information. Further, an entity's chosen methodology should be consistent with the basis for and method of determining the purchase price of an acquired entity and any synergies that management expects from the acquisition.

9.4.1 Recognition of goodwill in partial acquisitions

Goodwill is the residual element in a business combination and cannot, by itself, be determined and measured. In the acquisition of 100% of a business, goodwill results from comparing the fair value of the consideration transferred for the acquired business with the aggregate amounts assigned to the acquired identifiable net assets. In acquisitions of a controlling interest but less than all of the ownership interests in the entity (partial acquisitions), ASC 805 requires that the acquired net assets be recognized at their fair value, regardless of the ownership percentage acquired. Goodwill is then determined as the aggregate fair value of (1) the consideration transferred, (2) the noncontrolling interest, and (3) in a step acquisition, the previously held equity interest, less the recognized amount of the identifiable net assets of the acquired entity measured based on the acquisition method guidance of ASC 805. See Example BCG 5-1.

9.4.2 Goodwill attributable to controlling interests and NCI

In partial acquisitions, goodwill is recognized for the controlling and the noncontrolling interests. Any future impairment loss will need to be allocated to the controlling and the noncontrolling interests on a rational basis in accordance with ASC 350-20-35-57A. See Example BCG 9-19, Example BCG 9-20, and Example BCG 9-21 for illustrations of acceptable methods of allocating any impairment loss.

Example BCG 9-8 illustrates a rational method of attributing goodwill to the controlling and noncontrolling interests for purposes of allocating a potential future goodwill impairment loss.

EXAMPLE BCG 9-8

Goodwill attributable to controlling and noncontrolling interests

Company A obtains control of Company B by purchasing 80% of the equity interests in Company B for total consideration of \$800 million. The net aggregate value of Company B's identifiable assets and liabilities measured in accordance with ASC 805 is determined to be \$700 million, and the fair value of the noncontrolling interest is determined to be \$200 million. Accordingly, \$300 million of goodwill is recognized by Company A on the acquisition date.

How would goodwill be attributed to the controlling and noncontrolling interests?

Analysis

The total goodwill of \$300 million may be attributed as follows (in millions):

Fair value of the noncontrolling interest	\$200
Noncontrolling interest's share of the recognized net assets	(140) ¹
Goodwill attributable to the noncontrolling interest	\$60
Fair value of the consideration transferred	\$800
Controlling interest's share of the recognized net assets	(560) ²
Goodwill attributable to the controlling interest	\$240

¹ The noncontrolling interest's share of the recognized net assets acquired represents the noncontrolling ownership interest multiplied by the acquisition-date amounts of the net assets acquired, measured in accordance with ASC 805 (20% × \$700).

² The controlling interest's share of the recognized net assets acquired represents its ownership interest multiplied by the acquisition-date amounts of the net assets acquired, measured in accordance with ASC 805 (80% × \$700).

9.4.3 *Determination of fair value for the NCI*

While the fair value of the ownership interest acquired by the acquirer may be determined based on the consideration transferred, the determination of the fair value of the noncontrolling interest in transactions when less than all the outstanding ownership interests are acquired may present certain challenges to the acquirer. The consideration transferred for the controlling interest may provide a reliable indication of the fair value of the noncontrolling interest; however, an acquirer will need to consider factors that might cause this not to be the case. For example, an acquirer will need to consider the impact of any control premium (also referred to as a market participant acquisition premium) that may be included in the amounts transferred for the controlling interest or further synergies that may be achievable in obtaining control. In some situations, the fair value of the noncontrolling interest may need to be established through other valuation techniques and methods. See BCG 5.3.4 and FV 7.3.5 for further information on these techniques and methods.

9.4.4 *Reassigning goodwill as acquirer's reporting structure changes*

As an entity's operations evolve over time (through acquisitions, disposals, and/or reorganizations), the entity will be required to track its reporting units' goodwill, as well as the reporting units' other assets and liabilities, to facilitate goodwill impairment testing.

When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the entity should first reassign assets and liabilities (excluding goodwill) to the reporting units affected. In accordance with ASC 350-20-35-45, goodwill should then be reassigned to the affected reporting units by using a relative fair value approach similar to the approach used when an entity disposes a portion of a reporting unit, regardless of whether or not the transferred assets meet the definition of a business. As a result, the amount of goodwill attributed to each reporting unit is determined based on the relative fair values of (1) the elements transferred and (2) the elements remaining within the original reporting units.

Events affecting a reporting unit, such as a change in the composition or carrying amount of its net assets due to a reorganization, may trigger the need to perform a goodwill impairment test. An entity should establish that a change in composition of net assets or reorganization did not otherwise prevent

recognition of an impairment that existed prior to the change or reorganization. It would not be appropriate for an entity to reorganize its reporting structure simply to avoid an impairment charge.

When reporting units are reorganized subsequent to the period-end, but prior to the issuance of the financial statements, the reporting structure in place at period-end should be used to perform goodwill impairment testing.

Example BCG 9-9 and Example BCG 9-10 illustrate the reassignment of goodwill.

EXAMPLE BCG 9-9

Basic principle of goodwill reassignment

Company X transfers a portion of Reporting Unit A's operations into two newly formed reporting units, B and C (which each meet the definition of a business), in connection with a corporate restructuring. The fair value of the transferred operations was determined to be \$50 million, with \$20 million assigned to the operations transferred to Reporting Unit B and \$30 million to the operations associated with Reporting Unit C. The fair value of the remaining elements in Reporting Unit A is \$150 million. Total goodwill assigned to Reporting Unit A before the restructuring was \$40 million.

How should goodwill be reassigned for each reporting unit?

Analysis

The goodwill reassignment would be as follows (\$s in millions):

	Reporting Unit A	Reporting Unit B	Reporting Unit C	Total
Fair values of the operations	\$150	\$20	\$30	\$200
Relative fair value	75%	10%	15%	100%
Goodwill	\$30	\$4	\$6	\$40

EXAMPLE BCG 9-10

Reassignment of goodwill when reporting structure changes

Company Z has 2 reporting units, Reporting Unit 1 and Reporting Unit 2, with goodwill of \$1 million and \$2 million, respectively. Company Z reorganizes its business and creates a new reporting structure. As a consequence, operations in Reporting Unit 1 are transferred into 4 newly created reporting units (Reporting Unit A, Reporting Unit B, Reporting Unit C, and Reporting Unit D). A small portion of operations in Reporting Unit 2 are transferred to Reporting Unit D and the remainder of Reporting Unit 2 is renamed Reporting Unit E. The relative fair values of the operations transferred due to the restructuring are as follows:

New Reporting Units	A	B	C	D	E
Relative fair value transferred from reporting unit 1	40%	40%	15%	5%	
Relative fair value transferred from reporting unit 2				10%	90%

How should goodwill be reassigned to each reporting unit when Company Z's reporting structure changes?

Analysis

As a result of the change in the composition of its reporting structure, Company Z is required to reassign its goodwill using a relative fair value approach similar to that used when a portion of a reporting unit is disposed of (see ASC 350-20-35-45).

In accordance with the guidance in ASC 350-20, Company Z should first reassign assets and liabilities (excluding goodwill) from legacy reporting units, Reporting Unit 1 and Reporting Unit 2, to the new reporting units. Then, goodwill should be reassigned to the new reporting units using the relative fair value approach. Therefore, the amount of goodwill attributed to each new reporting unit would be determined based on the relative fair values in the legacy reporting units of (1) the elements transferred and (2) the elements remaining within the original reporting units. The goodwill of each reorganized reporting unit should be separately reattributed to the new reporting units (i.e., goodwill should not be aggregated for each reorganized reporting unit before the reattribution).

In this case, \$1 million of goodwill from Reporting Unit 1 should be reattributed to Reporting Units A, B, C, and D based on the relative fair value of operations transferred from Reporting Unit 1 (i.e., 40%, 40%, 15%, and 5%, respectively). \$2 million of goodwill from Reporting Unit 2 should be attributed to Reporting Unit D and Reporting Unit E based on relative fair values of 10% and 90%, respectively.

New Reporting Units	A	B	C	D	E	Total
Goodwill reattribution of Reporting Unit 1	\$400,000	\$400,000	\$150,000	\$50,000		\$1,000,000
Goodwill reattribution of Reporting Unit 2				200,000	\$1,800,000	2,000,000
Total	\$400,000	\$400,000	\$150,000	\$250,000	\$1,800,000	\$3,000,000

9.4.5 Translation of goodwill denominated in a foreign currency

Acquisition accounting adjustments attributable to a foreign entity but recorded in the parent's accounting records need to be considered in the translation process as if those adjustments were pushed down and recorded at the foreign entity level.

Example BCG 9-11 illustrates the translation of goodwill assigned to a foreign entity.

EXAMPLE BCG 9-11

Translation of goodwill assigned to a foreign entity

Company A acquired European Business X, whose functional currency is the Euro. On the acquisition date, goodwill was determined to be €100 million, which was the equivalent of \$150 million, and was recorded at the parent level and not pushed down to Business X's general ledger. At period-end, the exchange rate is 1€ for \$1.25.

At period-end, how would goodwill assigned to Business X be translated in Company A's consolidated financial statements?

Analysis

In translating Business X's assets and liabilities at period-end for the purpose of preparing Company A's consolidated financial statements, the €100 million goodwill determined at the acquisition date would be recorded as \$125 million with a corresponding charge to other comprehensive income of \$25 million.

After goodwill assigned to foreign entities is translated to the reporting currency, any associated changes in the goodwill balance should be assigned to the reporting units where the respective goodwill resides.

While Example BCG 9-11 addresses circumstances in which the reporting entity acquires a business that is entirely a foreign entity, translating goodwill as if it were pushed down to a foreign subsidiary applies in other circumstances as well. For example, the reporting entity may acquire a multinational company domiciled in the United States with foreign operations that give rise to a portion of the overall goodwill recorded in the business combination. In this circumstance, an appropriate portion of the goodwill should be considered in the translation process for the relevant foreign subsidiaries as if a portion of the goodwill had been pushed down to those foreign entities. See FX 5.2 and FX 8.2.1 for additional information on translation procedures and the translation of goodwill, respectively.

Example BCG 9-12 illustrates an acceptable method to assign a change in goodwill due to the effects of changes in foreign exchange rates.

EXAMPLE BCG 9-12

Assigning changes in goodwill due to changes in foreign exchange rates

Company A acquired European Business X, whose functional currency is the Euro. On the acquisition date, goodwill was determined to be €100 million, which was the equivalent of \$150 million, and was recorded at the parent level and not pushed down to Business X's general ledger. At period-end, the exchange rate is 1€ for \$1.25.

Company A assigned Business X to Reporting Unit 1 but determined that €20 million of its goodwill was synergistic to Reporting Unit 2 and, accordingly, assigned €80 million to Reporting Unit 1, and €20 million to Reporting Unit 2 at the acquisition date. Both reporting units reside in Europe and have the Euro as their functional currency.

How would the decrease in goodwill of \$25 million be assigned to each reporting unit?

Analysis

The \$25 million decrease in goodwill resulting from foreign currency translation may be assigned to each reporting unit based on the relative fair value of the goodwill assigned to Reporting Unit 1 and Reporting Unit 2 at the acquisition date. Therefore, \$20 million ($\$25 \times \text{€}80 / (\text{€}20 + \text{€}80)$) of the decrease in goodwill would be assigned to Reporting Unit 1 and \$5 million ($\$25 \times \text{€}20 / (\text{€}20 + \text{€}80)$) of the decrease in goodwill would be assigned to Reporting Unit 2.

9.4.6 Documentation to support goodwill assignment

ASC 350-20-35-41 requires that the methodology used to determine the assignment of goodwill to a reporting unit be reasonable, supportable, and applied in a consistent manner. ASC 350-20-35-40 addresses how an entity should consider assigning assets used in multiple reporting units to its reporting units. ASC 350-20-35-40 also requires that the basis for and method of determining the fair value of an acquiree and other related factors (such as the underlying reasons for the acquisition and management's expectations related to dilution, synergies, and other financial measurements) be documented at the acquisition date.

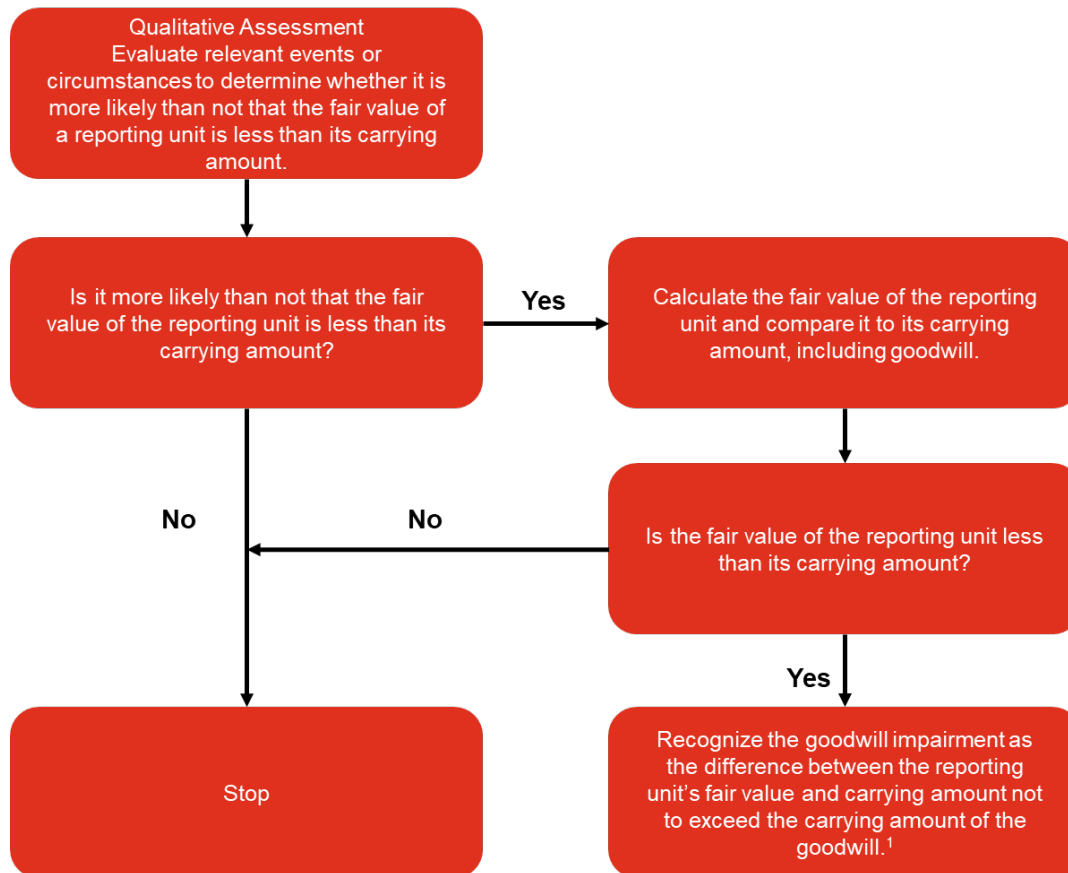
9.5 Overview of the goodwill impairment model

In assessing goodwill for impairment, an entity may first assess qualitative factors (step zero) to determine whether it is necessary to perform a quantitative goodwill impairment test (see BCG 9.6).

If an entity bypasses the qualitative assessment or determines based on its qualitative assessment that further testing is required, the quantitative goodwill impairment test should be followed to determine if there is an impairment of goodwill and, if so, to measure the amount of such goodwill impairment (see BCG 9.8).

Figure BCG 9-3 illustrates the goodwill impairment model.

Figure BCG 9-3
Goodwill impairment model



¹ When a reporting unit has tax-deductible goodwill, a goodwill impairment may necessitate an iterative calculation (using what is often referred to as the “simultaneous equations method”) to determine the ultimate goodwill impairment amount and the related deferred tax adjustment. See BCG 9.9.6 for additional information.

9.5.1 **Timing considerations for goodwill impairment testing**

An entity is required to test the carrying amount of a reporting unit’s goodwill for impairment on an annual basis in accordance with ASC 350-20-35-28. In accordance with ASC 350-20-35-30, an entity should also test goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. ASC 350-20-35-3A defines “more likely than not” as “a likelihood of more than 50 percent.”

9.5.1.1 **Triggering events for goodwill impairment testing**

If an event occurs or circumstances change between annual tests that could more likely than not reduce the fair value of a reporting unit below its carrying amount (triggering events), the goodwill of that reporting unit should be tested for impairment using the process described in BCG 9.8. The factors considered in a qualitative assessment of goodwill (outlined in BCG 9.6) are also examples of interim triggering events that should be considered in determining whether goodwill should be tested for impairment during interim periods. Such factors include changes in macroeconomic conditions, cost increases, and share price, among others.

In accordance with ASC 350-20-40-7, when 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 must also be tested for impairment. See BCG 9.10 for further information.

Question BCG 9-3

Can the original transaction price be used as an indicator of fair value in the first post acquisition goodwill impairment test? What if the next highest bid was substantially lower?

PwC response

When assessing fair value in the first goodwill impairment test after an acquisition, an acquirer may consider the purchase price as one data point, among others, in determining fair value, unless there is contradictory evidence. ASC 820-10-30-3A requires that a reporting entity consider factors specific to the transaction in determining whether the transaction price represents fair value. The fact that the next highest bid was substantially lower than an acquirer's bid does not necessarily mean that the transaction price is not representative of fair value, but it could indicate that significant acquirer-specific synergies were included in the determination of the purchase price.

Question BCG 9-4

If none of the events and circumstances described in ASC 350-20-35-3C are present, can an entity conclude that it does not have a requirement to perform an interim impairment test for goodwill?

PwC response

No. The indicators listed in ASC 350-20-35-3C are examples, and do not comprise an exhaustive list. ASC 350-20-35-3F indicates that an entity should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit.

Additional examples of events that may indicate that an interim impairment test is necessary include:

- Impairments of other assets or the establishment of valuation allowances on deferred tax assets
- Cash flow or operating losses at the reporting unit level (the greater the significance and duration of losses, the more likely it is that a triggering event has occurred)
- Negative current events or long-term outlooks for specific industries impacting the company as a whole or specific reporting units
- Not meeting analyst expectations or internal forecasts in consecutive periods, or downward adjustments to future forecasts
- Planned or announced plant closures, layoffs, or asset dispositions
- Market capitalization of the company below its book value

Therefore, only after considering all available evidence, can a company conclude that it does not have a requirement to perform an interim impairment test for goodwill.

Question BCG 9-5

Does the option to perform a qualitative impairment assessment change how an entity would determine whether it needs to perform an event-driven interim test?

PwC response

The option to perform a qualitative impairment assessment does not change when an entity should perform a goodwill impairment test. An interim test should be performed if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

For entities with publicly traded equity or debt securities, although the impairment test for goodwill occurs at the reporting unit level, a significant decline in the market value of such securities may indicate the need for an interim impairment test. It is important to remember that the goodwill test is not based on an “other than temporary” decline. When a substantial decline occurs, an entity should consider whether it is “more likely than not” that the fair value of any of the entity’s reporting units has declined below the reporting unit’s carrying amount. In these situations, an entity should examine the underlying reasons for the decline, the significance of the decline, and the length of time the market price has been depressed to determine if a triggering event has occurred. A decline that is severe, even if it is recent, as a result of an event that is expected to continue to affect the company will likely trigger the need for a test. Further, a decline that is of an extended duration will also likely trigger the need for a test. In contrast, a relatively short-term decline in the market price of the company’s stock may not be indicative of an actual decline in the company’s fair value when one considers all available evidence. Interim impairment triggers can also be present at the reporting unit level even when a public company’s market capitalization is equal to or greater than its book value. All available evidence should be considered when determining a reporting unit’s fair value.

Question BCG 9-6

In lieu of performing its goodwill impairment test, can a company, whose market capitalization is significantly below book value, write off its goodwill in its entirety?

PwC response

To recognize a goodwill impairment, the company will need to test each reporting unit to determine the amount of a goodwill impairment loss. If the fair value of a reporting unit is greater than its carrying amount in the quantitative goodwill impairment test, a company cannot record a goodwill impairment.

Question BCG 9-7

If a company experiences a decline in market capitalization that is consistent with declines experienced by others within its industry, is it reasonable for the company to assert that a triggering event has not occurred and that the decline is an indication of distressed transactions and not reflective of the underlying value of the company?

PwC response

There are times when a distressed transaction may be put aside. However, a distressed market cannot

be ignored. A decline in a company's market capitalization, consistent with declines experienced by others within its industry, may be reflective of the underlying value of the company in a distressed market and the impact of an economic downturn or changes in market multiples in the company's industry, which is one of the factors described in ASC 350-20-35-3C. Entities should distinguish between a distressed market, in which prices decline yet liquidity exists with sufficient volume, and a forced or distressed transaction. Transactions at depressed prices in a distressed market would not typically be distressed transactions.

Question BCG 9-8

If a company has not experienced a decline in its cash flows and expects that it will continue to meet its projected cash flows in the future, can the company assert that a triggering event has not occurred even though the decline in its market capitalization may be significant?

PwC response

While a company may not have experienced a decline in its cash flows and does not anticipate a future decline in projected cash flows, it is not appropriate to simply ignore market capitalization when evaluating the need for an interim impairment test. The market capitalization usually reflects the market's expectations of the future cash flows of the company. A company may need to reconsider its projected cash flows due to heightened uncertainty about the amount and/or timing of cash flows, particularly for industries in which customer purchases are discretionary. Even if there is no change in a company's cash flows, higher required rates of return demanded by investors in an economic downturn may decrease a company's discounted cash flows. This, in turn, will decrease fair value.

Question BCG 9-9

If a company completed its annual goodwill impairment test during the fourth quarter and the company has not identified any significant changes in its business during the first quarter of the following year, is a continued depressed stock price or a further decline during the first quarter a triggering event for performing a goodwill impairment test?

PwC response

If a company's stock price remains at a depressed level or continues to decline during the first quarter, it is important to ensure all available evidence has been evaluated to determine if a triggering event has occurred. The market capitalization generally reflects the market's expectations of the future cash flows of the company. When the market capitalization drops, this may indicate that an event has occurred, or circumstances or perceptions have changed that would more likely than not reduce the fair value of a company's reporting unit below its carrying amount. For example, the decline in the stock price may be an indicator that the company's cash flow projections in future periods are too optimistic when considering the most recent macroeconomic forecasts.

A company should compare its actual results to date against budget and consider whether its projections appropriately reflect current expectations of the length and severity of recent economic conditions. Reviewing externally available information (e.g., analyst reports, industry publications, and information about peer companies) may provide further insight on the factors attributable to the decline and whether a reporting unit has had a triggering event. When evaluating external information, it is important to ensure it is comparable to the reporting unit under review and not solely to the consolidated company. Further, the amount by which the fair value of the reporting unit

exceeded its carrying amount at the last goodwill impairment test date may also be a consideration in evaluating if it is more likely than not that the fair value of a reporting unit has dropped below its carrying amount.

Similar to other impairment charges, financial statement users, auditors, and regulators may scrutinize the timing of goodwill impairment losses. Entities that recognize a goodwill impairment loss should be prepared to address questions about (1) the timing of the impairment charge, (2) the events and circumstances that caused the reporting unit's goodwill to become impaired, and (3) for public entities, the adequacy of the entity's "early warning" disclosures (e.g., those described in SEC FRM 9510.3), including relevant risks and business developments leading up to the charge, in its public reporting for prior periods.

9.5.1.2 Annual goodwill impairment testing date

An entity may perform the annual goodwill impairment test for each reporting unit at any time during the year, as long as the test is consistently performed at the same time every year for that reporting unit. In addition, an entity may test the goodwill of different reporting units at different times during the year.

In determining the timing of the annual impairment test, the entity may find it useful to consider the following factors, at a minimum:

- Availability of relevant information (e.g., prepared as part of the annual budgeting/forecasting cycle)
- Time and resource requirements to perform the test and the effect on timely reporting to the public
- Timing of the annual impairment test for indefinite-lived intangible assets assigned to the same reporting unit
- Effects of impairment losses on the entity's capital market communication (e.g., it might be difficult to explain an impairment loss in the first quarter, just after filing the annual report)
- Seasonal cycles in the reporting unit's business

Management may choose to test goodwill for impairment at a quarter-end date because of the more robust closing procedures that generally take place at quarter end. However, consideration should be given to the potential difficulty in completing the annual test prior to release of the quarterly results, especially if third-party valuations firms are engaged to assist management with its analysis.

A change in a reporting unit's annual goodwill impairment test date is considered to be a change in accounting principle (i.e., a change in the method of applying an accounting principle). Accordingly, a company that makes a change in the annual goodwill impairment test date must demonstrate that the change is preferable in accordance with ASC 250-10-45-1 through ASC 250-10-45-2. An entity with publicly traded securities in the United States is generally required to obtain a preferability letter from its auditor when making a change in accounting principle. However, in a 2014 speech the SEC staff advised that if a company determines that a change in the annual goodwill impairment test date is not material, the SEC staff would no longer request a preferability letter so long as the company

prominently discloses the change within the financial statements. Judgment is required in determining whether the change is material.

A change in accounting principle is required to be applied retrospectively to all prior periods unless it is impracticable to do so. ASC 250-10-45-9 provides guidance on impracticability for retrospective application, including conditions that either require assumptions about management's intent in a prior period that cannot be independently substantiated or require significant estimates of amounts and it is impossible to distinguish information about those estimates objectively without the use of hindsight. We believe a change in the annual goodwill impairment test date may be applied prospectively if a company determines it to be impracticable to apply it retrospectively or the change does not have a material effect on the financial statements in light of the company's design and operating effectiveness of its internal control over financial reporting in prior periods and the requirements under ASC 350-20 to assess goodwill impairment upon certain triggering events.

When an entity changes its annual goodwill impairment testing date, no more than 12 months may elapse between the original annual impairment test date and the new date selected for testing. Additionally, the change in the annual goodwill impairment test date cannot accelerate, delay, avoid, or cause an impairment charge.

Unlike a change in the annual goodwill impairment test date, ASC 350-30 does not specifically require the annual impairment test for indefinite-lived intangible assets to be performed at the same time each year. Therefore, a company does not need to assess preferability when it changes its impairment test date for indefinite-lived intangible assets. See BCG 8.3 for additional guidance on impairment of indefinite-lived intangible assets.

Example BCG 9-13 illustrates a change in the timing of the annual goodwill impairment test.

EXAMPLE BCG 9-13

A change in the timing of the annual goodwill impairment test

Company A, a public registrant, changes its fiscal year end for competitive and business reasons from July 31 to December 31 and will prepare and file financial statements for the five-month period from August 1 through December 31. Historically, Company A has performed all of its annual impairment tests in its fourth quarter on May 31, and intends to realign the annual impairment test date to a similar date in its new fourth quarter (i.e., October 31).

Is Company A's change in its annual impairment test date due to the change of its fiscal year end considered a change in accounting principle?

Analysis

Yes. As such, it would need to be preferable. While each situation must be considered based on its own facts and circumstances, in this example, the change would allow the date of the impairment test to correspond with the new annual budgeting cycle and move the performance of the test closer to the new fiscal year end. It is therefore likely that the new impairment date would be considered preferable.

Company A will need to perform impairment tests as of May 31 and October 31 in the year of change because skipping the May 31 test would result in a period greater than 12 months between annual impairment tests.

An entity may complete an acquisition shortly before the date of its annual impairment test for goodwill for all of its reporting units and may intend to use that same date for impairment testing of goodwill arising from the current acquisition. The question arises as to whether the acquiring entity could omit the first year's annual impairment test for the recent acquisition, because the related valuation and determination of goodwill had just occurred; thus, impairment of goodwill shortly after the acquisition would be unlikely. However, omitting the impairment test for the goodwill in the recent acquisition at its usual annual testing date and performing it for the first time in the year after the acquisition would result in a period in excess of 12 months before the first goodwill impairment test.

As the first annual impairment test for the goodwill recorded in the current acquisition should be performed within 12 months of the date of close of the acquisition, the entity may wish to consider including the recent acquisition in its usual annual goodwill impairment test. The entity should consider updating the acquisition valuation for any changes in the acquiree's business. If the recent acquisition constitutes its own reporting unit, the reporting unit may not be a good candidate for the qualitative impairment assessment as there would not likely be cushion on the acquisition date. Despite the fact that a fair value analysis was just completed upon acquisition, the lack of cushion could make it a challenge to conclude based solely on the qualitative assessment that no further impairment testing is necessary. As such, the qualitative assessment may not be appropriate to use in this circumstance.

Alternatively, the entity would be required to use a different date, which would be within twelve months of the date of close of the acquisition, for its annual impairment test for the recently acquired goodwill. However, for practical reasons, most companies assign the same annual goodwill impairment test date to all of their reporting units, including those reporting units that have been recently acquired.

Question BCG 9-10

If a company performs its annual quantitative goodwill impairment test at the beginning of the fourth quarter and determines that a reporting unit's fair value is greater than its carrying amount, does the company need to further assess whether it may have a triggering event in the fourth quarter?

PwC response

While a reporting unit's fair value may be determined to be greater than its carrying amount in the quantitative goodwill impairment test at the beginning of the fourth quarter, this does not eliminate the company's need to continue to assess events and circumstances through the end of the reporting period which may indicate that it is more likely than not that a reporting unit's fair value has fallen below its carrying amount. For example, management may need to consider whether a significant decline in the company's stock price in the fourth quarter represents a triggering event.

Question BCG 9-11

If a company performs its annual quantitative goodwill impairment test at the beginning of the fourth quarter and determines that a reporting unit's fair value is less than its carrying amount, does the company need to assess events occurring after the annual testing date when assessing its impairment loss for the fourth quarter?

PwC response

If a calendar year-end company performs its annual quantitative goodwill impairment test on October 1 and determines that a reporting unit's fair value is less than its carrying amount, the company would record a goodwill impairment loss for the amount by which the carrying value of the reporting unit exceeded its fair value (not to exceed the carrying value of the goodwill). If the company's stock price declines significantly or other indicators of potential impairment arise subsequent to the annual goodwill impairment test, the company may still need to perform an interim quantitative goodwill impairment test as of the end of the fourth quarter as that may be an indication that it is more likely than not that the fair value of the reporting unit is less than its carrying value (as there would be no cushion as a result of the impairment loss recorded on the annual test).

9.6 *The qualitative goodwill impairment assessment*

The following section applies to all reporting units, regardless of whether each has a positive, zero, or negative carrying amount. See BCG 9.8.2 for the accounting for reporting units with zero or negative carrying amounts.

The carrying amount of a reporting unit's goodwill should be tested for impairment at least on an annual basis and in between annual tests in certain circumstances. An entity is permitted to first assess qualitatively whether it is necessary to perform a goodwill impairment test. The quantitative impairment test is required only if the entity concludes that it is more likely than not that a reporting unit's fair value is less than its carrying amount. In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity should consider the totality of all relevant events or circumstances that affect the fair value or carrying amount of a reporting unit.

ASC 350-20-35-3C provides examples of such events and circumstances.

ASC 350-20-35-3C

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 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
- g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

These examples are not all-inclusive, as noted in ASC 350-20-35-3F. An entity should consider other relevant events or circumstances specific to its reporting units when determining whether to perform the quantitative goodwill impairment test. For example, the AICPA Accounting and Valuation Guide – *Testing Goodwill for Impairment* (“AICPA Goodwill Guide”) provides additional examples of events that may require consideration such as (1) market reaction to a new product or service, (2) technological obsolescence, (3) a significant legal development, (4) contemplation of a bankruptcy proceeding, or (5) an expectation of a change in the risk factors or risk environment influencing the assumptions used to calculate the fair value of a reporting unit, such as discount rates or market multiples.

During the assessment, an entity should consider each adverse factor as well as the existence of any positive and mitigating events and circumstances, including the difference between a reporting unit’s fair value and carrying amount if determined in a recent fair value calculation (“cushion”).

Entities should give more weight to those events and circumstances that impact most significantly a reporting unit’s fair value or carrying amount. Some events and circumstances will affect most, if not all, reporting units. For example, many entities likely will determine that it is necessary to perform the quantitative goodwill impairment test in an unfavorable economic environment. However, the relative importance of the various factors will be different for each reporting unit.

None of the individual examples summarized above are intended to represent standalone triggering events that would require an entity to perform the quantitative goodwill impairment test. Similarly, the existence of positive and mitigating events and circumstances would not represent a rebuttable presumption that an entity does not need to perform the quantitative goodwill impairment test.

If, after assessing the totality of events or circumstances such as those described above, an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then a quantitative goodwill impairment test would be needed to identify and measure an impairment loss, if any. If the entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, no further impairment testing is necessary.

Example BCG 9-14 illustrates the application of the qualitative goodwill impairment assessment by a company with two reporting units.

EXAMPLE BCG 9-14

Goodwill impairment assessment by a company with two reporting units

Company A has two reporting units: Reporting Unit X and Reporting Unit Y. The most recent annual quantitative goodwill impairment test, completed one year ago, resulted in a 40% cushion (i.e., fair value exceeded carrying amount by 40%) for Reporting Unit X and a 10% cushion for Reporting Unit Y. During the current year, macroeconomic trends have improved and the markets in which Reporting Units X and Y operate have remained stable. Company A has experienced increased access to capital at lower rates and market capitalization has trended higher. Analysts reported a positive outlook for Company A. While there was limited deal activity in the industry, the deals that were completed had multiples consistent with the multiples used by Company A in the valuation of its reporting units in the prior year. Demand has grown for Reporting Unit X's products as evidenced by a better-than-expected increase in revenue, lower costs, and higher profit margins, resulting in Reporting Unit X's operating results exceeding budget. Demand for Reporting Unit Y's products, on the other hand, has been soft due to intense competition. As a result, Reporting Unit Y's revenue and profit margins were flat as compared to the prior year, but below budget. Company A had no change in management.

Should Company A perform a qualitative or quantitative assessment for Reporting Units X and Y?

Analysis

In this fact pattern, Company A would likely perform a qualitative assessment for Reporting Unit X. The starting cushion of 40%, positive macroeconomic and market indicators, and the current year results exceeding budget indicate that the entity's management may be able to conclude, absent other significant negative information, that it is more likely than not that the fair value of Reporting Unit X exceeds its carrying value.

In contrast, Company A would likely proceed directly to the quantitative goodwill impairment test for Reporting Unit Y. The lack of significant beginning cushion combined with the adverse impact of intense competition on revenue and profit margins makes it more difficult for Company A to conclude, solely using a qualitative assessment, that no further impairment testing is necessary. Because small changes in the assumptions or inputs could impact the valuation of Reporting Unit Y, management would likely be unable to conclude, based solely on a qualitative assessment, that it is more likely than not that the fair value of Reporting Unit Y exceeds its carrying value.

9.6.1 Selecting reporting units for the qualitative assessment

An entity can choose to perform the qualitative assessment on none, some, or all of its reporting units. Moreover, an entity can bypass the qualitative assessment for any reporting unit in any period and proceed directly to the quantitative goodwill impairment test, and then perform the qualitative assessment in any subsequent period. The selection of reporting units on which to perform the qualitative assessment is not an accounting policy decision that needs to be followed consistently every period. Therefore, an entity should tailor its use of the qualitative assessment based on specific facts and circumstances for each reporting unit.

Use of the qualitative assessment may be appropriate in many, but not all, situations. A qualitative assessment alone may not be sufficient to support a more likely than not assertion when certain adverse factors are present. In other cases, the qualitative assessment may not be cost effective compared to performing the quantitative goodwill impairment test. If an initial review of the facts and circumstances suggests it will require an extensive qualitative assessment and there remains a strong possibility that the quantitative goodwill impairment test may still need to be performed, an entity may conclude it will be more efficient to perform the quantitative goodwill impairment test. An entity that already has an efficient and robust process in place for determining the fair value of its reporting units may prefer to bypass the qualitative assessment and proceed directly to the quantitative goodwill impairment test rather than implement additional processes and internal controls for performing the qualitative assessment. Also, if a significant amount of time has elapsed since the last quantitative goodwill impairment test, an entity may elect to perform the quantitative goodwill impairment test as a means of refreshing its understanding of the extent of cushion between a reporting unit's fair value and carrying amount.

The qualitative assessment will be most appropriate when there is significant cushion based on a recent fair value measurement and no significant adverse changes have since occurred. Conversely, a qualitative assessment alone may not be effective or efficient if the cushion indicated by the most recent fair value measurement is not significant. This is the case, for example, when a reporting unit has recently been acquired or reorganized, or its goodwill recently impaired. The lack of cushion in these circumstances would cause the reporting unit to be highly sensitive to adverse changes in entity-specific factors such as actual and forecasted cash flows and non entity-specific factors such as discount rates and market multiples.

9.6.2 Consider prior FV measurements in qualitative assessment

The amount of cushion, if any, between the fair value and the carrying amount of the reporting unit from a prior fair value measurement is a critical factor in the qualitative assessment. However, an entity should not look solely at the amount of cushion from a recent fair value measurement to determine whether to perform a qualitative assessment. An entity must first determine whether the assumptions and projections underlying the previous fair value measurement are still reasonable in the current period. For example, an entity's actual results for the current year combined with updated current forecasts may differ from the entity's prior year forecasts used in a discounted cash flow valuation model. The significance of the differences may indicate that the projections used for the last fair value calculation were too aggressive and that less weight should be given to the apparent cushion from the prior valuation. Conversely, more weight would likely be given to a prior cushion when actual results are consistent with or more favorable to the reporting unit's fair value than prior projections.

Question BCG 9-12

How much cushion between a reporting unit's fair value and its carrying amount is required to allow an entity to start with a qualitative assessment of goodwill impairment rather than the quantitative goodwill impairment test?

PwC response

There are no bright lines. The test is qualitative and should consider all facts and circumstances impacting the comparison of a reporting unit's fair value to its carrying amount, including the length of time elapsed since the last fair value calculation and the impact of adverse qualitative factors. All

else being equal, a reporting unit with significant cushion is more likely to allow an entity to start with a qualitative assessment than a reporting unit with little to no cushion.

9.6.3 *Periodically refreshing a reporting unit's fair value*

Entities should consider periodically “refreshing” a reporting unit’s fair value calculation. The more time that has elapsed since a recent fair value calculation, the more difficult it may be to support a conclusion based solely on a qualitative assessment. The frequency with which an entity refreshes its fair value calculation for a reporting unit will depend on a variety of factors, including how much cushion existed at the last fair value calculation, the reporting unit’s financial performance, the current operating environment, the current market environment for similar entities, and any significant changes in the composition of the reporting unit. If an entity chooses not to refresh and determines that it will continue to apply the qualitative test, the entity may need to lessen the amount of weight it would place on the previous fair value calculation in its qualitative assessment.

Question BCG 9-13

How many years can an entity use a previously measured fair value of a reporting unit as a basis for assessing the extent of cushion between a reporting unit’s fair value and its carrying amount?

PwC response

There are no bright lines. A determination of the appropriate length of time between quantitative measurements of the fair value of a reporting unit is a matter of judgment. Some entities may choose to establish policies requiring reporting unit fair values to be reassessed periodically. Even with such a policy, an entity may still need to determine a reporting unit’s fair value more frequently than the policy requires if events and circumstances indicate a quantitative goodwill impairment test is appropriate.

9.6.4 *An entity's assertion of its annual qualitative assessment*

An entity should make a positive assertion about its conclusion reached and factors considered if it determines as part of its annual qualitative assessment that the quantitative goodwill impairment test is unnecessary. Therefore, while the level of documentation will vary based on facts and circumstances specific to each reporting unit, an entity should clearly document the conclusion reached and factors considered in an annual test.

Question BCG 9-14

What processes would an entity be expected to have in place if it wishes to support its conclusion reached based on application of a qualitative assessment?

PwC response

An entity should make a positive assertion about its conclusion reached and the events and circumstances taken into consideration in performing a qualitative assessment. Therefore, in most cases, a robust process with supporting documentation will be needed to support an entity’s conclusion that a quantitative goodwill impairment test is not necessary.

Generally, entities that use the qualitative assessment should have in place a comprehensive process to:

- Determine which factors are the key drivers of each reporting unit’s fair value and monitor changes in those factors
- Identify the internal and external sources of information needed to monitor the relevant factors for each reporting unit; consider whether analyst and other external information is consistent with the entity’s assessment of events and circumstances that could impact the reporting unit’s fair value
- Consider the amount of “cushion” from the most recent fair value calculation and evaluate the financial performance of the reporting unit since that analysis
- Monitor changes in other market-based metrics that could impact significantly the fair value of the reporting unit, including items such as the long-term discount rate and market multiples for companies in the reporting unit’s peer group
- Evaluate and weigh the impact of adverse and mitigating factors based on the extent those factors impact the comparison between fair value and carrying amount
- Consider if, and how frequently, a quantitative goodwill impairment analysis should be performed for the purpose of “refreshing” the baseline valuation
- Affirmatively consider and document the qualitative assessment that includes consideration of the factors identified from the entity’s process and the basis for its conclusion; generally, the greater the extent of analysis needed to assert that no further testing is necessary, the greater the extent of documentation that should be prepared

9.7 Goodwill fair value considerations

The fair value of a reporting unit is determined in accordance with ASC 820. The fair value of a reporting unit refers to the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants at the measurement date.

9.7.1 Determining the fair value of a reporting unit

The FASB decided not to prescribe how to determine the fair value of a reporting unit. When attributing assets and liabilities to reporting units, entities can use either an equity premise (i.e., total assets net of all liabilities) or an enterprise premise (i.e., total assets net of only operating liabilities) applied consistently period to period. Assigning all liabilities to the reporting unit under the equity premise may result in a negative carrying value.

As illustrated in Example BCG 9-15, the premise used to attribute assets and liabilities to reporting units can impact the amount of goodwill impairment.

EXAMPLE BCG 9-15**Impact of the valuation premise on goodwill impairment**

Reporting Unit A has the following recorded assets and liabilities:

Goodwill	\$40
Other assets	\$60
Operating liabilities	\$(20)
Nonrecourse long-term debt	\$(60)

The fair value of Reporting Unit A excluding debt is \$50. The fair value of Reporting Unit A including debt would likely be determined based on an option pricing model and thus yield a value greater than zero, but for illustration purposes, is assumed to be zero.

What is the impact of selecting the equity or enterprise premise when determining fair value?

Analysis

The goodwill impairment is different under each of the valuation premises. As shown in the table below, while both the equity premise and the enterprise premise result in an impairment, the amounts differ.

	Equity premise	Enterprise premise
Carrying amounts	\$20 ¹	\$80 ²
Fair value	0	50
Goodwill impairment	\$20	\$30

¹ \$40 (goodwill) + \$60 (Other assets) – \$20 (Operating liabilities) – \$60 (Long-term debt)

² \$40 (goodwill) + \$60 (Other assets) – \$20 (Operating liabilities)

9.7.2 Fair value of reporting units assigned goodwill

Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for fair value measurement, if available. However, in many cases a company's reporting units may not have their own publicly traded securities. Even if that is the case, ASC 350-20-35-22 provides guidance that the quoted market prices of an individual security may not be representative of the fair value of the reporting unit as a whole. For example, a control premium (i.e., the premium an acquiring entity is willing to pay for a controlling interest versus the amount an investor would be willing to pay for a noncontrolling interest) may cause the fair value of a reporting unit to exceed its market capitalization. However, an entity should not adjust quoted market prices using broad assumptions. For example, it would not be appropriate to assume that a standard percentage for a control premium

should be added to quoted market prices. Instead, a control premium should be based on a detailed analysis and should consider such things as industry and market, economic and other factors that market participants typically consider when determining the fair value of the entity.

Question BCG 9-15

What is a reasonable control premium in determining the fair value of a reporting unit?

PwC response

A control premium can vary considerably depending on the nature of the business, industry and other market conditions. Accordingly, determining a reasonable control premium will be a matter of judgment. In some instances, little or no premium may be appropriate. Generally, when assessing the reasonableness of a control premium, consideration should be given to why an acquirer would pay a premium (e.g., what synergies could market participants achieve if they acquired the reporting unit) and why the current owner is unable to create that value absent a sale. Other consideration should include recent trends in a company's market capitalization, comparable transactions within a company's industry, the number of potential acquirers, and the availability of financing. A well-reasoned and documented assessment of the control premium value is necessary; the level of supporting evidence would be expected to increase as the control premium increases from past norms. Further, in a distressed market, consideration should be given as to whether prior market transactions used to evaluate control premiums would be indicative of future transactions. The use of arbitrary percentages or rules of thumb would not be appropriate.

A control premium is justified presumably due to synergies within the business that can be realized upon obtaining control. Therefore, one way to evaluate the reasonableness of a control premium is to perform a bottom up approach by identifying areas in which market participants could extract savings or synergies by obtaining control (e.g., eliminate duplicative costs and product diversification) and quantifying the discounted cash flows expected from the presumed synergies.

The SEC staff has, in some cases, issued comments to companies that assert their current market capitalization does not reflect fair value because of a control premium. Such comments generally request management to provide support for their assertion.

Question BCG 9-16

In distressed markets, is it expected that control premiums will rise?

PwC response

Some have asserted that control premiums should rise when there are broad market price decreases. Their theory is that the underlying fundamentals of a business may remain strong and, therefore, the business maintains its underlying fair value. Similarly, some companies have asserted that they would not be willing to sell at the pricing suggested by the market capitalization, thus suggesting a significant control premium would exist in a fair value transaction. There are several factors that these views may not consider; therefore, a significant increase in control premiums in a time of distressed markets would generally not be expected.

First, in distressed markets, there tends to be a decrease in the number of acquirers willing and able to acquire entities for a variety of reasons, including lack of available capital, increased scrutiny by investors on significant purchases, or a desire to conserve cash. A reduced acquisition demand theoretically leads to a general decline in sales prices. Furthermore, as cash flows and discount rates are revisited in a distressed market, one may find that the fair value of a business has declined. This decrease in fair value would reduce the difference between the fair value of the business and its market capitalization, resulting in a decrease in apparent control premiums.

Accordingly, increased control premiums in a distressed market should be carefully evaluated. A larger control premium must be adequately supported and consider the synergies inherent in a market participant's perspective of the fair value of a reporting unit. Only in those instances in which a reporting unit could command a higher price in the market can management consider applying a higher control premium. This assessment should be based on all facts and circumstances.

Question BCG 9-17

Can multiple reporting units be combined for purposes of determining fair value?

PwC response

Generally, no. ASC 350-20-35-22 indicates that “the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date.” Measuring the fair value of multiple reporting units together and then attributing the aggregate fair value to the individual reporting units (top-down approach) would generally not be consistent with this guidance. Instead, the fair value of each reporting unit should generally be assessed individually. Any specifically identifiable synergies available to an individual reporting unit by working in combination with other reporting units (e.g., the benefits of lower costs arising from the combined purchasing power of multiple reporting units) may be included in the determination of the reporting unit's fair value if market participants would be expected to realize such synergies (bottom-up approach).

See FV 7.2 and FV 7.4 for further information on ASC 820 and its impact on determining the fair value of reporting units.

9.7.3 Fair value of reporting units using the income approach

It is often necessary to adjust management's existing cash flow projections to ensure consistency with the valuation objective of determining the fair value of a reporting unit under ASC 350-20. Following are several considerations provided in the AICPA Goodwill Guide that may result in adjustments to cash flow projections:

- **Planned acquisition activity:** Generally, cash flow projections used to determine the fair value of a reporting unit should not include prospective cash flows expected from future acquisitions, as market participant cash flows typically would not include assumptions for acquisition activity for unknown targets with unknown purchase prices and synergies.
- **Working capital:** The discounted cash flow method generally provides an indication of fair value that is consistent with normalized levels of working capital. If a reporting unit has an excess or deficit working capital position on the measurement date, that amount should be an adjustment to the fair value of the reporting unit. Generally, a required operating level of cash would be included

- in normalized levels of working capital. However, if there is excess cash not required for operations, it is generally excluded from the required working capital in the discounted cash flow model and is included as a non-operating asset adjustment. Net working capital is generally calculated by excluding the current portion of funded long-term debt because the cash flow model is typically prepared on a debt-free basis. When interest-bearing operating debt is determined to be part of working capital, the interest expense on the interest-bearing operating debt would be treated as part of the cash flows. It is generally appropriate to include deferred revenues as a component of working capital when revenue projections are developed on an accrual basis.
- **Non-operating assets and liabilities:** To the extent non-operating assets and liabilities are reflected in the carrying amount of a reporting unit, the reporting unit's fair value should consider these assets and liabilities.
 - **Legal form of reporting unit:** Reporting units may be held in nontaxable entities such as partnerships or limited liability companies. Generally, it is expected that market participants would be in the legal form of C corporations and thus subject to income taxes. Accordingly, cash flow projections are typically calculated on an after-tax basis to ensure consistency with market participant assumptions.
 - **Depreciation and amortization amounts:** While depreciation and amortization are not cash flow items, tax depreciation and tax amortization benefits result in cash tax savings and should be included in the cash flow projections used to determine a reporting unit's fair value.
 - **Share-based compensation:** Non-cash expenses associated with share-based compensation should generally be included as a cash outflow when measuring the fair value of a reporting unit to the extent that these expenses are thought to be compensation in lieu of cash.
 - **Income tax rate:** The appropriate tax rate would generally represent statutory rates adjusted for assumptions that are observable and applicable to market participants.
 - **Related party transactions:** Intercompany transactions may require adjustment if the terms are not consistent with what market participants would expect to incur or receive. Also, see BCG 9.3.1 for additional projected cash flow related considerations regarding (1) the use of assets not assigned to the carrying value of the reporting unit and (2) the use of the reporting unit's assets by other reporting units.

See FV 7.2.5.1 for further information about determining the fair value of a reporting unit using the income approach.

Question BCG 9-18

If management uses a discounted cash flow approach to value a reporting unit and completes its annual budget process on September 30, would it be reasonable for the company with a calendar year end to rely on this budget to complete its fourth quarter goodwill impairment test?

PwC response

Although the September 30 budget may be an appropriate starting point, during volatile economic times, cash flow estimates can change quickly. For impairment testing purposes, the company may

need to revise its estimates if market events after September 30 impact the timing or amount of cash flows.

9.7.4 Fair value of reporting units using the market approach

When valuing a reporting unit using the market approach, stock trading prices or transaction prices generated by market transactions involving businesses comparable to the reporting unit are used. Two commonly used valuation techniques for measuring the fair value of a reporting unit are the guideline public company method and the guideline transaction method. The guideline public company method identifies the stock prices of public companies that are comparable to the reporting unit being tested. Performance metrics, such as price-to-revenues or price-to-EBITDA, are calculated for the comparable public companies and applied to the subject reporting unit's applicable performance metrics to estimate the reporting unit's fair value. The guideline transaction method identifies recent merger and acquisition transaction data for acquisitions of target companies that are similar to the subject reporting unit. Metrics such as multiples of the selling price to revenue, EBITDA or earnings measures are calculated for the guideline transactions and applied to the subject reporting unit's applicable revenue or earnings metric to estimate the reporting unit's fair value.

Under both the guideline public company method and the guideline transaction method, it is necessary to consider what makes a company "comparable" to the subject reporting unit from a valuation standpoint. While not an all-inclusive list, the AICPA Goodwill Guide lists operational characteristics that may be considered, such as whether the comparable company and the reporting unit (1) are in the same industry or sector, (2) are in similar lines of business, (3) have similar geographic reach (e.g., domestic versus international versus multinational), (4) have similar customers and distribution channels, (5) have contractual or noncontractual sales, (6) have similar seasonality trends, (7) have similar business life cycles (e.g., short cycle characterized by ever-changing technology versus long cycle driven by changes in commodity pricing), (8) are in similar stage of business life cycle (e.g., start up, high growth, mature), or (9) have similar operating constraints (e.g., reliance or dependence on key customers or government regulations).

The AICPA Goodwill Guide also lists financial characteristics that may be considered, such as whether the comparable company and the subject reporting unit (1) are of similar size (e.g., revenues, assets, or market capitalization, if the company is public), (2) have similar profitability (e.g., EBITDA, operating margin, contribution margin), (3) have similar projected future growth in revenues and profits, (4) have a similar asset-base (e.g., manufacturing versus service business), or (5) have a similar pattern of owning versus leasing real properties, machinery, and equipment (e.g., an entity that owns its manufacturing operations versus one that leases the building and machinery used for its operations).

Under both the guideline public company method and the guideline transaction method, it is often necessary to adjust observed market multiples or transactions to make the comparable company data more consistent with the subject reporting unit. If guideline companies or transactions exhibit certain differences from the subject reporting unit but are otherwise deemed to be comparable to the reporting unit, the multiples or transactions associated with these companies should be adjusted to account for these differences. Such adjustments may relate to factors including profitability, anticipated growth, size, working capital, nonrecurring or nonoperating income or expenses, or differences in accounting policies. Once multiples or transactions have been adjusted, outliers that are not considered to be sufficiently comparable to the reporting unit should be eliminated from the data set. Generally, multiples that are in a narrow range are better indications of value than a data set with multiples that exhibit wide dispersion.

While the considerations applicable to the guideline public company method and guideline transaction method are similar, some additional considerations in applying the guideline transaction method include:

- **Availability of data:** Sufficient data about a specific transaction may not be available to determine whether the transaction provides a basis for measuring the reporting unit's fair value. For example, if information supporting the financial characteristics or the tax structure of the transaction is not available, it may be difficult to establish that the transaction would be comparable to a transaction in which the reporting unit is sold.
- **Relevant time period:** It is not appropriate to use guideline transactions that took place during periods in which economic conditions were not comparable to conditions at the goodwill impairment test date. Generally, the older the transaction, the less relevant the information.

When applying the market approach, it is important to determine whether the resulting enterprise value would be considered a controlling or noncontrolling interest. The guideline public company method has historically been regarded as indicating the enterprise or equity value on a noncontrolling basis. Because the subject reporting unit is valued on a controlling interest basis in the quantitative goodwill impairment test, in some cases, it may be appropriate to apply a control premium to convert the reporting unit value determined using the guideline public company method to a controlling interest basis.

The guideline transaction method is typically regarded as indicating the enterprise or equity value on a controlling interest basis. Therefore, a premium for control would generally not be applied to the reporting unit value determined using the guideline transaction method.

Question BCG 9-19

May management rely exclusively on comparable company pricing multiples when determining the fair value of a reporting unit?

PwC response

A common pitfall is the use of a market multiple of a public company that is not comparable to the reporting unit being tested. For example, a reporting unit may not be comparable to a public company that includes multiple reporting units. In these cases, relying solely on market comparables would not be appropriate, and in determining fair value, management may need to place more reliance on another method, such as a discounted cash flow analysis.

9.7.5 Use of quoted market price of reporting unit on single date

ASC 820 requires an entity to begin its analysis in determining the fair value of a reporting unit with the quoted market price, if one is available, as of the measurement date (i.e., as of a single date). However, when using quoted market prices to estimate the fair value of a reporting unit, an entity should consider all available evidence. Accordingly, a single day's quoted market price may not necessarily reflect a reporting unit's fair value. That might be the case if, for example, significant events occur which impact share price near the time goodwill is being tested for impairment. Determining whether to consider quoted market prices on more than a single date will depend on the facts and circumstances of each situation.

In a distressed market, it may be appropriate to consider recent trends in a company's trading price instead of just a single day's trading price in evaluating fair value. Frequently, averages over relatively short periods are used to determine representative market values. In some cases, prices may have moved dramatically over a short period of time or there may be a specific event that may have impacted market prices. Therefore, all relevant facts and circumstances must be evaluated. For example, an average may not be appropriate if a company's share price had a continued downward decline. On the other hand, an average may be a reasonable proxy for fair value when share prices experience significant volatility.

If a reporting unit's market capitalization falls below its carrying amount, it may not be appropriate for an entity to assert that the reporting unit's market capitalization is not representative of its fair value. Examples of evidence to support a fair value greater than market capitalization may be (1) an analysis that indicates that a control premium should be added to the reporting unit's market capitalization; or (2) as a result of an unusual event or circumstance, a temporary decline in quoted market prices occurs that indicates that the reporting unit's market capitalization during that brief time would not represent the reporting unit's fair value.

9.7.6 *Multiple techniques to estimate reporting unit fair value*

In instances where a quoted market price in an active market is not available or the current market price is believed to not be representative of fair value, the methodology used to determine fair value may be a single valuation technique or multiple valuation techniques (e.g., a present value technique and a market pricing multiple). If multiple valuation techniques are used, the entity should evaluate and weigh the results considering the reasonableness of the range indicated in determining the fair value. The results may indicate that a single point within the range or a weighting of values within the range is the most representative of fair value in the circumstances. The methodology (including the use of more than one valuation technique) that an entity uses to determine the fair value of a reporting unit should be applied consistently.

If a weighted approach with multiple valuation techniques is used to determine the fair value of reporting units, it is not necessary to use the same weighting for all reporting units. Each reporting unit should be valued individually using an approach that results in the best estimate of fair value of the reporting unit in the given circumstances—different approaches or weightings may be appropriate for determining the fair values of different reporting units.

Question BCG 9-20 considers the accounting treatment of a change in valuation technique from a market approach to an income approach.

Question BCG 9-20

If a company has historically utilized a market multiple approach in determining the fair value of its reporting units, can it use a discounted cash flow analysis in the current year?

PwC response

Yes. In accordance with ASC 820-10-35-25, a change in a valuation technique is appropriate if the change is an equal or better representation of fair value. A change in a valuation technique is considered a change in accounting estimate, not a change in accounting policy. See FV 4.4.4 for additional information.

9.7.7 *Reconciling total fair value of reporting units to market cap*

Frequently, public companies have more than one reporting unit and, therefore, do not use the quoted market price of their stock to directly determine the fair value of reporting units. However, there is an expectation that the aggregation of reporting unit fair values can be reconciled to the company's market capitalization. While not a requirement of ASC 350-20, the company's overall market capitalization should reconcile, within a reasonable range, to the sum of the fair values of the individual reporting units.

Such reconciliation often includes both qualitative and quantitative assessments. As is the case in many areas requiring judgment, contemporaneous documentation of the assumptions and their applicability to the specific facts and circumstances is important.

When an entity performs a qualitative assessment for some reporting units but proceeds to the quantitative goodwill impairment test for others, reconciling the overall market capitalization to the aggregate fair value of reporting units can be challenging. There is no requirement to determine the fair value of reporting units that do not have goodwill or for which only a qualitative impairment test is performed. It may not be cost effective for some entities to determine the fair value of a reporting unit not subject to the quantitative goodwill impairment test solely to allow for a reconciliation to the company's overall market capitalization. However, a comparison of the aggregate fair values of reporting units for which the quantitative goodwill impairment test is performed to the entity's market capitalization still may be useful in order to establish that the aggregate fair value is not unreasonable relative to overall market capitalization. For example, if an entity has five significant reporting units and performs the quantitative goodwill impairment test for three of the five reporting units, the fair value determined for those three reporting units should not exceed the overall market capitalization for the entity and in most cases should be less than the overall market capitalization since the other two reporting units would be presumed to have value. In addition, the AICPA Goodwill Guide indicates that when performing an overall comparison to market capitalization, entities could include the current year fair values for reporting units for which quantitative measurements were performed and estimate the fair value for the reporting units for which qualitative assessments were performed using a reasonable methodology.

Even though a reconciliation to market capitalization may not be required, the underlying factors surrounding a decline in market capitalization and whether those factors affect the fair value of the reporting unit being tested should be considered. SEC staff comments have historically focused on significant market declines and on the reconciliation of reporting unit fair values to a company's overall market capitalization. In these comments, the SEC staff frequently asks how companies took into consideration the fact that their market capitalization was below their book value when determining that goodwill had not been impaired.

Question BCG 9-21

If management believes that the current trading price of its stock is not representative of fair value, can it assert that the market data is not relevant when determining the fair value of a reporting unit?

PwC response

A company's market capitalization and other market data cannot be ignored when assessing the fair value of a company's reporting units. In a depressed economy, declines in market capitalization could

represent factors that should be considered in determining fair value, such as an overall re-pricing of the risk associated with the company. However, in inactive markets, market capitalization may not be representative of fair value, and other valuation methods may be required to measure the fair value of an entity comprised of a single reporting unit. Determining the factors affecting market capitalization and their impact on fair value requires the application of judgment.

Question BCG 9-22

Is it acceptable if there is a significant difference between the aggregate fair values of a company's reporting units (derived using a cash flow analysis) and overall market capitalization?

PwC response

When a significant difference exists between a company's market capitalization and the aggregate fair values of a company's reporting units, the reasons for the difference should be understood. A company's cash flow models may not fully consider the risk associated with achieving those cash flows. Cash flow assumptions should be revisited and potential changes in the amount, timing, and risks associated with those cash flows should be evaluated given the market environment. Cash flow analyses based on probability-weighted scenarios should likely include a wide range of potential outcomes.

Question BCG 9-23

What are common reconciling items between the aggregate fair values of a company's reporting units and its market capitalization?

PwC response

A common reason for a difference between the aggregate fair values of the reporting units and the company's overall market capitalization is that control premiums associated with a reporting unit are not reflected in the quoted market price of a single share of stock.

Other differences may be linked to external events or conditions, such as broad market reaction to circumstances associated with one or a few reporting companies. For example, the deteriorating financial condition of one company in a particular market sector could cause temporary market declines for other companies in the same sector. Unusual market activity, such as a spike in short selling activity, may also have a temporary impact on a company's market capitalization but not reflect its underlying fair value. Short-term fluctuations in volatile markets may not necessarily reflect underlying fair values. It is therefore important to be able to explain the market fluctuations as part of the reconciliation of market capitalization to the estimated fair values of reporting units. The AICPA Goodwill Guide indicates it is a best practice to identify and document the reasons for differences between the aggregate fair value of reporting units and the observable market capitalization. Factors identified include control synergies, data that may not be available to a market participant, tax consequences, entity-specific versus market participant capital structures, excessive short positions against the stock, and controlling or large block interests.

9.8 *The quantitative goodwill impairment test*

As described in BCG 9.5, the quantitative goodwill impairment test is performed by calculating the fair value of the reporting unit and comparing it to its carrying amount (book value). The book value is the reporting unit's carrying amount after all of the reporting unit's other assets (excluding goodwill) have been adjusted for impairment, if necessary, under other applicable GAAP. This assumes the reporting unit is not a disposal group or part of a disposal group under ASC 360, *Property, Plant, and Equipment*. See BCG 9.10.1 for further information.

- If the fair value of the reporting unit is greater than its carrying amount, the reporting unit's goodwill is not impaired.
- If the carrying amount of the reporting unit is greater than its fair value, the reporting unit's goodwill is impaired. The goodwill impairment loss is the difference between the reporting unit's fair value and carrying amount, not to exceed the carrying amount of the goodwill. Once a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill will be its new accounting basis. In accordance with ASC 350-20-35-13, once a goodwill impairment loss is recognized it cannot be subsequently reversed.

9.8.1 *Foreign currency translation adjustments*

When the quantitative goodwill impairment test is performed, a reporting entity needs to consider the impact of foreign currency translation adjustments.

Question BCG 9-24

How should foreign currency translation adjustments be treated when determining the carrying value of a reporting unit?

PwC response

In accordance with ASC 350-20-35-39A, the carrying amount of a reporting unit should include the currently translated balances of the assets and liabilities within that reporting unit. However, foreign currency translation adjustments should not be allocated to the reporting unit from the reporting entity's accumulated other comprehensive income.

9.8.2 *Zero or negative carrying amounts*

The quantitative goodwill impairment test is applied to all reporting units, including those with zero or negative carrying amounts. Goodwill attributed to reporting units with zero or negative carrying amounts generally will not be impaired as the fair value of a reporting unit is rarely negative.

To perform the quantitative goodwill impairment test, a reporting entity needs to determine the fair value of the reporting unit and compare it to its carrying amount. The FASB did not prescribe how to determine the fair value of a reporting unit (see BCG 9.7.1). The FASB has indicated that it might be appropriate to change from the equity premise to the enterprise premise for a reporting unit with a negative carrying amount if it results in a more representative impairment evaluation under the quantitative goodwill impairment test.

9.9 *Other goodwill impairment assessment considerations*

Additional complexities often arise in performing the quantitative impairment test.

9.9.1 *Deferred taxes: impact on reporting unit carrying and fair values*

An acquiring entity must recognize a deferred tax asset or liability for the differences between the assigned values and income tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with ASC 805-740-25-2. An acquiring entity's tax bases in the assets acquired and liabilities assumed in a business combination are generally based on whether the combination was a taxable transaction (which results in new tax bases) or a nontaxable transaction (which results in carryover tax bases). Therefore, the amount of deferred income taxes recorded in a business combination and, in turn, the amount of goodwill recorded, can be significantly impacted by whether the combination was a nontaxable or taxable transaction. See TX 10.2.1 for further information on determining whether the business combination was a nontaxable or taxable transaction.

When an entity tests goodwill for impairment, a question arises as to how the entity should consider recorded deferred tax balances that relate to differences between the book and tax bases of assets and liabilities assigned to reporting units. Specific considerations include how deferred taxes impact a reporting unit's fair value and carrying amount for applying the quantitative goodwill impairment test.

ASC 350-20 provides guidance on how deferred income taxes should be considered in determining the fair value and carrying amount of a reporting unit. ASC 350-20-35-25 notes that the determination of the fair value of the reporting unit should include an assumption as to whether the reporting unit would be bought or sold in a taxable or nontaxable transaction. Whether the reporting unit would be bought or sold in a taxable or nontaxable transaction is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated carefully on a case-by-case basis as outlined in ASC 350-20-35-25 through ASC 350-20-35-27.

ASC 350-20-35-25

Before estimating the fair value of a reporting unit, an entity shall determine whether that estimation should be based on an assumption that the reporting unit could be bought or sold in a nontaxable transaction or a taxable transaction. Making that determination is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated carefully on a case-by-case basis (see Example 1 [paragraphs 350-20-55-10 through 55-23]).

ASC 350-20-35-26

In making that determination, an entity shall consider all of the following:

- a. Whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value
- b. The feasibility of the assumed structure
- c. Whether the assumed structure results in the highest and best use and would provide maximum value to the seller for the reporting unit, including consideration of related tax implications.

ASC 350-20-35-27

In determining the feasibility of a nontaxable transaction, an entity shall consider, among other factors, both of the following:

- a. Whether the reporting unit could be sold in a nontaxable transaction
- b. 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.

When evaluating whether a reporting unit would be sold in a taxable or nontaxable transaction, the AICPA Goodwill Guide states that it may be useful to consider the (1) structure of observed comparable transactions in the market, (2) type of buyer, and (3) tax status of a market participant.

Question BCG 9-25 addresses income tax considerations when performing the quantitative goodwill impairment test.

Question BCG 9-25

How should income taxes be considered when determining the fair value of a reporting unit for the quantitative goodwill impairment test?

PwC response

An entity should determine whether the fair value of a reporting unit should be based on an assumption that the reporting unit would be sold in a nontaxable or taxable transaction. This assumption is a matter of judgment that depends on the relevant facts and circumstances in accordance with ASC 350-20-35-25. The assumed structure of the transaction can affect the price a buyer is willing to pay for the reporting unit and the seller's tax cost on the transaction. For example, in a taxable transaction, the net assets of the entity are considered sold, and the buyer records a fair value tax basis in the net assets. The buyer may be willing to pay more to acquire a reporting unit in a taxable transaction if the transaction provides a step-up in the tax basis of the acquired net assets. In a nontaxable transaction, the stock of the company is sold and the buyer records a fair value tax basis in the acquired stock, but carryover (or predecessor) tax basis in the net assets. The buyer may be willing to pay more to acquire a reporting unit in a nontaxable transaction if the reporting unit has significant net operating loss or other carryforwards that the buyer would be able to utilize.

The gross proceeds expected to be realized from a sale must be reduced by the seller's tax cost when determining economic value. The seller's tax cost should reflect, and can vary with, the structure of the transaction. For example, in a nontaxable sale, the seller's gain (or loss), and thus the seller's tax cost, is measured by reference to its tax basis in the stock of the reporting unit; in a taxable sale, the seller's taxable gain (or loss) is measured by reference to the tax basis in the net assets of the reporting unit. The effect of existing tax attributes of the seller would be considered in measuring the seller's tax cost.

The type of transaction that is consistent with market participant assumptions, is feasible, and provides the highest economic value to the seller should be used in determining the fair value of a reporting unit.

ASC 350-20-35-7 requires that the carrying amount of the reporting unit for purposes of the quantitative goodwill impairment test should include deferred tax assets and liabilities arising from assets and liabilities assigned to the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming the reporting unit would be bought or sold in a taxable or nontaxable transaction.

Example BCG 9-16 demonstrates the analysis of determining a goodwill impairment loss in a taxable versus nontaxable transaction.

EXAMPLE BCG 9-16

Determining the goodwill impairment loss in a taxable versus nontaxable transaction

Company A is testing a reporting unit for impairment. A sale of the reporting unit would be feasible in both a taxable and nontaxable transaction.

- The carrying amount of net assets, excluding goodwill and deferred taxes, is \$1,300.
- The tax basis of net assets is \$900 and Company A's tax basis in the shares of the reporting unit is \$1,125. There is no tax-deductible goodwill.
- The nondeductible book goodwill is \$500.
- The net deferred tax liabilities are \$160 (\$1,300 carrying amount of net assets, excluding goodwill and deferred taxes, less \$900 tax basis of net assets at a 40% tax rate).
- In a taxable transaction, the reporting unit could be sold for \$1,600.
- In a taxable transaction, at a 40% tax rate, current taxes payable resulting from the transaction would be \$280 (\$1,600 fair value less \$900 tax basis of net assets at a 40% tax rate).
- In a nontaxable transaction, the reporting unit could be sold for \$1,500.
- In a nontaxable transaction, current taxes payable resulting from the transaction are assumed to be \$150 (\$1,500 fair value less Company A's tax basis in the shares of \$1,125 at 40%).

After determining if a taxable or nontaxable sale is the more feasible option, how would Company A conduct an impairment test on its reporting unit?

Analysis

Determination of taxable or nontaxable sale:

	Taxable	Nontaxable
Gross proceeds from sale (fair value)	\$1,600	\$1,500
Tax arising from transaction	(280)	(150)
Economic value from the reporting unit	\$1,320	\$1,350

The highest economic value could be realized in a nontaxable transaction. A nontaxable sale is assumed to be feasible for purposes of testing the reporting unit's goodwill for impairment.

Performance of the quantitative goodwill impairment test:

	Nontaxable
Fair value of reporting unit	\$1,500
Net assets (excluding goodwill and deferred taxes)	1,300
Goodwill	500
Deferred taxes	(160)
Reporting unit carrying amount	1,640
Difference—Goodwill impairment loss	\$(140)

For the quantitative goodwill impairment test, the fair value of the reporting unit is compared to its carrying amount. Fair value is determined using the pretax proceeds that would be realized from a nontaxable sale and not the economic value that would be received after tax. Because the reporting unit's carrying amount exceeds its fair value, there is a goodwill impairment loss for the reporting unit.

To illustrate the determination of an impairment loss in a taxable sale, assume that the company had determined that the highest economic value could be realized in a taxable transaction. In that case, the fair value of the reporting unit of \$1,600 is compared to the carrying amount of the reporting unit of \$1,640, which would result in a goodwill impairment loss of \$40 under the quantitative goodwill impairment test.

Taxable business combinations can generate goodwill that is deductible for tax purposes. This can give rise to what is called component-1 and component-2 goodwill in ASC 805-740-25-8. When such goodwill is impaired for financial reporting purposes, there may be an impact on deferred taxes. See BCG 9.9.6 for guidance on the simultaneous equation method as well as the allocation of the impairment loss to component-1 and component-2 goodwill.

9.9.2 Impairment of goodwill shortly after acquisition

An impairment of goodwill shortly after an acquisition is possible but rare.

ASC 805 requires that the value of equity securities issued as consideration in the acquisition of a business be measured on the date of the business combination. As a result, the acquisition date fair value of the consideration transferred may differ from the fair value of the consideration as of the date the acquisition was agreed to if an acquirer's share price has increased or decreased significantly prior to the closing of the acquisition. If there is a significant increase in the fair value of the acquirer's share price, then more goodwill would be recognized on the date of acquisition—this may be viewed as an overpayment. In connection with its deliberations of ASC 805, the FASB acknowledged that overpayments are possible, however, the Board believed that it would be unlikely that the amount would be known or measurable at the acquisition date and that overpayments are best addressed through subsequent impairment testing. Therefore, any impairment charge would need to follow the

guidance in ASC 350-20, including assigning the goodwill to reporting units and evaluating if a triggering event has occurred based on changes in economic conditions relative to the business acquired that evidence impairment.

An acquirer's conclusion that goodwill is impaired within a short period of time after the acquisition should be supported by an analysis of the underlying events and circumstances. Such an analysis would need to consider a number of factors, including a review of the fair value determinations at the "agreed to and announced" date and acquisition date, any adjustments to provisional amounts recorded during the measurement period, the method for assigning goodwill to reporting units, and changes in economic conditions relative to the business acquired that evidence impairment. Given the subjective nature of these judgments and the infrequency of reporting a goodwill impairment loss immediately upon or shortly after the acquisition, a decision to impair goodwill shortly after an acquisition may attract considerable attention.

9.9.3 *Interaction with impairment testing for other assets*

Goodwill and other assets of a reporting unit that are held and used may be required to be tested for impairment at the same time, for instance, when certain events trigger interim impairment tests under ASC 350-20 and ASC 360-10. In such situations, other assets, or asset groups, should be tested for impairment under their respective standards (e.g., ASC 360-10, ASC 350-30, and ASC 323-10) and the other assets' or asset groups' carrying amounts should be adjusted for impairment before testing goodwill for impairment in accordance with ASC 350-20-35-31. Note, however, the ordering for impairment testing will differ if goodwill is included as part of a disposal group that is classified as "held for sale" under ASC 360-10. See PPE 5.2.2 and PPE 5.3.2 for further information on impairment testing of other assets under the held and used and held for sale approaches, respectively.

A reporting unit may include assets, or asset groups, whose fair values are less than their carrying amounts but for which an impairment is not recognized. This would be the case if these assets' or asset groups' book values were determined to be recoverable under ASC 360-10 (i.e., the undiscounted cash flow test was sufficient to recover the carrying amount of the asset or asset group). In such a case, no adjustment to the carrying amounts would be permitted for the purpose of the quantitative goodwill impairment test under ASC 350-20.

A goodwill impairment loss would be measured as the difference between the reporting unit's fair value and its carrying amount, not to exceed the carrying amount of the goodwill. If the difference between the reporting unit's fair value and its carrying amount is greater than the carrying amount of the goodwill, the excess is not recorded as an impairment against other assets in the reporting unit if those assets were not impaired under their respective accounting standards.

9.9.4 *Impairment testing when an NCI exists*

ASC 805 requires that the acquirer record all assets and liabilities of the acquiree at their fair values with limited exceptions and record goodwill associated with the entire business acquired. This means that in a partial business combination in which control is obtained, the acquiring entity will recognize and measure 100% of the assets and liabilities, including goodwill attributable to the noncontrolling interest, as if the entire entity had been acquired. Therefore, in terms of goodwill recognition and the amount of any subsequent impairment loss, no difference exists between acquiring a partial controlling interest in a business and the acquisition of an entire business accounted for in accordance with ASC 805.

The fair value of the reporting unit should be compared to its carrying amount inclusive of any interest attributable to noncontrolling shareholders. Any impairment loss measured in the goodwill impairment test must be allocated to the controlling and noncontrolling interests on a rational basis.

Example BCG 9-17 and Example BCG 9-18 illustrate acceptable methods to allocate a goodwill impairment loss to the controlling and noncontrolling interests.

EXAMPLE BCG 9-17

Allocation of a goodwill impairment loss to the noncontrolling interest when the acquired entity is assigned to a new reporting unit

Company A acquires 80% of the ownership interests in Company B for \$800 million. Company A determines that the fair value of the noncontrolling interest is \$200 million. The aggregate value of the identifiable assets acquired and liabilities assumed, measured in accordance with ASC 805, is determined to be \$700 million. Company A's determination of goodwill related to the acquisition of Company B for purposes of allocating a goodwill impairment loss is as follows (in millions):

Fair value of the consideration transferred	\$800
Fair value of the noncontrolling interest	200
	1,000
Values of 100% of the identifiable net assets	(700)
Goodwill recognized	\$300
Goodwill attributable to the noncontrolling interest	\$60 ¹
Goodwill attributable to the controlling interest	\$240 ²

¹ The goodwill attributable to the noncontrolling interest is the difference between the fair value of the noncontrolling interest and the noncontrolling interest's share of the recognized amount of the identifiable net assets (\$60 = \$200 less 20% of \$700).

² The goodwill attributable to the controlling interest is the difference between the fair value of the consideration transferred measured in accordance with ASC 805 and the controlling interest's share of the recognized amount of the identifiable net assets (\$240 = \$800 less 80% of \$700).

For purposes of Company A's goodwill impairment testing, all of Company B's assets (including goodwill) and liabilities are assigned to a new reporting unit, Reporting Unit X.

Subsequent to the acquisition, another entity unexpectedly introduces a product that competes directly with Reporting Unit X's primary product. As a result, the fair value of Reporting Unit X falls to \$900 million and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that the carrying amount of Reporting Unit X did not change between the acquisition date and the goodwill impairment testing date. Further, assume that Reporting Unit X's net assets other than goodwill do not require adjustment in accordance with other GAAP (e.g., ASC 360-10). For simplicity, all tax effects have been ignored.

How would a goodwill impairment loss at Reporting Unit X be allocated to the controlling and noncontrolling interest?

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows (in millions):

Quantitative goodwill impairment test:

Fair value of reporting unit	\$900
Carrying amount of reporting unit	(1,000)
Goodwill impairment loss	\$ (100)
Goodwill impairment loss allocated to the noncontrolling interest	\$ (20) ¹
Goodwill impairment loss allocated to the controlling interest	\$ (80) ²

¹ The goodwill impairment loss allocated to the noncontrolling interest is determined based on the total amount of the impairment loss of \$100 multiplied by the 20% ownership interest of the noncontrolling interest. The impairment loss would be the same if it was allocated based on the relative interest of the goodwill prior to impairment (\$60 attributable to the noncontrolling interest of \$300 of total goodwill). Note, however, that the full impairment loss of \$100 would be recorded in the income statement.

² The goodwill impairment loss allocated to the controlling interest is determined based on the total amount of the impairment loss of \$100 multiplied by the 80% ownership interest of the controlling interest. The impairment loss would be the same if it was allocated based on the relative interest of the goodwill prior to impairment (\$240 attributable to the controlling interest of \$300 of total goodwill).

In Example BCG 9-17, the goodwill impairment loss was allocated based on the relative ownership interests of the controlling and noncontrolling interests. The allocation would not have changed if it was determined using the relative interests in goodwill. However, as discussed in BCG 9.4.3, the fair value of the noncontrolling interest may not merely be an extrapolation of the consideration transferred for the controlling interest and, therefore, the fair value of the noncontrolling interest may have to be independently derived. In such cases, it is possible that the goodwill recorded in the acquisition may not be attributed to the controlling and noncontrolling interests based on their relative ownership interests.

EXAMPLE BCG 9-18

Allocation of a goodwill impairment loss to the controlling and noncontrolling interests when a premium is attributable to the controlling interest

Company A acquires an 80% ownership interests in Company B for \$1,000. The value of the identifiable assets and liabilities measured in accordance with ASC 805 is determined to be \$700, and the fair value of the noncontrolling interest is determined to be \$200. Company A's determination of goodwill related to the acquisition of Company B is as follows:

Fair value of the consideration transferred	\$1,000
Fair value of the noncontrolling interest	200
	<hr/>
	1,200
Fair values identifiable net assets	(700)
	<hr/>
Goodwill recognized	\$500
	<hr/>
Goodwill attributable to the noncontrolling interest	\$60 ¹
	<hr/>
Goodwill attributable to the controlling interest	\$440 ²
	<hr/>

¹ The goodwill attributable to the noncontrolling interest is the difference between the fair value of the noncontrolling interest and the noncontrolling interest's share of the recognized amount of the identifiable net assets (\$60 = \$200 less 20% of \$700).

² The goodwill attributable to the controlling interest is the difference between the value of the consideration transferred measured in accordance with ASC 805 and the controlling interest's share of the recognized amount of the identifiable net assets (\$440 = \$1,000 less 80% of \$700).

Because Company A paid a premium to acquire a controlling interest in Company B, Company A's interest in goodwill is 88% (\$440 / \$500). This is higher than Company A's 80% ownership interest in Company B. Because the noncontrolling interest is always recorded at fair value, any control premium paid that does not also provide benefit to the noncontrolling interest is embedded in the controlling interest's share of goodwill.

For purposes of Company A's goodwill impairment testing, all of Company B's assets (including goodwill) and liabilities are assigned to a new reporting unit, Reporting Unit X.

Subsequent to the acquisition, another entity unexpectedly introduces a product that competes directly with Reporting Unit X's primary product. As a result, the fair value of Reporting Unit X falls to \$1,100 and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that the carrying amount of Reporting Unit X did not change between the acquisition date and the goodwill impairment testing date. Further, assume that Reporting Unit X's net assets other than goodwill do not require adjustment in accordance with other GAAP (e.g., ASC 360-10). For simplicity, all tax effects have been ignored.

How would a goodwill impairment loss at Reporting Unit X be allocated to the controlling and noncontrolling interest?

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows:

Quantitative goodwill impairment test:

Fair value of reporting unit	\$1,100
Carrying amount of reporting unit	(1,200)
Goodwill impairment loss	\$(100)
Goodwill impairment loss allocated to the noncontrolling interest	\$(12) ¹
Goodwill impairment loss allocated to the controlling interest	\$(88) ²

¹ The goodwill impairment loss allocated to the noncontrolling interest is determined based on the carrying amount of the goodwill attributable to the noncontrolling interest prior to impairment of \$60 relative to the total goodwill of \$500 ($\$12 = (\$60 / \$500) \times \100). Note, however, that the full impairment loss of \$100 would be recorded in the income statement.

² The goodwill impairment loss allocated to the controlling interest is determined based on the carrying amount of the goodwill attributable to the controlling interest prior to impairment of \$440 relative to the total goodwill of \$500 ($\$88 = (\$440 / \$500) \times \100).

The allocation of any goodwill impairment loss to the controlling interest and the noncontrolling interest will not change unless there is a change in the relative ownership interests. If there is a change in ownership interests, any subsequent goodwill impairment loss is allocated to the controlling and noncontrolling interests on a rational basis.

Impact of legacy FAS 141 guidance on calculations of impairment

If a company has a partially-owned subsidiary, and only recorded goodwill related to the controlling interest in accordance with the prior guidance in FAS 141, the noncontrolling interest was not recorded at fair value and an impairment test using fair value for the entire reporting unit may be perceived to not be a like comparison. Several methodologies may be appropriate when performing the goodwill impairment test.

One methodology would be to gross up the carrying amount of the reporting unit to reflect recorded goodwill associated with the controlling interest and the notional amount of goodwill allocable to the noncontrolling interest (equaling the grossed-up goodwill and other net assets) based on the acquisition date ownership interests and compare the reporting unit's adjusted carrying value to the fair value of the reporting unit determined in accordance with ASC 350-20. A second methodology would be to compare the carrying amount of the reporting unit, without adjustment, to its fair value — this may result in a cushion because the carrying amount of the reporting unit will only reflect a partial step-up of goodwill in the net assets of the subsidiary, but the fair value will consider the full value of the subsidiary. Any impairment loss should be allocated entirely to the parent's controlling interest if the goodwill was recognized in accordance with the prior guidance in FAS 141.

9.9.4.1 Fair value of NCI based on where NCI is recorded

The fair values of controlling and noncontrolling interests may differ on a per share basis. An understanding of whether and to what extent the noncontrolling interest benefits from synergies, rights, and preferences that benefit the reporting unit as a whole is needed when determining the fair value of the noncontrolling interest. A noncontrolling interest may exist above the reporting unit while

in other cases it may exist within the reporting unit. For example, the reporting unit could be partially owned by its parent.

Figure BCG 9-4 illustrates a structure where a noncontrolling interest exists above the reporting unit.

Figure BCG 9-4
Noncontrolling interest above the reporting unit

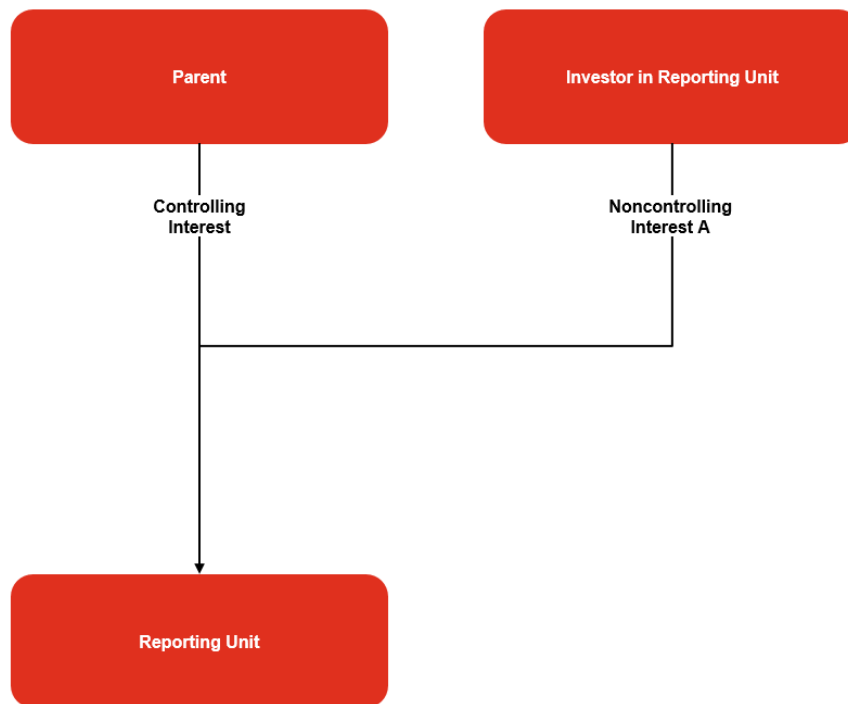
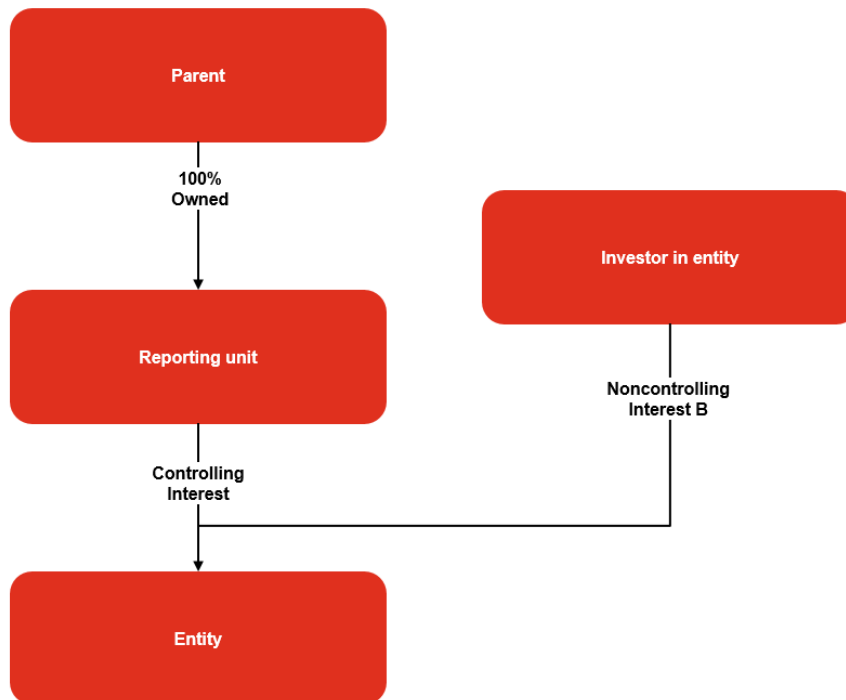


Figure BCG 9-5 illustrates a structure where a wholly-owned reporting unit consolidates an entity that is partially owned by the reporting unit.

Figure BCG 9-5

Wholly-owned reporting unit that consolidates an entity that is partially owned by the reporting unit



The fair value of a reporting unit refers to the price that would be received for selling the unit as a whole. When a noncontrolling interest exists above the reporting unit (similar to Noncontrolling interest A in Figure BCG 9-4), the fair value of the controlling interest and the noncontrolling interest would likely be the same on a per-share value basis as both would likely participate in the exchange transaction for the sale of the reporting unit at the same per share price absent any rights or restrictions to the contrary. Conversely, when a noncontrolling interest exists within a reporting unit (similar to Noncontrolling interest B in Figure BCG 9-5), the sale of the reporting unit as a whole could leave the noncontrolling interest outstanding. If the noncontrolling interest is not expected to participate in the sale of a reporting unit, there may be a difference in the per-share fair value of the controlling and noncontrolling interests.

9.9.4.2 *Other impairment considerations related to NCI*

When a noncontrolling interest exists, a number of complex scenarios may arise when goodwill is tested for impairment. For example, a reporting unit that includes a partially owned subsidiary could have operations and goodwill from another acquisition assigned to it, or the net assets and goodwill of a partially owned subsidiary might be assigned to more than one reporting unit. When goodwill in a reporting unit was generated from multiple acquisitions, including a partial acquisition, the tracking of acquisition-related goodwill may be necessary to appropriately allocate goodwill impairment losses between the controlling and noncontrolling interests.

The exposure draft on business combinations released by the FASB in 2005 proposed to amend ASC 350-20 to provide guidance on how to determine and allocate subsequent impairment losses to the controlling and noncontrolling interests. While the final standard did not include an amendment to provide guidance for allocating a goodwill impairment loss, we believe the exposure draft guidance may provide one acceptable alternative for allocating any such loss. The allocation approach provided was as follows:

- If the partially owned subsidiary is part of a reporting unit, the portion of the impairment loss allocated to that subsidiary would be determined by multiplying the goodwill impairment loss by the portion of the carrying amount of the goodwill assigned to that partially owned subsidiary over the carrying amount of the goodwill assigned to the reporting unit as a whole.
- The amount of the impairment loss allocated to the partially owned subsidiary would then be allocated to the controlling and noncontrolling interests pro rata based on the relative carrying amounts of goodwill attributed to those interests.

Example BCG 9-19 provides an example of this allocation approach.

EXAMPLE BCG 9-19

Allocation of a goodwill impairment loss to the noncontrolling interest when the reporting unit contains multiple acquisitions

Reporting Unit X includes a partially owned Subsidiary Z previously acquired in a business combination. The annual goodwill impairment test for Reporting Unit X resulted in an impairment loss of \$200 million. At the time of the acquisition of Subsidiary Z, the carrying amount of goodwill in Reporting Unit X was \$500 million, of which \$300 million is attributable to partially-owned Subsidiary Z, and of that amount, \$75 million is attributable to the noncontrolling interest.

How should the impairment loss be allocated to the noncontrolling interest in Subsidiary Z?

Analysis

The impairment loss of \$200 million should be allocated to the controlling and noncontrolling interest based on the pro rata carrying amounts of goodwill as follows (in millions):

Step one: Allocate the impairment loss to the partially owned subsidiary

Partially owned Subsidiary Z:

$$\$200 \times (\$300 / \$500) = \$120$$

The residual \$80 (\$200 - \$120) of the impairment loss that is not related to the partially owned subsidiary is included in the impairment loss allocated to the controlling interest of Reporting Unit X.

Step two: Allocate the impairment loss related to the partially-owned subsidiary to the controlling and noncontrolling interests

Controlling interest of Subsidiary Z:

$$\$120 \times (\$225 / \$300) = \$90$$

Noncontrolling interest of Subsidiary Z:

$$\$120 \times (\$75 / \$300) = \$30$$

Step three: Sum the controlling and noncontrolling interests' allocations

Impairment loss allocated to the controlling interest of Reporting Unit X:

$$\$80 + \$90 = \$170$$

Impairment loss allocated to the noncontrolling interest of Reporting Unit X = \$30

The allocation of an impairment loss to the noncontrolling interest effectively results in an allocation of goodwill to entities below the reporting unit level. As described in Example BCG 9-19, an acquired partially owned subsidiary may be combined in a reporting unit with other acquired entities for which goodwill has been recorded. In this case, the goodwill impairment loss is allocated between the partially and wholly owned subsidiaries. Such allocations could represent additional operational challenges to management when other organizational changes are made that result in changes to reporting units.

9.9.4.3 *Impairment: separate subsidiary financial statements*

When a subsidiary of an entity issues separate financial statements that are prepared in accordance with US GAAP, ASC 350-20-35-48 requires that all goodwill that is recognized in those financial statements must be tested for impairment as though the subsidiary were a standalone entity. This includes goodwill arising from the parent's acquisition of the subsidiary, which may be recognized under push-down accounting, any acquisitions by the subsidiary, and any acquisitions by the parent that have been transferred to, and included in, the subsidiary's financial statements.

A subsidiary should test its recognized goodwill for impairment based on subsidiary-specific reporting units. The reporting units of the subsidiary must be determined from the perspective of the subsidiary's operating segments and an analysis of the components of those operating segments. We would expect the CODM and segment managers at the subsidiary level to review different information than the CODM at the consolidated level. Accordingly, the determination of operating segments, pursuant to ASC 280-10, could differ.

9.9.4.4 *Impact of impairment at subsidiary level to the parent*

Any goodwill impairment loss that is recognized at the subsidiary level would not necessarily be recognized in the parent company's consolidated financial statements. Instead, the consolidated entity's reporting units that includes a subsidiary's reporting units with impaired goodwill should be tested for impairment if it is more likely than not that the event or circumstance that gave rise to the goodwill impairment loss at the subsidiary level would reduce the fair values of the consolidated entity's reporting units below the carrying amount of the reporting units. In other words, an impairment loss at the subsidiary level may represent a triggering event for an interim impairment test at the consolidated level. The consolidated entity should recognize a goodwill impairment loss only when goodwill is impaired from the perspective of the consolidated entity's reporting units.

Even when a subsidiary is a single reporting unit from the perspective of the consolidated entity, the subsidiary may have two or more of its own reporting units for purposes of testing its goodwill for impairment. If such a subsidiary recognized a goodwill impairment loss within one of its two reporting units, the impairment loss may be shielded at the consolidated level due to the consideration of the subsidiary as a whole as a single reporting unit by the consolidated entity. In another example, the subsidiary may consist of a single reporting unit, consistent with the consolidated entity; however, the balance of goodwill in the consolidated entity's reporting unit may not mirror the goodwill recorded by the subsidiary. Such instances could arise because the consolidated entity's reporting unit may also include goodwill assigned from other acquisitions or the goodwill may be reduced due to the assignment of goodwill to other reporting units due to synergies from the acquisition.

Example BCG 9-20 demonstrates consideration of the impact of a subsidiary impairment loss at the consolidated level.

EXAMPLE BCG 9-20

Considering a subsidiary impairment loss at the consolidated level

Subsidiary A is issuing standalone financial statements. Subsidiary A has goodwill of \$300 million. At Parent X, Subsidiary A and Subsidiary B combine to form one reporting unit, which includes goodwill of \$300 million (all Subsidiary A goodwill). Based on the completion of the annual quantitative goodwill impairment test at Parent X, no goodwill impairment is indicated.

As a result of completion of the goodwill impairment tests at Subsidiary A, a goodwill impairment loss of \$100 million is determined.

How would goodwill impairment be recognized in Parent X and Subsidiary A's financial statements?

Analysis

In this situation, Subsidiary A would record a goodwill impairment charge of \$100 million in its standalone financial statements. No goodwill impairment charge would be recorded in Parent X's consolidated financial statements because, at the Parent X level, there was no impairment of goodwill as a result of performing the annual quantitative goodwill impairment test.

9.9.5 Equity method: goodwill not subject to impairment test

Although equity method investments are accounted for under ASC 323-10 rather than ASC 805, the difference between the acquisition cost of an equity method investment and the amount of the investor's underlying equity in the net assets of the investee should be accounted for as if the investee were a consolidated subsidiary. Therefore, a portion of the difference may be attributable to goodwill (equity method goodwill), which is not separately reported outside the equity method investment. Equity method goodwill is not amortized unless a private company/not-for-profit entity makes an accounting policy election to apply the accounting alternative for amortizing goodwill (see BCG 9.11). As described in ASC 350-20-35-59, equity method goodwill should not be tested for impairment in accordance with ASC 350-20; rather, the total carrying amount of the equity method investment should be reviewed for impairment in accordance with ASC 323. ASC 323-10-35-32 states that the impairment standard for an equity method investment is "a loss in value of an investment that is other than a temporary decline." When a determination is made that an other-than-temporary decline

exists, the equity method investment should be written down to its fair value, which then establishes a new cost basis.

An equity method investor should not separately test an investee's underlying assets, including goodwill, for impairment. However, the investor generally should record its share of any impairment recognized by the investee and consider the effect, if any, of the impairment on its basis difference in the assets giving rise to the investee's impairment. In the case of goodwill, the investee will be testing its own goodwill under the provisions of ASC 350-20 because it controls the underlying businesses that gave rise to the goodwill. An investor, on the other hand, does not control the businesses or underlying assets of an equity method investee that gave rise to the goodwill of the investee. Therefore, an equity method investor should recognize its proportionate share of a goodwill impairment loss recorded by an investee because the investee's goodwill would not be subject to direct impairment testing by the investor in its reporting unit structure. After an investor records its share of any impairment of the investee, the remaining investment should be tested for an other-than-temporary decline.

Under ASC 350-20 an entity may include equity method investments within the overall net assets of a reporting unit for the purpose of performing a goodwill impairment test on the reporting unit as a whole, provided that the equity method investment is appropriately assigned to the reporting unit. See BCG 9.3.5 for further information. In such cases, when the criteria in ASC 350-20-35-39 are met, the equity method investment should be treated the same as any other asset within the reporting unit and, therefore, should be included in both the carrying amount and the fair value of the reporting unit when performing the goodwill impairment test. The equity method investment would be tested for impairment under ASC 323-10 prior to performing the reporting unit's goodwill impairment test. Any adjusted carrying amount should be recorded as the new carrying value of the investment and included in the carrying amount of the reporting unit.

9.9.6 Allocation of impairment to goodwill components for tax purposes

As more fully discussed in TX 10.4, ASC 805-740-25-2 states that an acquirer should recognize and measure deferred tax assets and liabilities arising from the assets acquired and liabilities assumed in a business combination in accordance with ASC 740-10. Some business combination transactions, particularly taxable business combinations, can result in goodwill that is deductible for tax purposes (also referred to as "tax-deductible goodwill"). The amount assigned to goodwill for book and tax purposes could differ due to different valuation and allocation rules and differences in determining the amount of consideration transferred (e.g., different treatment of costs incurred for the transaction).

ASC 740, *Income taxes*, describes the separation of goodwill into components at the acquisition date to assist in determining the appropriate deferred tax accounting. The first component (component-1) equals the lesser of (1) goodwill for financial reporting or (2) tax-deductible goodwill. The second component (component-2) equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting in excess of tax-deductible goodwill or (2) the remainder, if any, of tax-deductible goodwill in excess of the goodwill for financial reporting (ASC 805-740-25-8). See TX 10.8 for further guidance on separating goodwill into its two components.

ASC 805 prescribes the recognition of a deferred tax asset resulting from an excess of tax-deductible goodwill over book goodwill. However, ASC 805 prohibits recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (i.e., book goodwill in excess of tax-deductible goodwill).

Any difference that arises between the book and tax bases of component-1 goodwill in future years (e.g., as a result of amortization for tax purposes or impairment for book purposes) is a temporary difference for which a deferred tax liability or asset is recognized, based on the requirements of ASC 740-10. If component-2 is an excess of tax-deductible goodwill over the amount of goodwill for financial reporting, future changes in the entire temporary difference (i.e., both component-1 and component-2 goodwill) are recorded. For example, future amortization of tax-deductible goodwill will reduce the corresponding deferred tax asset until the tax basis is equal to the book basis and will give rise to a deferred tax liability for the basis difference created by tax amortization thereafter (see ASC 805-740-25-9). However, if only a portion of the goodwill is amortizable for tax purposes, then the goodwill impairment must be allocated between component-1 and component-2 book goodwill.

We believe a reasonable methodology to allocate a book goodwill impairment between the components would include a proportionate allocation based on the book carrying amounts of component-1 and component-2 goodwill. We are aware that other approaches may also be acceptable. The approach an entity selects should be applied consistently.

Any goodwill impairment allocated to component-1 book goodwill will either decrease a previously created deferred tax liability or create/increase a deferred tax asset. The amount allocated to component-2 book goodwill will have no current or deferred tax effect (i.e., it is a permanent difference).

As described in ASC 350-20-35-8B, when a reporting unit has tax-deductible goodwill, a goodwill impairment may necessitate an iterative calculation (using what is often referred to as the “simultaneous equations method”) to determine the ultimate goodwill impairment amount and the related deferred tax adjustment.

ASC 350-20-35-8B

If a reporting unit has tax deductible goodwill, recognizing a goodwill impairment loss may cause a change in deferred taxes that results in the carrying amount of the reporting unit immediately exceeding its fair value upon recognition of the loss. In those circumstances, the entity shall calculate the impairment loss and associated deferred tax effect in a manner similar to that used in a business combination in accordance with the guidance in paragraphs 805-740-55-9 through 55-13. The total loss recognized shall not exceed the total amount of goodwill allocated to the reporting unit. See Example 2A in paragraphs 350-20-55-23A through 55-23C for an illustration of the calculation.

Example BCG 9-21 demonstrates the tax effect of a goodwill impairment when there is excess goodwill for financial reporting purposes at acquisition over the amount of tax-deductible goodwill.

EXAMPLE BCG 9-21

Deferred tax effect of a goodwill impairment: excess book-over-tax-goodwill at acquisition

Company A acquired reporting unit X four years ago in a taxable acquisition accounted for as a business combination. As a result of applying acquisition accounting, Company A recognized goodwill of \$1,200 million for book purposes; tax deductible goodwill was \$900 million and is amortizable for tax purposes over 15 years. In the current period, Company A performs its annual goodwill impairment test and concludes that the carrying value of the reporting unit exceeds its fair value by

\$400 million. Assume an applicable tax rate of 40%. Company A concludes that a valuation allowance on its deferred tax assets is not necessary both before and after the goodwill impairment.

How should Company A report the pre-tax and tax effects of the goodwill impairment?

Analysis

In order for the carrying amount of the reporting unit to equal its fair value after recognition of the impairment, a net after-tax impairment charge of \$400 million will need to be recognized. The iterative calculation described below and referenced at ASC 350-20-35-8B is used to determine the “pre-tax” goodwill impairment and related deferred tax benefit to arrive at a net \$400 million charge. Assuming Company A will allocate the impairment between component-1 and component-2 goodwill in proportion to their book bases, the calculation of the pre-tax impairment charge and deferred tax benefit is illustrated as follows:

(\$ millions)	Component-1 goodwill	Component-2 goodwill	Book basis	Tax basis	Deferred taxes
Balance at acquisition date	\$900 ¹	\$300	\$1,200	\$900	\$—
Tax amortization	—	—	—	(240) ²	(96) ²
Balance before impairment test	900	300	1,200	660	(96)
Impairment loss	(428) ³	(143) ³	(571) ³	—	171
Ending balance	\$472	\$157	\$629	\$660	\$75

¹ Component-1 goodwill equals the lesser of (1) goodwill for financial reporting (\$1,200) or (2) tax-deductible goodwill (\$900). Therefore, component-1 goodwill is \$900.

² The tax amortization for the tax basis is calculated as the \$900 tax basis amortized for tax purposes over 15 years, multiplied by the number of years of amortization since reporting unit X was acquired (4 years): $(\$900 / 15) \times 4 = \240 . The deferred tax liability is calculated as the tax amortization (\$240) multiplied by the tax rate (40%): $\$240 \times 40\% = \96 .

³ The total impairment of \$571 would be allocated between the components based on the book balance of goodwill prior to the impairment test (75% to component-1 and 25% to component-2).

Calculating the deferred tax effect of the impairment charge involves the following steps (dollar amounts in millions):

Step 1: Determine the ratio of component-1 goodwill to total goodwill: $\$900 / \$1,200 = 75\%$

Step 2: Determine the “effective” tax rate for the impairment charge by applying the component-1 ratio to the applicable tax rate: $75\% \times 40\% = 30\%$

Step 3: Calculate the tax rate to apply to the preliminary impairment using the iterative calculation illustrated in paragraphs ASC 805-740-55-9 through ASC 805-740-55-13: $30\% / (1 - 30\%) = 42.86\%$

Step 4: Apply the rate determined in Step 3 to the preliminary goodwill impairment of \$400 to determine the total deferred tax benefit: $\$400 \times 42.86\% = \171

Step 5: Add the amount determined in Step 4 to the preliminary goodwill impairment to compute the total pretax impairment: $\$400 + \$171 = \$571$

Following this approach, the tax benefit of the goodwill impairment equals \$171 million (\$571 million at an “effective” tax rate of 30%) and the net deductible temporary difference between the tax basis in goodwill of \$660 million and the remaining book basis in component-1 goodwill of \$472 million is \$188 million. Multiplying that amount by the applicable tax rate of 40% results in a deferred tax asset of \$75 million.

The following table summarizes the results of the above calculation, including the allocation of the \$171 million pre-tax “gross-up” of the goodwill impairment between component-1 and component-2 goodwill:

(\$ millions)	Carrying Amount before Impairment		Preliminary Impairment	Adjustment for Equation	Carrying Amount after Impairment	
	\$	%			\$	%
Component-1 goodwill	\$900	75%	\$(300)	\$(128)	\$472	75%
Component-2 goodwill	300	25%	(100)	(43)	157	25%
Deferred taxes	(96)	n/a		171	75	n/a

Example BCG 9-22 illustrates the accounting for a goodwill impairment charge when excess tax-deductible goodwill is present.

EXAMPLE BCG 9-22

Deferred tax effect of a goodwill impairment: excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition

Company A acquired a business (reporting unit X) in a nontaxable transaction. At the acquisition date, Company A has goodwill for financial reporting purposes of \$400 million and tax-deductible goodwill of \$900 million (carried over from a prior acquisition). The tax rate is 40%. A deferred tax asset of \$200 million is recognized for the excess tax-deductible goodwill at the acquisition date. The tax goodwill is deductible ratably over 10 years.

In year 4, Company A performs its annual goodwill impairment test and concludes that the carrying value of reporting unit X exceeds its fair value by \$200 million. Company A concludes that a valuation allowance on its deferred tax assets is not necessary both before and after the goodwill impairment.

How should Company A report the pre-tax and tax effects of the goodwill impairment?

Analysis

In order for the carrying amount of the reporting unit to equal its fair value after recognition of the impairment, a net after-tax impairment charge of \$200 million will need to be recognized in year 4.

The preliminary goodwill impairment of \$200 million would be grossed up using an iterative calculation illustrated in ASC 350-20-35-8B to arrive at the total impairment charge. In this case, the \$200 million “preliminary” goodwill impairment would be multiplied by 66.7% ($40\% / (1 - 40\%)$), resulting in a gross-up of \$133 million, or a pre-tax impairment of \$333 million. The resulting deferred tax asset after the impairment would be \$189 million ((tax basis of \$540 million less book basis of \$67 million) $\times 40\%$). To arrive at a net after-tax charge of \$200 million, a pre-tax goodwill impairment of \$333 million and a deferred tax benefit of \$133 million would be recognized.

(\$ millions) Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortization	Deferred taxes
At acquisition	\$400	\$900	\$ —	\$200
Year 1	400	810	90	164
2	400	720	90	128
3	400	630	90	92
4	400	540	90	56
Book impairment loss	(333)	—	—	133
Post-impairment carrying amount (Year 4)	\$67	\$540	\$ —	\$189

If the goodwill impairment occurred in a later year, it is possible that the tax basis of the goodwill would have been amortized to a point where it was lower than the book basis, giving rise to a deferred tax liability prior to the impairment. Using the same method described above, the total impairment charge may then reduce the book goodwill to a point where it is lower than the tax basis, giving rise to a deferred tax asset that must be assessed for realizability along with all of the company’s other deferred tax assets.

Example BCG 9-21 and Example BCG 9-22 both demonstrate how to apply the simultaneous equations method referenced in ASC 350-20-35-8B when the goodwill impairment impacts component-1 (i.e., tax-deductible) goodwill. However, if the reporting unit’s deferred taxes are subject to a full valuation allowance—meaning the net deferred tax assets (considering the valuation allowance) are zero—both before and after the goodwill impairment, the iterative calculation is not necessary. This is because the tax effect of the goodwill impairment is zero since any impact on deferred tax balances resulting from the goodwill impairment would be offset by an equal change in the valuation allowance.

In a situation when there is no valuation allowance before the goodwill impairment but some amount of valuation allowance will be needed after the goodwill impairment, or when there is a partial valuation allowance before the goodwill impairment (i.e., net deferred tax assets considering the valuation allowance are not zero) and a larger valuation allowance is necessary after the goodwill impairment, we believe the iterative calculation may need to be modified. If the iterative calculation is not modified, the carrying value of the reporting unit after the goodwill impairment (including the

gross-up for the tax effects using the simultaneous equation) will typically be less than the fair value of the reporting unit.

9.9.7 *Determining goodwill under ASC 740-10 vs. ASC 350-20*

The determination of goodwill for tax purposes must be performed on a jurisdictional basis. However, when assigning goodwill for financial reporting purposes, ASC 350-20 requires that goodwill be assigned to reporting units, which in many cases will not align with specific tax jurisdictions. Reporting units may include various tax jurisdictions and legal entities, or only portions of a company's operations contained in certain tax jurisdictions or legal entities. Consequently, at the reporting unit level, the tax goodwill associated with the reporting unit may be different than the goodwill assigned under ASC 350-20. In the case of goodwill impairments or other changes in goodwill (e.g., dispositions), the entity will need to evaluate the goodwill for financial reporting purposes and the tax basis of goodwill attributable to reporting units for purposes of determining the tax effects of such changes on the reporting units under ASC 740-10.

9.10 *Disposal considerations (goodwill)*

When a reporting unit is to be disposed of in its entirety, the entity must include in the reporting unit's carrying amount the goodwill of that reporting unit in determining the gain or loss on disposal. When some, but not all, of a reporting unit is to be disposed of, the accounting for that reporting unit's goodwill will depend on whether the net assets that are to be disposed of constitute a business. If the net assets that are to be disposed of do not constitute a business, no goodwill should be attributed to those net assets. If, on the other hand, the net assets that are to be disposed of do constitute a business, the entity should attribute a portion of the reporting unit's goodwill to that business in determining the gain or loss on the disposal of the business. In accordance with ASC 350-20-40-3, the amount of goodwill that is attributed to the business should be based on the relative fair values of (1) that business and (2) the portion of the reporting unit that will be retained.

If, however, the business that is to be disposed of was never integrated into the reporting unit after its acquisition and thus the rest of the reporting unit never realized the benefits of the acquired goodwill, the relative fair value allocation approach is not used. This situation might occur when the acquired business is operated as a standalone entity or when the business is to be disposed of shortly after it is acquired. In that case, goodwill associated with the nonintegrated business would not be included in a relative fair value calculation. Instead, the original goodwill amount associated with that business should be included when determining the gain or loss on disposal. However, these situations occur infrequently because some amount of integration generally occurs after an acquisition. The determination of whether the business to be disposed of has never been integrated largely depends on the specific facts and circumstances and requires significant judgment. The following factors are helpful when determining whether some level of integration has occurred:

- Level of management interaction between the acquired business and its parent
- Length of time between the acquisition date and the subsequent disposal
- Level of shared customers, shared customer lists, customer referrals, etc. amongst the acquired business and the parent
- Extent of any corporate level services provided to the acquired business by the parent

- Joint marketing efforts between the acquired business and the parent or other businesses owned by the parent
- Use of common brands and trademarks
- Expected integration plans and synergies underlying the original acquisition
- Legal ownership structure
- Geographic proximity (potentially indicating shared services and market operations)

When only a portion of a reporting unit's goodwill is attributed to a business that is to be disposed of, the goodwill remaining in the portion of the reporting unit that is to be retained should be tested for impairment in accordance with ASC 350-20-40-7. See BCG 9.4.4 for further information.

9.10.1 *Impairment testing: disposal of a business*

The disposal timeline can usually be divided into three discrete accounting events that require consideration: (1) a current expectation of an impending disposal, (2) classification of the disposal group as held for sale under ASC 360-10, and (3) the actual disposal. See PPE 5.3 for further information on classification of the disposal group as held for sale under ASC 360-10. These three events may occur in the same accounting period and, therefore, require no separate accounting consideration. Usually, however, the events transpire over two or more accounting periods. Therefore, because each event may result in an impairment test or other consequences for the carrying amount of goodwill, the accounting associated with a disposition may involve more than simply recording a gain or loss upon sale.

In cases in which management is planning to sell a business before the end of the estimated useful lives of the underlying long-lived assets, management would need to consider whether to revise the remaining estimated useful lives of the assets, if the entity determines the business does not yet meet the held for sale criteria. See PPE 4.2.3 for further information.

When there is a planned sale of a business, a company should consider the relevant guidance in determining the carrying amount of the business for purposes of evaluating the business and/or the underlying assets for impairment.

9.10.2 *Expectation of a disposal (goodwill)*

An entity should test all of a reporting unit's goodwill for impairment if (1) the entity has a "more likely than not" expectation that the reporting unit or a significant portion of the reporting unit will be sold or otherwise disposed of, and (2) based on that expectation, it is "more likely than not" that the fair value of the reporting unit is below its carrying amount. Any impairment charge resulting from this impairment test would be recognized as part of an impairment loss.

9.10.3 *Assets held for sale (goodwill)*

A disposal group that is classified as held for sale should be measured at the lower of its carrying amount (including goodwill if the disposal group is a reporting unit, or an allocation of goodwill, as described in BCG 9.10, if the disposal group represents a business that is part of a larger reporting unit) or fair value less cost to sell each reporting period following the guidance in ASC 360-10-35-43.

The carrying amount of any assets that are not covered by ASC 360-10, including goodwill, that are included in a disposal group classified as held for sale should be adjusted in accordance with other applicable US GAAP prior to measuring the fair value less cost to sell of the disposal group.

9.10.4 **Disposal of the business (goodwill)**

A gain or loss that results from the disposal of a business should be recognized at the date of sale. In most cases, such a gain or loss may not be significant when impairment losses have been recognized at the time the disposal group meets the held for sale criteria (or upon the expectation to sell) and is subsequently adjusted to its fair value less cost to sell prior to the disposition. At the time of sale, assets, including any goodwill, and liabilities included in the carrying amount of the disposal group will be factored into the determination of gain or loss on the disposal of a business.

Example BCG 9-23 demonstrates the goodwill accounting considerations when disposing of a business that is a portion of a reporting unit.

EXAMPLE BCG 9-23

Disposal of a business that is a portion of a reporting unit

Company A is a calendar year-end diversified manufacturing company that has an electronics reporting unit. The electronics reporting unit includes two geographically based businesses, one in the United States and the other in Europe, both of which were originally acquired in purchase transactions. Neither of these two businesses meet the definition of a component on their own as there is no discrete financial information regularly reviewed by segment management. Although its US electronics business is profitable and expected to remain stable, Company A's electronics business in Europe has only managed to break even and is in decline due to high levels of competition. Company A's annual goodwill impairment test is performed on December 31 each year. The December 31, 20X1 quantitative goodwill impairment test indicated that the \$1,100 carrying amount of the electronics reporting unit's goodwill was not impaired because the reporting unit's fair value of \$5,500 exceeded its carrying amount of \$5,100. For simplicity, all tax effects have been ignored, and assume that there is no change in other net assets throughout the example. It has also been assumed that there are no direct costs to sell the European electronics business.

What are Company A's goodwill accounting considerations given the decline in the European electronics operations?

Analysis

"More likely than not" expectation that European electronics business will be sold

In May 20X2, the European electronics business loses one of its significant customers. Based on this event, while Company A's management has not yet committed to a plan to sell the European electronics business, it determines that it is more likely than not that it will sell the European electronics business within the next year and that the fair value of the electronics reporting unit may no longer exceed the unit's carrying amount. Therefore, Company A tests the entire electronics reporting unit's goodwill for impairment during May 20X2. Prior to testing the electronics reporting unit's goodwill for impairment, Company A determines that the carrying amounts of the unit's other assets do not require adjustment under other applicable GAAP (e.g., ASC 350 and ASC 360-10) including testing the European electronics business under the held-and-used model. Company A

performs the quantitative goodwill impairment test of the electronics reporting unit and determines that there is a \$100 goodwill impairment loss because the fair value of the reporting unit is less than the carrying amount by that amount. After the entity recognizes the goodwill impairment loss, the carrying amount of the electronics reporting unit is as follows:

	Carrying Amount
Goodwill	\$1,000
Other net assets:	
US electronics business	2,300
European electronics business	1,700
Total	\$5,000

European electronics business is held for sale

In September 20X2, Company A's management commits to a plan to sell the European electronics business. That plan meets all of the criteria for the European electronics business to be (1) classified as held for sale (i.e., a disposal group) under ASC 360-10-45-9, and (2) reported as a discontinued operation pursuant to ASC 205-20. At this point, Company A would assign the electronics reporting unit's goodwill to the US and European electronics businesses based on the relative fair values of those businesses. Company A determines this goodwill attribution as follows:

	US	Europe	Total
Fair values	\$3,000	\$2,000	\$5,000
Relative fair value	60%	40%	100%
Goodwill	\$600	\$400	\$1,000

Company A would measure the European electronics business at the lower of its carrying amount or fair value less cost to sell pursuant to ASC 360-10. In doing so, however, Company A would first adjust the carrying amount of the goodwill that was assigned to the European electronics business by applying ASC 350-20's goodwill impairment test. After Company A assigns goodwill to the European electronics business, the business's carrying amount of \$2,100 (goodwill of \$400 and other net assets of \$1,700) exceeds its fair value of \$2,000. Thus, Company A determines the European electronics business has a \$100 goodwill impairment loss because the fair value of the business is less than its carrying amount.

In its third quarter financial statements, Company A would recognize an impairment loss of \$100. There would be no further loss recognized for classifying the European electronics business as held for sale because the carrying amount would be equal to the disposal group's fair value less cost to sell.

Company A would also need to test the goodwill of \$600 that was assigned to the US electronics business (i.e., the portion of the electronics reporting unit that is to be retained) for impairment. That goodwill would not be impaired because the US electronics business's fair value of \$3,000 exceeds its carrying amount of \$2,900 (goodwill of \$600 and other net assets of \$2,300).

European electronics business is sold

In November 20X2, Company A sells the European electronics business for \$1,800. The sales price is below Company A's previous estimates of the European electronics business's fair value because the business lost another major customer in October 20X2. In its fourth quarter financial statements, Company A would recognize a \$200 loss on sale (sales proceeds of \$1,800 minus a carrying amount of \$2,000) for the disposal of the European electronics business.

Company A does not believe that the additional loss is an indicator of the value of the goodwill assigned to the US electronics business and, therefore, it does not represent a triggering event for an interim impairment test of the goodwill included in the US electronics business. Company A is still be required to perform its annual goodwill impairment test on December 31, 20X2 for the US electronics business (Company A's remaining electronics reporting unit).

9.10.5 Attribution of goodwill in a spin-off (goodwill)

When a reporting unit or a portion of a reporting unit that constitutes a business is to be spun off to shareholders, goodwill associated with the disposal group should be attributed to and included in the distributed carrying value at the distribution date. In determining the goodwill to be attributed to the spin-off transaction, the parent would usually follow the relative fair value approach (assuming the parent is spinning off a portion of the reporting unit), and the goodwill attributed to the spin-off entity would be removed from the parent's balance sheet at the time of the spin-off. Until the time of the spin-off, the assets that will be spun off should be tested for impairment on a held and used basis. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, should be recognized when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value in accordance with ASC 360-10-40-4.

Goodwill recorded in the spin-off entity's financial statements is not necessarily the same amount as what the parent would eliminate from its balance sheet at the time of the spin-off (i.e., the accounting may not be symmetrical because the method of attributing goodwill to be removed from the parent's balance sheet may differ from the method used to measure the value of goodwill received by the spin-off entity). While the parent's accounting is based on the relative fair value of the reporting unit, the standalone or carve-out statements prepared for the spin-off entity follow a historical goodwill concept and reflect the acquisition-specific goodwill of any previously acquired entities that will be part of the spin-off. Such goodwill includes any goodwill residing at the parent level that had not previously been pushed down to any subsidiaries that are included in the spin-off entity. Furthermore, any prior impairments of goodwill at the parent level may not necessarily be reflected in the carve-out financial statements. Goodwill recorded at the spin-off entity level would be attributed to the spin-off entity's reporting units and may be separately tested for impairment for all prior periods, similar to subsidiary goodwill impairment testing as discussed in BCG 9.9.4.3. In such a case, impairment testing at the spin-off entity level may produce goodwill impairment charges that have not been required to be recorded at the parent level.

9.10.6 *Attribution of goodwill in a contribution to a joint venture*

When an investor contributes a subsidiary or group of assets that constitute a business to a joint venture, the investor should apply the deconsolidation and derecognition guidance in ASC 810-10-40. See EM 6.3.1.1 for additional information.

Question BCG 9-26

Should goodwill be attributed to a disposal group that is a business and part of a reporting unit in determining a gain or loss upon disposal when the disposal group is contributed to a joint venture?

PwC response

ASC 350-20-40-2 states that “when a portion of a reporting unit that constitutes a business ... is to be disposed of, goodwill associated with that business ... shall be included in the carrying amount of the business ... in determining the gain or loss on disposal.” The contribution of a business to a joint venture is analogous to other disposals (e.g., sales or spin-offs). The guidance in ASC 810-10-40-3A through ASC 810-10-40-5 should be followed when a subsidiary that is a business is transferred to an equity method investee or a joint venture. Therefore, a gain or loss would be realized based on the difference between the fair value of the equity investment in the joint venture received and the carrying amount of the business contributed, which includes an attribution of goodwill.

Following the attribution of goodwill to the disposed business, ASC 350-20-40-7 requires that any goodwill that remains in the reporting unit be tested for impairment.

9.11 *Accounting alternatives for private companies/NFP entities*

A private company/NFP entity may make an accounting policy election for the following accounting alternatives related to goodwill:

- Amortize goodwill on a straight-line basis over ten years, or less than ten years if the company demonstrates that another useful life is more appropriate (see BCG 9.11.1)
- Evaluate goodwill impairment triggering events as of the end of a reporting period (whether interim or annual) rather than throughout the reporting period (see BCG 9.11.2)

A private company/NFP entity may elect none, either, or both of the accounting alternatives.

Only private companies/NFP entities are eligible to elect the accounting alternatives related to goodwill. Companies considering adoption should carefully review the definition of a public business entity. A company that meets the definition of a public business entity is not eligible to apply any of the PCC’s accounting alternatives in its financial statements. Additionally, employee benefit plans are not eligible to adopt the PCC’s accounting alternatives.

Excerpt from ASC Master Glossary

Public business entity: A public business entity is a business entity meeting any one of the criteria below. Neither a not-for profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Presentation and disclosure guidance related to the goodwill accounting alternatives for private companies is included in FSP 8.10.2 and FSP 8.10.3.

9.11.1 Amortization of goodwill (private companies/NFPs)

If a private company/NFP entity elects the accounting alternative to amortize goodwill ("goodwill alternative"), the entity may amortize goodwill on a straight-line basis over ten years, or less than ten years if the company demonstrates that another useful life is more appropriate in accordance with ASC 350-20-35-63. The amortization guidance applies to existing goodwill, whether it resulted from a business combination or application of fresh-start reporting, at the adoption date as well as any new goodwill arising subsequent to adoption. Similarly, the accounting alternative to amortize goodwill also applies to equity method goodwill in accordance with ASC 350-20-35-81.

Question BCG 9-27

What factors should a private company consider before deciding whether it will adopt the goodwill alternative?

PwC response

A company should carefully consider whether it currently meets the definition of a public business entity and whether it expects to meet that definition in the future. If a company that is private today later meets the definition of a public business entity (for example, due to a public offering of the company's securities or as a result of being a "significant acquisition" of a registrant requiring audited financial statements under Article 3-05 of Regulation S-X), it will no longer be eligible to apply the goodwill alternative and will be required to retrospectively adjust its historical financial statements to apply the requirements of the existing goodwill accounting guidance.

In addition to determining whether a private company should adopt the goodwill alternative, it should also assess the impact a transition to the goodwill alternative will have on its key financial metrics, particularly those affecting its debt covenant compliance. While a company's EBITDA will not likely be impacted by adoption of the goodwill alternative, other key measures of performance such as net income, operating income, net assets and retained earnings will be affected.

Key differences between entities that adopt the goodwill alternative guidance and those that do not are summarized in Figure BCG 9-6.

Figure BCG 9-6

Key differences between entities that adopt the goodwill alternative guidance and those that do not

	Entities that adopt the goodwill alternative guidance	All other entities
Amortization	Requires goodwill to be amortized on a straight-line basis over a period of ten years, or less in certain circumstances	Does not allow goodwill to be amortized
Level of testing for impairment assessment	Either entity-wide or reporting unit (policy election upon adoption of the accounting alternative)	Reporting unit
Frequency of impairment assessment	Upon occurrence of a triggering event	At least annually, and between annual tests whenever a triggering event occurs
Allocation of impairment	Impairment charge allocated to separate amortizable units of goodwill using either a pro rata allocation based on relative carrying amounts of goodwill or another reasonable and rational basis	Impairment charge allocated at the reporting unit level

	Entities that adopt the goodwill alternative guidance	All other entities
Disposal of business that constitutes a portion of an entity (or reporting unit)	Goodwill attributed to disposed business using a reasonable and rational approach	Goodwill attributed based on the relative fair value of the business disposed of to the portion of the reporting unit being retained

Based on the guidance in ASC 350-20-65-2, a private company/NFP entity can adopt the goodwill alternative for the first time prospectively as of the beginning of any fiscal year without assessing preferability (i.e., there is no defined effective date). Upon adoption, a company should assign a useful life to its existing amortizable units of goodwill as of the beginning of the period of adoption and begin amortizing the goodwill on a straight-line basis from the beginning of the period. Assigning a remaining useful life of ten years to all existing goodwill on the adoption date, unless a shorter useful life is more appropriate, is intended to simplify the accounting. It is not appropriate for the company to refer to the original acquisition date(s) of its acquired businesses and apply a “cumulative catch-up” of amortization from that date over a ten-year period as of the adoption date. In no circumstances is a company permitted to assign a useful life in excess of ten years to its goodwill.

A company should assign a useful life to new goodwill arising after initial adoption on an acquisition-by-acquisition basis, thus creating separate amortizable units of goodwill. A useful life of ten years can be assigned to a new amortizable unit of goodwill as a practical expedient. As with existing goodwill on the adoption date, a company has the option to assign a shorter useful life to a new amortizable unit of goodwill if it demonstrates that the goodwill has a shorter useful life. The determination of the useful life of goodwill should be made separately for each amortizable unit of goodwill.

A company may revise the remaining useful life of each of its amortizable units of goodwill upon the occurrence of an event or change in circumstance that could indicate a different remaining useful life is more appropriate. The cumulative amortization period of any single amortizable unit of goodwill cannot exceed ten years. Therefore, if an individual amortizable unit of goodwill is initially assigned a useful life of ten years, it may be appropriate in certain circumstances to subsequently shorten the life, but in no circumstances should the useful life be extended beyond a total life of ten years. If the estimated remaining useful life of an amortizable unit of goodwill is adjusted, the change would be treated as a change in accounting estimate, and thus applied on a prospective basis from the date the useful life is adjusted in accordance with ASC 350-20-35-64.

9.11.1.1 Goodwill impairment model (private companies/NFPs)

The goodwill alternative simplifies many aspects of the goodwill impairment model for private companies/NFP entities by changing the level at which the impairment assessment is performed, when the test is performed, and how an impairment charge is calculated. The goodwill alternative does not change the order in which goodwill is assessed for impairment. The order of impairment testing is described in PPE 5.2.2 and PPE 5.3.2.

9.11.1.2 Level to test goodwill for impairment (private companies/NFPs)

Goodwill may be assessed for impairment at the entity-wide level or at the reporting unit level. The level at which to test goodwill for impairment is a policy election that is required to be made on the date the goodwill alternative is adopted.

- If a company elects to assess goodwill for impairment at the reporting unit level, it will continue to follow the existing goodwill model to determine its reporting units, assign assets and liabilities to its reporting units, and attribute goodwill to its reporting units. See BCG 9.2, BCG 9.3, and BCG 9.4 for more information about these topics.
- If a company elects to assess goodwill for impairment at the entity-wide level, a determination of the company's reporting units is not necessary. However, even if a reporting entity elects to test goodwill impairment at the entity-wide level (and not "push down" goodwill to lower-level reporting units for impairment testing), goodwill attributable to a foreign entity still needs to be considered in the foreign currency translation process as if that goodwill were pushed down and recorded at the foreign entity level. See BCG 9.4.5 for additional information.

9.11.1.3 Frequency of goodwill impairment testing (private companies/NFPs)

The impairment assessment is a trigger-based assessment, whereby a company is only required to test goodwill for impairment if an event occurs or circumstances change that indicate that the fair value of the entity may be below its carrying amount or the fair value of a reporting unit may be below its carrying amount depending on the level at which the test is performed based on the accounting policy adopted. A company is not required to assess goodwill for impairment on an annual basis under the accounting alternative.

The goodwill alternative does not change the examples of events and circumstances, identified in BCG 9.6, that indicate that the fair value of the entity (or reporting unit) may be below its carrying amount. However, those examples are not meant to be all-inclusive. As part of its analysis of potential triggering events, a company should consider other factors that could impact the fair value of the entity (or reporting unit), the extent to which each of the identified adverse events or circumstances impact the entity's (or reporting unit's) fair value, the presence of any positive or mitigating factors that impact fair value, and, if applicable, the results of any recent fair value calculations in accordance with ASC 350-20-35-68.

9.11.1.4 Goodwill impairment test (private companies/NFPs)

Based on the occurrence of an event or a change in circumstances, a company is permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount, including goodwill. The qualitative assessment, commonly referred to as "step zero," applied in the goodwill alternative is the same as the qualitative assessment discussed in BCG 9.6. An entity is also permitted to bypass the qualitative assessment and proceed directly to the quantitative test. If a company elects to bypass the qualitative assessment, or, after performing the qualitative assessment concludes that it is more likely than not that the fair value of the entity (or reporting unit) is less than its carrying amount, it should proceed to the quantitative impairment test.

A company should compare the fair value of the entity (or reporting unit) to its carrying amount, which includes goodwill. If the fair value exceeds the carrying value, no impairment loss exists. If the

fair value is less than the carrying amount, a goodwill impairment loss is recognized. In accordance with ASC 350-20-35-78, once a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill will be its new accounting basis, which will be amortized over the remaining useful life of goodwill. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

Consistent with the goodwill impairment guidance for public business entities, when determining the fair value of the entity (or reporting unit), a company will need to determine whether the entity (or reporting unit) would be bought or sold in a taxable or nontaxable transaction. However, when performing the quantitative goodwill impairment test, a company should include its deferred income taxes in the carrying amount of the entity (or reporting unit), regardless of how the fair value of the entity (or reporting unit) is determined (i.e., whether the entity (reporting unit) would be bought or sold in a taxable or nontaxable transaction) in accordance with ASC 350-20-35-76.

9.11.1.5 Measurement of an impairment loss (private companies/NFPs)

A goodwill impairment loss is measured as the amount by which the carrying amount of the entity (or reporting unit) exceeds its fair value. However, the impairment loss cannot exceed the entity's (or reporting unit's) carrying amount of goodwill in accordance with ASC 350-20-35-73.

Question BCG 9-28

A company elects to continue to assess goodwill for impairment at the reporting unit level and measures an impairment loss in one reporting unit that exceeds the carrying amount of that reporting unit's goodwill. Should the company attribute the excess amount to the goodwill in its other reporting units?

PwC response

No. For a company that assesses for impairment at the reporting unit level, the measurement of any impairment loss is limited to the carrying amount of goodwill in that reporting unit. Therefore, if the calculated impairment loss for any single reporting unit is greater than the carrying amount of the reporting unit's goodwill, the company should not attribute the remaining difference to its other reporting units. Separately, the company should assess its long-lived assets for impairment before assessing goodwill for impairment.

Example BCG 9-24 demonstrates measurement of an impairment loss under the goodwill alternative.

EXAMPLE BCG 9-24

Measurement of an impairment loss under the goodwill accounting alternative

Company A has elected to assess its goodwill for impairment at the entity-wide level. During 20x1, Company A experiences a decline in its consolidated earnings and operating cash flows, and on June 30, 20x1, concludes that it is more likely than not that the fair value of the entity has fallen below its carrying amount. Before assessing its goodwill for impairment, Company A assessed its long-lived assets and determined there were no impairments. On June 30, 20X1, the carrying amount of Company A's consolidated net assets is \$950, which includes goodwill of \$200.

How would Company A measure and record an impairment loss?

Analysis

Company A is required to assess its goodwill for impairment on June 30, 20x1, the date it has determined that the fair value of the entity may be below its carrying amount. On that date, Company A should determine the fair value of the consolidated entity using the same measurement principles described in ASC 350-20-35-22 through ASC 350-20-35-27 (i.e., the guidance for determining the fair value of a reporting unit). Company A concludes that its fair value is \$800. Therefore, Company A's carrying amount exceeds its fair value by \$150. Company A should recognize a goodwill impairment loss of \$150, thus reducing the carrying amount of its goodwill to \$50.

Alternatively, if the carrying amount of Company A's goodwill was \$100 on June 30, 20x1, the impairment loss would be limited to \$100 because the total impairment loss cannot exceed the carrying amount of goodwill.

ASC 350-20-35-73 requires a private company/NFP entity following the goodwill alternative accounting to consider the income tax effect from any tax-deductible goodwill on the carrying amount of the entity (or the reporting unit), if applicable, in accordance with ASC 350-20-35-8B when measuring the goodwill impairment loss. See BCG 9.9.6.

Question BCG 9-29

How should a company with a negative carrying amount at the entity (or reporting unit) level measure a goodwill impairment loss?

PwC response

The goodwill alternative does not specifically address how a company should test goodwill for impairment when the goodwill resides within a reporting unit with a negative carrying amount or when the goodwill is being tested for impairment at the entity-wide level and the entity has a negative carrying amount. For areas not addressed in the goodwill alternative, an entity should continue to follow the applicable requirements of the existing goodwill accounting and reporting model in accordance with ASC 350-20-05-6. See BCG 9.8.2 for the accounting for reporting units with zero or negative carrying amounts.

9.11.1.6 Allocation of a goodwill impairment loss (private companies/NFPs)

A company should allocate a goodwill impairment loss to individual amortizable units of goodwill of the entity if it tests for goodwill impairment at the entity-wide level, or to amortizable units of goodwill within the impaired reporting unit if it tests for goodwill impairment at the reporting unit level. Therefore, the level at which a company assesses its goodwill for impairment will determine how a goodwill impairment charge is allocated to the separate amortizable units of goodwill. A company is permitted to allocate the impairment loss on a pro rata basis using the relative carrying amounts of its separate amortizable units of goodwill. While a company may allocate the impairment loss using another reasonable and rational basis, entities generally should use the pro rata allocation method unless there is clear evidence supporting a specific identification of the impairment loss to one or more amortizable units of goodwill.

After the goodwill impairment charge is allocated to individual amortizable units of goodwill, the adjusted carrying amounts of the individual units should be amortized over their respective remaining useful lives in accordance with ASC 350-20-35-78.

Example BCG 9-25 demonstrates the allocation of a goodwill impairment loss to amortizable units of goodwill.

EXAMPLE BCG 9-25

Allocating an impairment loss to amortizable units of goodwill on a pro rata basis

Company A assesses goodwill for impairment at the entity-wide level. Upon a triggering event in 20x3, Company A performs the goodwill impairment test and determines that it has a goodwill impairment loss of \$100 that it needs to allocate to its three amortizable units of goodwill.

	Goodwill origin	Goodwill carrying amount before impairment loss	Remaining useful life at impairment test date
Unit 1	Existing goodwill on adoption date	\$300	5 years
Unit 2	20x1 acquisition	\$150	8 years
Unit 3	20x2 acquisition	\$50	9 years
Total		\$500	

Company A determines that the impairment loss will be allocated to its three amortizable units of goodwill on a pro rata basis using their relative carrying amounts.

How should Company A allocate the impairment loss to each unit?

Analysis

Unit 1's goodwill represents 60% of the total (\$300 / \$500). Unit 2's goodwill represents 30% of the total (\$150 / \$500). Unit 3's goodwill represents 10% of the total (\$50 / \$500). Using a pro rata allocation, Company A should allocate 60% of the impairment loss (\$60) to Unit 1, 30% (\$30) to Unit 2, and 10% (\$10) to Unit 3. The allocation of the impairment loss will impact the amount of amortization expense that will be recognized in each future period.

9.11.1.7 Disposal considerations (private companies/NFPs)

When a company disposes of a business that is part of an entity (or reporting unit), the goodwill associated with that business should be included in the carrying amount of the business in determining the gain or loss on disposal in accordance with ASC 350-20-40-9.

The amount of goodwill to attribute to a disposed business should be determined using a reasonable and rational approach. A relative fair value approach (as described in BCG 9.10) would generally be considered a reasonable and rational approach. Other approaches, such as an allocation based on a

pro rata basis relative to the carrying amounts of the individual amortizable units of goodwill or the remaining acquisition-specific goodwill value, may be considered reasonable and rational depending on a company's specific facts and circumstances.

9.11.2 Accounting alternative: impairment triggering event (private companies/NFPs)

In accordance with ASC 350-20-35-84, private companies/NFP entities may elect an accounting alternative to forgo the evaluation of goodwill impairment triggering events occurring throughout a reporting period. The accounting alternative allows private companies/NFP entities to evaluate goodwill impairment triggering events only as of the end of the reporting period, whether interim or annual, and to recognize and measure any resulting goodwill impairment as of that date, if necessary. This may provide relief to private companies by eliminating the requirement to evaluate goodwill impairment triggering events as they occur during the reporting period. See ASC 350-20-55-27 through ASC 350-20-55-29 for an illustrative example of the accounting alternative for a goodwill impairment triggering event evaluation.

The guidance under the accounting alternative affects the timing of an entity's evaluation of the occurrence of goodwill impairment triggering events. For example, a private company may prepare interim financial statements on a quarterly basis under a contractual arrangement with its equity holders or for debt compliance purposes. If such interim financial statements are prepared in accordance with GAAP, including relevant footnote disclosures in accordance with ASC 270-10, we believe a private company electing the accounting alternative would be required to assess goodwill impairment triggering events as of each interim reporting date.

Alternatively, a private company may provide only limited financial information (e.g., balance sheet and income statement) to a lender supporting quarterly debt covenant calculations. In this scenario, the private company should consider whether such financial information is asserted to be recognized and measured in accordance with GAAP. If it is, the quarterly period could be considered a reporting period, in which case goodwill impairment triggers would need to be assessed as of the end of the quarter.

In evaluating what constitutes a reporting period, private companies should consider all financial information reported to external users, including equity holders, lenders, and other third parties, including whether such information is asserted to be recognized and measured in accordance with GAAP.

Similar to the private company/NFP accounting alternative to amortize goodwill, entities are provided with an unconditional one-time option to adopt the goodwill impairment triggering events alternative prospectively at any time after its effective date without assessing preferability.

Chapter 10:
Pushdown accounting—
updated September 2023





10.1 Pushdown accounting

Business combinations are recorded using the acquisition method. The acquirer recognizes the assets acquired and liabilities assumed at fair value with limited exceptions. If the acquired business prepares separate financial statements, a question arises as to whether the historical basis of the acquired company or the “stepped-up basis” of the acquirer should be reflected in those separate financial statements. Pushdown accounting refers to the latter, which means establishing a new basis for the assets and liabilities of the acquired company based on a “push down” of the acquirer’s stepped-up basis. Pushdown accounting is optional under ASC 805-50-25-4.

Pushdown accounting typically results in higher net assets for the acquired company on the acquisition date because the assets and liabilities are “stepped-up” to fair value and goodwill is recognized. This in turn usually results in lower net income in periods subsequent to the acquisition due to higher amortization, higher depreciation, and potential impairment charges. Refer to Figure BCG 10-1 for an illustration of the impact of pushdown accounting on an acquired company’s financial statements.

Figure BCG 10-1

Typical impact of pushdown accounting on an acquired company’s financial statements

Assets		Impact of goodwill and “step up” in value of PP&E, intangibles, and inventory	Revenue	NEUTRAL	Prior to adoption of ASU 2021-08, future revenues could decrease if the fair value of acquired deferred revenue is less than book value
Liabilities	NEUTRAL	Liabilities could increase if contingencies are recorded at fair value	Expenses		Impact of increased amortization and depreciation expense
Equity		Reflects value paid by buyer, typically exceeds book value	Net income		Impact of increased expenses
Operating cash flows	NEUTRAL	Impact of pushdown is typically noncash	EBITDA	NEUTRAL	EBITDA could decrease if “step up” of inventory results in increased cost of goods sold

Presentation and disclosure guidance related to pushdown accounting is included in FSP 17.6.

10.1.1 Scope (pushdown accounting)

A company that is a business has the option to apply pushdown accounting when it is acquired by another party (a change-in-control event). A nonprofit activity or business also has the option to apply pushdown accounting when a not-for-profit acquirer obtains control of the nonprofit activity or business and initially recognizes their assets and liabilities in the acquirer's financial statements. In accordance with ASC 805-50-15-10, the election is available to the acquired company, as well as to any direct or indirect subsidiaries of the acquired company. The acquired company or, as noted in ASC 805-50-25-8, any of its subsidiaries can each make its own election independently for its separate financial statements.

Even when a subsidiary does not elect to apply pushdown accounting in its separate financial statements, its net assets may be subject to “push down” of the parent’s historical cost if those assets are subsequently transferred to another subsidiary under the parent’s control (i.e., in a common control transaction). See BCG 7 for further information.

In accordance with ASC 805-50-15-11, the pushdown accounting guidance does not apply to transactions listed in ASC 805-10-15-4 (e.g., asset acquisitions). See BCG 1.1.2 for additional information.

10.1.2 First step: identify the acquirer (pushdown accounting)

As described in ASC 805-50-25-4, the pushdown election is optional for an acquired company’s separate financial statements. However, the acquirer’s consolidated financial statements must apply acquisition accounting. Accordingly, the first step is to identify the acquirer in any change-in-control event. The acquirer is the entity or individual that obtains control of the acquiree, which may occur in a variety of ways, as described in BCG 10.1.4. The guidance on consolidations in ASC 810 and business combinations in ASC 805 should be followed to identify the acquirer. The acquirer is not always clearly evident in a business combination; for example, the legal acquirer may not be the same as the accounting acquirer (e.g., in a reverse acquisition). However, if the acquiree is a variable interest entity, the primary beneficiary of the acquiree is always the acquirer. In accordance with ASC 805-50-25-5, when it is not clear which entity is the acquirer in a business combination, the factors in ASC 805-10-55-11 through ASC 805-10-55-15 should be considered.

ASC 805-50-25-5

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

The determination of the accounting acquirer also may not be clearly evident when a new entity (NewCo) is created to effect a transaction. The determination of whether a NewCo is the accounting

acquirer is judgmental and requires an understanding of the substance and legal form of the transaction. If the NewCo is the acquirer, acquisition accounting (rather than pushdown accounting) would need to be applied in the NewCo's financial statements; it would not be optional.

Refer to BCG 2.3 for further guidance on identifying the accounting acquirer, and BCG 2.3.1 for guidance on when a NewCo is created to facilitate the business combination.

Example BCG 10-1 provides an example of the first step in evaluating a change-in-control event to identify the acquirer and the related pushdown accounting considerations by the acquiree.

EXAMPLE BCG 10-1

Identifying the accounting acquirer and pushdown accounting considerations by the acquiree

Parent Company acquires 100% of Target Company from Seller. In order to effect the transaction, a substantive entity (NewCo) that performs significant precombination activities is formed by Parent Company, which is used to acquire all of the shares of Target Company. Target Company will continue as a wholly-owned subsidiary of NewCo, and NewCo will be a reporting entity.

What are the accounting considerations for NewCo and Target Company?

Analysis

NewCo is the accounting acquirer and would be required to apply acquisition accounting for the acquisition of Target Company. The pushdown accounting election would only be available to Target Company and its subsidiaries (in their separate financial statements).

10.1.3 Considerations when making the pushdown election

Before making an election, it is important to consider the needs of the users of an acquired company's financial statements. Some users may prefer the "stepped-up basis" that results from pushdown accounting. Other users may prefer the historical basis to avoid distorting income statement trends as a result of increased amortization and depreciation expense. Users that are focused on cash flow and EBITDA measures may be indifferent, as these measures are not significantly affected by pushdown accounting. Assessing user needs may be more challenging when there are multiple users of the financial statements with different needs (e.g., creditors versus equity investors).

Some acquirers may prefer to apply pushdown accounting at the acquired company level to avoid separate tracking of assets, such as goodwill and fixed assets, at two different values (historical and "stepped-up basis"). Conversely, an acquired company may prefer to carry over its historical basis even when its acquirer is applying acquisition accounting. Companies may also want to consider tax reporting implications and may prefer to carry over their historical basis for financial reporting purposes when carry over basis is being used for tax reporting purposes (that is, when there is no tax "step-up").

The acquiree may also consider the impact on accounting policies when determining whether or not to apply pushdown accounting. If the acquiree elects to apply pushdown accounting, the acquirer's basis is used in the acquiree's separate financial statements. That basis is determined based on the existing accounting policies of the acquirer on the acquisition date. See BCG 2.12 for additional information on conforming the acquiree's accounting policies to those of the acquirer. Alternatively, if the acquiree

does not elect to apply pushdown accounting in its separate financial statements, the acquiree would not be able to change its accounting policies without demonstrating the preferability requirements in ASC 250.

10.1.4 Change-in-control events (pushdown accounting)

For purposes of pushdown accounting, a change-in-control event is one in which an acquirer obtains control of a company. An acquirer might obtain control of a company in a variety of ways, as described in ASC 805-50-25-4, including by transferring cash or other assets, by incurring liabilities, by issuing equity interests, or a combination thereof. In some cases, an acquirer might obtain control of a company without transferring consideration, such as when certain rights in a contract lapse. The guidance on consolidations in ASC 810 and business combinations in ASC 805 should be used to determine whether an acquirer has obtained control of a company. Refer to BCG 1.1.1 for additional guidance on determining whether an acquirer has obtained control.

A transaction that results in a party losing control without any other party obtaining control is not a change-in-control event; therefore, it is not eligible for pushdown accounting. There may also be instances when there is a change-in-control event, but acquisition accounting under ASC 805 is not applied by the acquirer. This may be the case, for example, if the acquirer is an individual that does not prepare financial statements, or an investment company that accounts for its investments at fair value (e.g., a private equity company). In these situations, an acquired company could still elect to apply pushdown accounting as if the acquirer had applied acquisition accounting under ASC 805.

10.1.5 When to make the pushdown accounting election

As described in ASC 805-50-25-6, the decision to apply pushdown accounting is made in the reporting period in which the change-in-control event occurs. This means that a company would have until its financial statements are issued (or are available to be issued for entities that do not file with the SEC) to make the election.

Pushdown accounting is applied as of the acquisition date. In accordance with ASC 805-50-25-9, once applied, pushdown accounting is irrevocable. However, as contemplated in ASC 805-50-25-7, if an entity has not applied pushdown accounting, it may elect to do so in a subsequent period as a change in accounting principle in accordance with ASC 250, provided that the change is preferable, and retrospectively adjust its reporting basis as of the date of the change-in-control event.

In such case, the entity is required to use the parent's acquisition accounting as of the most recent change-in-control event. A roll-forward of that accounting (e.g., depreciation and amortization of stepped-up values, and potential impairments) would also be required. Sometimes, the parent may not have applied acquisition accounting (e.g., a private equity parent) or may not have applied it at a precise enough level for the subsidiary's separate financial statements (see BCG 10.1.6). In those cases, the subsidiary would have to retrospectively determine the fair value of its assets and liabilities as of the most recent change-in-control event.

The pushdown accounting election upon a change-in-control event does not establish an accounting policy. That is, a company may elect to apply pushdown accounting for one change-in-control event and, independent from that election, decide not to apply pushdown accounting upon the next change-in-control event, or vice versa.

ASC 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 805-50-25-7

If the acquiree does not elect to apply pushdown accounting upon a change-in-control event, it can elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a change in accounting principle in accordance with Topic 250 on accounting changes and error corrections. Pushdown accounting shall be applied as of the acquisition date of the change-in-control event.

ASC 805-50-25-9

The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.

10.1.6 Applying pushdown accounting

When pushdown accounting is elected, an acquired company should record the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquired company. An acquiree that elects pushdown accounting must apply it in its entirety; applying the election to a subset of assets and/or liabilities is not permitted.

Excerpt from ASC 805-50-30-10

If an acquiree elects the option in this Subtopic to apply pushdown accounting, the acquiree shall reflect in its separate financial statements the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquiree by applying the guidance in other Subtopics of Topic 805.

In accordance with ASC 805-50-30-11, goodwill should be calculated and recognized by the acquired company consistent with the acquisition accounting applied by the acquirer. Bargain purchase gains, however, should not be recognized in the income statement of the acquired company applying pushdown accounting. Instead, they should be recognized in additional paid-in capital within equity.

ASC 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).

The amount of goodwill recognized by the acquiree in its separate financial statements may differ from the amount of goodwill assigned by the acquirer to the specific reporting unit(s) that include the acquiree in the acquirer's consolidated financial statements, as the acquirer may assign some of the goodwill that arose from the acquisition to other reporting units. See Example BCG 10-2 for an illustration. Further, a goodwill impairment charge recorded in the standalone financial statements of a subsidiary may not necessarily result in an impairment in the parent's consolidated financial statements (and vice versa), because each entity would use its own reporting unit structure. However, a goodwill impairment charge at the subsidiary may represent a triggering event for potential impairment of the parent company's goodwill. Refer to BCG 9.9.4.3 and BCG 9.9.4.4 for discussion on the subsequent accounting for goodwill in both the parent's consolidated financial statements and the standalone financial statements of the subsidiary when a subsidiary recognizes a goodwill impairment.

Example BCG 10-2 provides an illustration of how goodwill recognized by the acquired company when pushdown accounting is elected could differ from the amount of goodwill allocated by the acquirer to the reporting unit that includes the acquired company.

EXAMPLE BCG 10-2

Goodwill recognized by the acquired company – pushdown elected

Parent acquires Target Company and records \$100 of goodwill. Parent expects an existing reporting unit to benefit from the synergies of the acquisition and assigns \$20 of goodwill to that reporting unit. Parent assigns all of Target Company's identifiable assets acquired and liabilities assumed and remaining goodwill of \$80 to a new reporting unit. Parent prepares separate, stand-alone financial statements for Target Company subsequent to its acquisition.

Assuming pushdown accounting is elected, how much goodwill should be reflected in the post-acquisition separate financial statements of Target Company?

Analysis

The separate financial statements of Target Company should reflect goodwill of \$100. This is equal to the total amount of goodwill recognized by Parent for Target Company on the date of acquisition.

In accordance with ASC 805-50-30-12, acquisition-related debt should be recognized by the acquired company only if it represents an obligation of the acquired company. As such, contingent consideration or financing obtained in connection with the acquisition would generally not be recognized in the acquired company's separate financial statements unless the acquired company is the legal obligor.

An acquiree should recognize an acquisition-related liability incurred by the acquirer only if the acquiree is required to recognize a liability in accordance with other applicable GAAP. For example, a determination should be made as to whether any joint and several obligations that exist among multiple subsidiaries and/or the parent fall within the scope of ASC 405-40, *Obligations Resulting from Joint and Several Liability Arrangements*. Under this guidance, such obligations should be measured as the sum of (a) the amount the reporting entity agreed with its co-obligors to pay and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. The corresponding entries (e.g., cash, an expense, a receivable, equity) will depend on the specific facts and circumstances of the transaction.

In accordance with ASC 805-50-35-2, an acquiree that elects pushdown accounting should follow the subsequent measurement guidance in other subtopics of ASC 805 and other applicable GAAP to subsequently measure and account for its assets, liabilities, and equity instruments.

Transaction costs should generally be recognized as an expense by the acquirer, and not pushed down to the acquired company as they are typically not for the benefit of the acquired company. Refer to BCG 2.7.1 for further discussion on acquisition-related costs in a business combination, including information on accounting for certain acquisition-related costs "on the line" (BCG 2.7.1.5).

10.1.7 Expenses incurred on behalf of subsidiary

A parent company may incur certain expenses (including employee compensation) on behalf of its subsidiary. In these cases, SEC Staff Accounting Bulletin Topic 1.B.1, *Costs Reflected in Historical Financial Statements*, and SEC Staff Accounting Bulletin Topic 5.T, *Accounting for Expenses or Liabilities Paid by Principal Stockholder*, indicate that the income statement of a company should reflect all of its costs of doing business. Pushdown accounting under ASC 805-50 does not change this or other similar guidance in US GAAP (e.g., accounting for share-based payments under ASC 718), and, therefore, expenses incurred by a parent entity on behalf of its subsidiaries should be carefully evaluated even if a subsidiary does not elect pushdown accounting.

10.1.8 Foreign currency translation (pushdown accounting)

Acquisition accounting adjustments (i.e., step up) related to the acquisition of a foreign entity should be considered in the translation process by the parent entity in its consolidated financial statements as if those adjustments were pushed down to the foreign entity. In essence, pushdown accounting is effectively applied in the parent's consolidated financial statements for purposes of translating a foreign entity regardless of the foreign entity's basis of accounting in its separate financial statements. See BCG 9.4.5 for further guidance on this topic.

10.1.9 Tax bases (pushdown accounting)

If an acquired company does not elect to apply pushdown accounting, but the transaction is accounted for as a purchase of assets for tax purposes, there would be a change in the tax bases of the assets and liabilities of the acquired company without a corresponding change in the acquired company's book basis. In this situation, deferred taxes would be recognized in the acquired company's financial statements for the book-to-tax basis differences that result from the transaction. The initial deferred tax balances resulting from the transaction would be recorded in equity. See TX 14.6 for further guidance.

10.1.10 Measurement period adjustments

In accordance with ASC 805-10-25-13 through ASC 805-10-25-19 (described in BCG 2.9), an acquirer in a business combination should report provisional amounts when measurements are incomplete as of the end of the reporting period in which the business combination occurred. Changes arising during the measurement period, as defined in ASC 805-10-25-14, due to new information about facts and circumstances that existed at the acquisition date should be recorded by adjusting the amounts recognized at the acquisition date in the reporting period in which the adjustment amount is determined. Any cumulative income statement impacts, such as depreciation or amortization, should be recognized in current-period earnings. We believe the same measurement period accounting and disclosure requirements of the acquirer would apply to an acquiree that has elected pushdown accounting.