www.pwc.com

Global edition

Business combinations and noncontrolling interests

pwc

PwC guide library

Other titles in the PwC accounting and financial reporting guide series:

- *Bankruptcies and liquidations*
- *Consolidation and equity method of accounting*
- *Derivative instruments and hedging activities*
- *Fair value measurements, global edition*
- *Financial statement presentation*
- *Financing transactions*
- *Foreign currency*
- *IFRS and US GAAP: similarities and differences*
- *Income taxes*
- *Leases*
- *Loans and investments*
- *Property, plant, equipment and other assets*
- *Revenue from contracts with customers, global edition*
- *Stock-based compensation*
- *Transfers and servicing of financial assets*
- *Utilities and power companies*

Acknowledgments

The *Business combinations and noncontrolling interests, global edition,* represents the efforts and ideas of many individuals within PwC. The following PwC people contributed to the contents or served as technical reviewers of this publication:

Kassie Bauman
Cathy Benjamin
Nicole Berman
Wayne Carnall
Brett Cohen
Larry Dodyk
Donald Doran
Sarah Fleischer
Katie Hurley
Marc Jerusalem
Chenelle Manley
Andreas Ohl
Cody Smith
John Wayne
Shiri Wertman
Valerie Wieman

Special thanks

Special thanks to all the other resources within PwC that contributed to the overall quality of this guide, including the final editing and production of the document.

Preface

PwC is pleased to offer our global accounting and financial reporting guide for *Business combinations and noncontrolling interests*. This guide has been updated as of December 2017.

In January 2017, the FASB issued final guidance that revises the definition of a business. The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across most industries, particularly real estate and pharmaceuticals. The definition of a business also affects many other areas of accounting, including disposals, consolidation, and segment changes. BCG 1 discusses the revised definition and new framework, as well as the effective date and transition.

In January 2017, the FASB issued final guidance that eliminates Step 2 of the current goodwill impairment test, which requires a hypothetical purchase price allocation to measure goodwill impairment. A goodwill impairment loss will instead be measured at the amount by which a reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. BCG 9 discusses the new goodwill impairment model, as well as effective dates and transition.

References to US GAAP and IFRS

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification and standards issued by the IASB are clearly designated, either within quotes in the regular text or enclosed within a shaded box. The remaining text is PwC's original content.

References to other chapters and sections in this guide

When relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "BCG" followed by the specific section number (e.g., BCG 2.3.1 refers to section 2.3.1 in chapter 2 of this guide).

References to other PwC guidance

This guide focuses on the accounting and financial reporting considerations for business combinations and noncontrolling interests. It supplements information provided by the authoritative accounting literature and 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 chapter or section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Fair value measurements, global edition (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions: debt, equity and the instruments in between (FG)*
- *Income taxes (TX)*

- *Leases (LG)*
- *Property, plant, equipment and other assets (PPE)*
- *Revenue from contracts with customers, global edition (RR)*
- *Stock-based compensation (SC)*

In addition, PwC's *Accounting and reporting manual* (the ARM) provides information about various accounting matters in US GAAP.

PwC guides may be obtained through CFOdirect (www.cfodirect.com), PwC's comprehensive online resource for financial executives, a subscription to Inform (www.pwcinform.com), PwC's online accounting and financial reporting reference tool, or by contacting a PwC representative.

Guidance date

This guide has been updated and considers guidance as of December 1, 2017. Additional updates may be made to keep pace with significant developments. Users should ensure they are using the most recent edition available on CFOdirect (www.cfodirect.com) or Inform (www.pwcinform.com).

Other information

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, definitions of key terms, and a summary of significant changes from the previous edition.

* * * * *

This guide has been prepared to support you as you consider the accounting for transactions and address the accouting, financial reporting, and regulated regulatory matters relevant to business combinations and noncontrolling interests. 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.

We hope you find the information and insights in this guide useful.

Paul Kepple
US Chief Accountant

Table of contents

1 Scope

1.1 Chapter overview 1-2

1.2 Definition of a business– before adoption of ASU 2017-01 1-3

1.2.1 Development stage enterprises 1-5

1.2.2 The presence of goodwill 1-5

1.2.3 Distinguishing a business from an asset or group of assets 1-5

1.2.4 Identifying market participants when determining whether an acquired group is a business 1-7

1.2.5 Distinguishing a business from an asset or group of assets 1-7

1.3 Definition of a business – after adoption of ASU 2017-01 1-11

1.3.1 The screen test 1-12

1.3.1.1 Single asset 1-13

1.3.1.2 Similar assets 1-13

1.3.1.3 Gross assets 1-15

1.3.2 The framework 1-16

1.3.2.1 Evaluating the framework when outputs are not present 1-16

1.3.2.2 Evaluating the framework when outputs are present 1-18

1.3.3 The presence of goodwill 1-21

1.4 Identifying a business combination 1-21

1.4.1 Stapling transactions and dual-listed companies 1-23

1.4.2 Merger of equals, mutual enterprises, and “roll-up” or “put-together” transactions 1-23

1.4.3 Exchanges of assets between companies 1-24

1.4.4 Multiple transactions that result in the acquisition of a business 1-24

1.4.5 Transactions excluded from the scope of ASC 805 and IFRS 3 1-25

1.5 Identifying a joint venture [joint arrangement] 1-26

1.6 Common control business combinations 1-27

1.7 US GAAP and IFRS differences: definition of control 1-27

1.7.1 US GAAP 1-27

1.7.2 IFRS 1-28

1.7.3 Investment entity—IFRS 1-29

1.7.4 Investment companies—US GAAP 1-30

2 Acquisition method

2.1 Chapter overview 2-2

2.2 The acquisition method 2-2

2.3 Identifying the acquirer 2-3

2.3.1 New entity formed to effect a business combination 2-5

2.3.2 Other considerations in identifying the acquirer 2-7

2.4 Determining the acquisition date 2-8

2.4.1 Determining the acquisition date for a business combination achieved without the transfer of consideration 2-9

2.5 Recognizing and measuring the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree 2-9

2.5.1 Assets that the acquirer does not intend to use 2-11

2.5.1.1 Defensive intangible assets 2-11

2.5.2 Asset valuation allowances 2-11

2.5.3 Inventory 2-12

2.5.4 Contracts 2-12

2.5.4.1 Loss contracts 2-12

2.5.5 Intangible assets 2-13

2.5.6 Reacquired rights 2-13

2.5.6.1 Determining the value and useful life of reacquired rights 2-14

2.5.7 Property, plant, and equipment 2-15

2.5.7.1 Government grants 2-16

2.5.7.2 Consideration of decommissioning and site restoration costs 2-16

2.5.8 Income taxes 2-16

2.5.9 Recognition of assets held for sale—US GAAP [IFRS] 2-17

2.5.10 Employee benefit plans 2-17

2.5.11 Payables and debt 2-19

2.5.12 Guarantees 2-19

2.5.13 Contingencies 2-20

2.5.13.1 Initial recognition and measurement—US GAAP 2-21

2.5.13.2 Subsequent measurement—US GAAP 2-22

2.5.13.3 Contingent liabilities—IFRS 2-24

2.5.14 Indemnification assets 2-24

2.5.15 Recognition of liabilities related to restructurings or exit activities 2-26

2.5.16 Deferred or unearned revenue 2-27

2.5.17 Deferred charges arising from leases 2-27

2.5.18 Classifying or designating identifiable assets and liabilities 2-28

2.5.19 Financial instruments—classification or designation of financial instruments and hedging relationships 2-30

2.5.20 Long-term construction contracts 2-30

2.5.20.1 Percentage of completion method—prior to adoption of ASC 606 [IFRS 15] 2-31

2.5.20.2 Completed contract method—US GAAP only prior to adoption of ASC 606 2-31

2.6 Recognising and measuring goodwill or a gain from a bargain purchase 2-31

2.6.1 Goodwill 2-31

2.6.2 Bargain purchase 2-32

2.6.3 Measuring and recognizing consideration transferred 2-33

2.6.3.1 Share-based payment awards 2-33

2.6.3.2 Consideration transferred includes other assets and liabilities of the acquirer 2-33

2.6.4 Contingent consideration 2-34

2.6.4.1 Contingent consideration—US GAAP 2-34

2.6.4.2 Contingent consideration—IFRS 2-40

2.6.5 Classification of contingent consideration arrangements—US GAAP and IFRS examples 2-42

2.6.5.1 Contingent consideration arrangements requiring continued employment 2-50

2.6.5.2 Existing contingent consideration arrangements of an acquiree—US GAAP 2-51

2.6.5.3 Existing contingent consideration arrangement of an acquiree—IFRS 2-51

2.6.5.4 Effect of contingent equity issued in a business combination on earnings per share 2-52

2.6.5.5 Contingent consideration—seller accounting 2-53

2.6.6 Noncontrolling interest 2-57

2.6.6.1 Redeemable noncontrolling interest—US GAAP 2-58

2.6.7 Calls and puts related to the noncontrolling interest 2-61

2.6.7.1 Calls and puts related to the noncontrolling interest—US GAAP 2-61

2.6.7.2 Calls and puts related to the noncontrolling interest—IFRS ... 2-67

2.6.8 Treatment of a previously held equity interest in an acquiree 2-70

2.6.9 Business combinations achieved without consideration transferred 2-71

2.7 Assessing what is part of a business combination transaction 2-71

2.7.1 Employee compensation arrangements 2-73

2.7.2 Reimbursement arrangements between the acquiree and the acquirer for transaction costs incurred 2-74

2.7.3 Settlement of preexisting relationships between the acquirer and acquiree 2-75

2.7.3.1 Calculating the gain or loss on settlement of preexisting relationships 2-76

2.7.4 Settlement of debt 2-78

2.7.5 Acquisition-related costs 2-79

2.7.6 Financial instruments entered into by the acquirer in contemplation of a business combination 2-80

2.7.7 Transaction service arrangements 2-80

2.8 Example of applying the acquisition method 2-81

2.9 Measurement period adjustments 2-83

2.10 Reverse acquisitions 2-86

2.10.1 Reverse acquisition (merger) involving a nonoperating public shell and a private operating entity 2-87

2.10.2 Consideration transferred in a reverse acquisition 2-88

2.10.3 Presentation of consolidated financial statements 2-89

2.10.4 Noncontrolling interest in a reverse acquisition 2-92

2.10.5 Computation of earnings per share in a reverse acquisition 2-93

2.11 Applying the acquisition method for variable interest entities and special purpose 2-95

2.12 Conforming accounting policies of the acquiree to those of the acquirer 2-97

2.13 Continuing transition requirements 2-97

2.13.1 Income tax transition provisions 2-97

2.13.1.1 Acquired tax benefits disclosure 2-99

2.14 Contingent consideration of an acquiree 2-99

3 Employee compensation arrangements

3.1 Chapter overview 3-2

3.2 Assessing what is part of the consideration transferred for the acquiree 3-3

3.3 Contingent payments—determining whether the arrangement is compensation.. 3-4

3.3.1 Golden parachute and stay bonus arrangements 3-7

3.4 Exchange of employee share-based payment awards 3-8

3.4.1 Determining the fair value attributable to precombination and postcombination services 3-11

3.4.1.1 Awards with graded-vesting features 3-14

3.4.2 Service required after the acquisition date is equal to or greater than the original service requirement 3-17

3.4.3 Service required after the acquisition date is less than the original service requirement 3-17

3.4.3.1 Acquiree awards with an automatic change in control provision 3-18

3.4.3.2 Acquiree awards with a discretionary change in control provision 3-19

3.4.4 Excess fair value of the acquirer's replacement award 3-19

3.4.5 Acquiree awards that continue after the business combination 3-20

3.4.6 Awards with performance or market conditions 3-20

3.4.7 Illustrative summary of attributing fair value to precombination and postcombination services 3-22

3.5 Cash settlement of employee share-based payment awards 3-25

3.5.1 Initiated by the acquirer 3-25

3.5.2 Initiated by the acquiree 3-26

3.6 Other arrangements 3-27

3.6.1 "Last-man-standing" arrangements 3-27

3.6.2 "Dual trigger" arrangements 3-28

3.7 Postcombination accounting for share-based payment awards 3-30

3.8 US GAAP and IFRS differences—income tax effects of share-based payment awards 3-32

3.8.1 Accounting for the income tax effects of replacement awards—IFRS 3-32

3.9 US GAAP and IFRS difference—recognition of social charges 3-34

4 Intangible assets acquired in a business combination

4.1 Chapter overview 4-2

4.2 Intangible assets and the identifiable criteria 4-2
4.2.1 Contractual-legal criterion 4-3
4.2.2 Separability criterion 4-4
4.2.3 Examples of applying the identifiable criteria 4-5
4.3 Types of identifiable intangible assets 4-6
4.3.1 Marketing-related intangible assets 4-8
4.3.1.1 Trademarks, trade names, and other types of marks 4-8
4.3.1.2 Trade dress, newspaper mastheads, and internet domain names 4-9
4.3.1.3 Noncompetition agreements 4-9
4.3.1.4 Customer-related intangible assets 4-10
4.3.1.5 Customer contracts and related customer relationships 4-10
4.3.1.6 Noncontractual customer relationships 4-12
4.3.1.7 Customer lists 4-13
4.3.1.8 Customer base 4-13
4.3.1.9 Order or production backlog 4-13
4.3.2 Artistic-related intangible assets 4-14
4.3.3 Contract-based intangible assets 4-14
4.3.3.1 Contracts to service financial assets 4-15
4.3.3.2 Employment contracts 4-15
4.3.3.3 Use rights 4-16
4.3.3.4 Insurance and reinsurance contract intangible assets 4-16
4.3.3.5 Favorable and unfavorable contracts 4-16
4.3.3.6 At-the-money contracts 4-18
4.3.3.7 Lease agreements (accounted for under ASC 840 or IAS 17) 4-18
4.3.4 Technology-based intangible assets 4-25
4.3.4.1 Intangible assets used in research and development activities 4-26
4.3.4.2 Patented technology, unpatented technology, and trade secrets 4-26

4.3.4.3 Computer software, mask works, databases, and title plants 4-26

4.4 Complementary intangible assets and grouping of other intangible assets 4-27

4.4.1 Assessment of other factors in determining grouping of complementary assets—US GAAP 4-28

4.5 Intangible assets that the acquirer does not intend to use or intends to use differently than other market-participants 4-28

4.6 Summary of intangible assets and typical useful life characteristics found in major industries 4-30

4.7 Private company accounting alternative for intangible assets acquired in a business combination under US GAAP 4-34

4.7.1 Customer-related intangible assets 4-34

4.7.2 Noncompetition agreements 4-36

4.7.3 Disclosures 4-36

4.7.4 Transition and related considerations 4-36

5 Partial acquisitions, step acquisitions, and accounting for changes in the noncontrolling interest

5.1 Chapter overview 5-2

5.2 Definition and classification of the noncontrolling interest 5-2

5.2.1 Measurement of the noncontrolling interest—fair value method 5-3

5.2.2 Measurement of the noncontrolling interest—proportionate share method—IFRS 5-3

5.3 Accounting for changes in ownership interest 5-4

5.4 Accounting for partial and step acquisitions 5-7

5.4.1 Fair value method 5-7

5.4.2 Remeasurement of previously held equity interest in a business or VIE and recognition of gains and losses 5-7

5.4.3 Examples of the fair value method 5-8

5.4.4 Fair value considerations 5-12

5.4.5 Consideration of goodwill when noncontrolling interest exists—US GAAP 5-12

5.4.6 Consideration of goodwill when noncontrolling interest exists—IFRS 5-12

5.4.7 Bargain purchase in a partial or step acquisition—US GAAP companies and IFRS companies choosing the fair value method 5-13

5.4.8 Partial acquisition and step acquisition—proportionate share method—IFRS 5-14

5.4.9 Bargain purchase in a partial or step acquisition—proportionate share method—IFRS 5-17

5.5 Accounting for changes in ownership interest that do not result in loss of control 5-19

5.5.1 Parent company accounting for an equity-classified freestanding written call option on subsidiary's shares 5-28

5.5.2 Parent company accounting for employee stock option issued by a subsidiary 5-31

5.5.3 Accounting for a transaction in which a noncontrolling interest in a wholly owned subsidiary is exchanged for a controlling interest in another entity 5-31

5.5.4 Accumulated other comprehensive income considerations 5-33

5.5.5 Accumulated other comprehensive income considerations when the parent disposes of a group of assets in a consolidated foreign entity 5-34

5.5.6 Acquisition of a noncontrolling interest through a business combination 5-35

5.5.7 Acquisition of additional ownership interests in a variable interest entity—US GAAP 5-37

5.6 Changes in interest resulting in a loss of control 5-37

5.6.1 Loss of control—US GAAP 5-38

5.6.2 Loss of control—IFRS 5-38

5.6.3 Accounting for changes in interest if control is lost 5-39

5.6.4 Retained noncontrolling investment 5-43

5.6.5 Nonreciprocal transfer to owners 5-44

5.6.6 Multiple transactions or agreements that result in loss of control 5-44

5.6.7 Multiple transactions or agreements that result in gaining control 5-45

5.7 Attribution of net income and comprehensive income to controlling and noncontrolling interests 5-45

5.7.1 Attribution of losses to noncontrolling interests in excess of carrying amount of noncontrolling interests 5-46

5.7.2 Attribution of other items to noncontrolling interests in excess of carrying amount of noncontrolling interests–US GAAP 5-46

5.8 Recognition of gain or loss by investor in a joint venture—IFRS 5-47

5.9 Accounting for transaction costs associated with sale or purchase of noncontrolling interest 5-47

5.10 Required disclosures and supplemental schedule 5-47

5.11 Classification of financial instruments as noncontrolling interest 5-48

6 Common control transactions

6.1 Chapter overview 6-2

6.2 Common control transactions under US GAAP 6-3

6.2.1 Assessing whether common control exists 6-4

6.2.1.1 Common control and control groups 6-5

6.2.1.2 Entities consolidated under the variable interest approach (the variable interest entities subsections of ASC 810-10) 6-6

6.2.1.3 Entities with a high degree of common ownership 6-6

6.2.2 Nature of the transfer 6-9

6.2.2.1 Specialized accounting considerations 6-9

6.2.3 Accounting and reporting by the receiving entity 6-12

6.2.3.1 Basis of transfer 6-12

6.2.3.2 Guidance for presenting a change in reporting entity 6-14

6.2.3.3 Determining the on-going reporting entity in certain common control transactions 6-15

6.2.3.4 Noncontrolling interest in a common control transaction 6-17

6.2.3.5 Goodwill impairment and reporting unit assessment 6-20

6.2.3.6 Deferred taxes 6-22

6.2.3.7 Last-In, First-Out (LIFO) inventories 6-23

6.2.3.8 Conforming accounting policies 6-23

6.2.4 Accounting and reporting by the contributing entity 6-23

6.2.4.1 Accounting for the transfer 6-23

6.2.4.2 Allocation of contributed entity goodwill 6-25

6.2.4.3 Transfers to owners 6-26

6.3 Common control transactions under IFRS 6-27

6.3.1 Assessing whether common control exists 6-28

6.3.1.1 Common control and control groups 6-29

6.3.1.2 Entities with a high degree of common ownership 6-31

6.3.2 Transitory common control 6-32

6.3.3 Nature of the acquisition—group of assets or net assets versus business 6-34

6.3.4 Business combinations versus reorganisations 6-34

6.3.5 Predecessor values method 6-34

6.3.5.1 Basis of transfer 6-34

6.3.5.2 Financial statement presentation 6-36

6.3.6 Noncontrolling interest in a common control business combination 6-36

6.3.7 Accounting and reporting by the selling (contributing) entity 6-39

7 Asset acquisitions

7.1 Chapter overview 7-2

7.2 Assets acquired in an exchange transaction 7-2

7.2.1 Initial Recognition 7-2

7.2.2 Initial measurement 7-3

7.2.2.1 Nonmonetary transactions accounting—US GAAP 7-3

7.2.2.2 Nonmonetary transactions accounting—IFRS 7-4

7.2.3 Allocating cost (the fair value of consideration given) 7-4

7.2.4 Accounting for an asset acquisition versus a business combination 7-5

7.2.5 Accounting after acquisition 7-12

7.2.6 Acquisition of intangible assets disclosures 7-12

8 Accounting for intangible assets postacquisition—US GAAP

8.1 Chapter overview 8-2

8.2 Indefinite-lived intangible assets 8-2

8.2.1 Reclassification of intangible assets between indefinite-life and finite-life categories 8-3

8.2.2 Renewable intangible assets 8-3

8.2.3 Reacquired rights 8-4

8.2.4 Intangible assets used in research and developmental activities 8-4

8.2.4.1 Enabling technology 8-5

8.3 Impairment of indefinite-lived intangible assets 8-5

8.3.1 The indefinite-lived intangible asset impairment test 8-6

8.3.1.1 The qualitative indefinite-lived intangible asset impairment assessment 8-7

8.3.1.2 Selecting an indefinite-lived intangible asset for the qualitative assessment 8-8

8.3.1.3 Considering the results of prior fair value measurements in the qualitative assessment 8-9

8.3.1.4 Periodically refreshing an indefinitve-lived asset's fair value 8-10

8.3.2 The quantitative indefinite-lived intangible asset impairment test 8-10

8.3.2.1 Unit of accounting for indefinite-lived intangible assets 8-10

8.4 Assets that an acquirer does not intend to actively use, including defensive assets 8-14

8.5 Financial statement presentation and disclosure guidance 8-15

9 Accounting for goodwill postacquisition—US GAAP

9.1 Chapter overview 9-2

9.2 Identify reporting units 9-3

9.2.1 Operating segments as the starting point for determining reporting units 9-4

9.2.2 Reporting unit may be an operating segment or one level below 9-5

9.2.3 Discrete financial information and business requirement for components 9-5

9.2.4 Components are combined if economically similar 9-6

9.2.5 Aggregation of components across operating segments is not permitted 9-6

9.2.6 Periodic reassessment of reporting units 9-7

9.2.7 Summary of impact of reporting levels on determining reporting units 9-7

9.3 Assigning assets and liabilities to reporting units 9-10

9.3.1 Assigning assets and liabilities relating to multiple reporting units 9-9

9.3.2 Assigning corporate assets and liabilities 9-12

9.3.3 Interaction between assigning assets and liabilities to reporting units and segment reporting 9-12

9.3.4 "Full" allocation for entities with a single reporting unit 9-12

9.3.5 Guidance for specific balance sheet components 9-12

9.4 Assigning all recorded goodwill to one or more reporting units 9-16

9.4.1 Determination and recognition of goodwill in partial acquisitions 9-18

9.4.2 Goodwill attributable to controlling and noncontrolling interests 9-19

9.4.3 Determination of fair value for the noncontrolling interest 9-20

9.4.4 Reassignment of goodwill as an acquirer's reporting structure changes 9-20

9.4.5 Translation of goodwill denominated in a foreign currency 9-22

9.4.6 Documentation to support goodwill assignment 9-23

9.4.7 Other considerations 9-24

9.4.7.1 Subsequent resolution of certain matters arising from acquisitions recorded prior to the adoption of ASC 805 that may continue to impact goodwill 9-24

9.4.7.2 Litigation stemming from a business combination 9-25

9.5 Impairment model 9-26

9.5.1 Timing considerations for goodwill impairment testing 9-27

9.5.1.1 Triggering events for goodwill impairment testing 9-28

9.5.1.2 Annual goodwill impairment testing dates 9-31

9.6 The qualitative goodwill impairment assessment 9-33

9.6.1 Selecting reporting units for the qualitative assessment 9-36

9.6.2 Considering the results of prior fair value measurements in the qualitative assessment 9-36

9.6.3 Periodically refreshing a reporting unit's fair value 9-37

9.6.4 An entity's assertion of its annual qualitative assessment 9-37

9.6.5 Qualitative assessment for reporting units with zero or negative carrying amounts 9-38

9.7 Fair value considerations 9-39

9.7.1 Determining the fair value of a reporting unit 9-39

9.7.2 Determining the fair value of reporting units to which goodwill has been assigned 9-40

9.7.3 Considerations unique to determining the fair value of reporting units when using the income approach 9-42

9.7.4 Considerations unique to determining the fair value of reporting units when using the market approach 9-43

9.7.5 Use of quoted market price of a reporting unit on a single date 9-45

9.7.6 Use of more than one valuation technique to estimate the fair value of a reporting unit 9-46

9.7.7 Reconciling the aggregate fair values of the reporting units to market capitalization 9-46

9.8 The quantitative goodwill impairment test 9-48

9.8.1 Step one: fair value of the reporting unit 9-48

9.8.1.1 Additional considerations for performing step one – prior to adoption of ASU 2017-04 9-48

9.8.1.2 Additional considerations for performing step one – after adoption of ASU 2017-04 9-49

9.8.1.3 Reporting units with zero or negative carrying amounts – after adoption of ASU 2017-04 9-52

9.8.2 Step two: implied fair value – before the adoption of ASU 2017-04 9-52

9.8.2.1 Application of step two of the impairment test for goodwill 9-53

9.8.2.2 Step two may not always result in an impairment loss 9-54

9.8.2.3 Consistency between the fair values used to test indefinite-lived intangible assets for impairment and step two of the goodwill impairment test 9-54

9.8.2.4 Consistency of valuation methodologies between ASC 805 and step two of the goodwill impairment test 9-54

9.8.2.5 Estimate of an impairment loss if assessment is not completed before issuing financial statements 9-56

9.9 Other impairment assessment considerations 9-56

9.9.1 Deferred income tax considerations when determining the fair value of a reporting unit and the implied fair value of goodwill of a reporting unit 9-56

9.9.1.1 Income tax effect of goodwill impairment loss – after adoption of ASU 2017-04 9-61

9.9.2 Impairment of goodwill shortly after acquisition 9-63

9.9.3 Interaction with impairment testing for other assets 9-63

9.9.4 Impairment testing when a noncontrolling interest exists 9-64

9.9.4.1 Fair value of a noncontrolling interest may differ depending on whether a noncontrolling interest exists above the reporting unit or within the reporting unit 9-69

9.9.4.2 Impairment testing when a noncontrolling interest exists and the reporting unit contains goodwill from multiple acquisitions 9-70

9.9.4.3 Impairment testing of goodwill for separate subsidiary financial statements 9-72

9.9.4.4 Impact of impairment at a subsidiary level on impairment testing at the parent level 9-72

9.9.5 Equity-method investment goodwill not subject to the ASC 350-20 impairment test 9-73

9.9.6 Allocation of impairment to goodwill components for tax purposes 9-74

9.9.7 Different aggregation of goodwill for ASC 740-10 and ASC 350-20 9-81

9.10 Disposal considerations 9-81

9.10.1 Impairment testing in connection with the disposal of a business 9-82

9.10.2 Expectation of a disposal 9-82

9.10.3 Assets held for sale 9-82

9.10.4 Disposal of the business 9-83

9.10.5 Allocation of goodwill in a spin-off 9-85

9.10.6 Allocation of goodwill for a nonmonetary exchange transaction 9-86

9.11 Presentation and disclosures 9-87

9.12 Private company accounting alternative 9-87

9.12.1 Amortization of goodwill 9-89

9.12.2 Amortization after initial adoption 9-89

9.12.3 Impairment model 9-90

9.12.4 Level to test goodwill for impairment 9-90

9.12.5 Frequency of impairment testing 9-90

9.12.6 The goodwill impairment test 9-90

9.12.7 Measurement of an impairment loss 9-91

9.12.8 Allocation of an impairment loss 9-93

9.12.9 Disposal considerations 9-94

9.12.10 Presentation and disclosure 9-94

10 Postacquisition accounting issues—IFRS

10.1 Chapter overview 10-2

10.2 Overview of impairment testing under IAS 36 10-2

10.3 Accounting issues for the acquirer 10-3

10.3.1 Indemnification assets 10-3

10.3.2 Contingent consideration 10-4

10.4 Intangible assets 10-5

10.4.1 Grouping intangible assets 10-5

10.4.2 Intangible assets—useful lives 10-6

10.4.3 Renewal periods 10-6

10.4.4 Reacquired rights 10-6

10.4.5 Indefinite useful lives 10-7

10.4.6 Acquired in-process research and development 10-7

10.4.7 Intangible assets that the acquirer does not intend to use 10-7

10.4.8 Amortization 10-7

10.4.9 Specific issues in impairment testing of intangible assets 10-8

10.5 Goodwill 10-10

10.5.1 Goodwill and the valuation choice for noncontrolling interests 10-11

10.5.2 Allocating goodwill impairment losses to controlling and noncontrolling interests 10-12

10.5.3 Disposals and group reorganizations with goodwill 10-16

10.6 Impairment of assets 10-16

10.6.1 Scope of IAS 36 10-16

10.6.2 Indicators of impairment 10-17

10.6.3 Determination of cash-generating units 10-18

10.6.4 Grouping cash-generating units 10-19

10.6.5 Allocating assets and liabilities to cash-generating units 10-20

10.6.6 Determining recoverable amount—fair value less costs of disposal 10-21

10.6.7 Determining recoverable amount—value in use 10-22

10.6.8 Cash flows for value in use 10-22

10.6.9 Selection of a discount rate 10-23

10.6.10 Recognizing an impairment loss 10-23

10.6.11 Reversing an impairment loss 10-24

11 Other business combination considerations

11.1 Chapter overview 11-2

11.2 Insurance industry considerations 11-2

11.2.1 Accounting for business combinations 11-2

11.2.2 Distinguishing between a business combination, a reinsurance transaction, and an asset acquisition 11-3

11.2.3 Acquired insurance and reinsurance contracts in a business combination 11-4

11.2.4 Insurance contract intangible assets and liabilities related to insurance contracts acquired in a business combination 11-4

11.2.4.1 Insurance contract intangible asset and liabilities related to acquired non-life short-duration and financial guarantee insurance contracts under US GAAP 11-4

11.2.4.2 Insurance contract intangible asset and liabilities related to acquired long-duration insurance contracts under US GAAP 11-6

11.2.4.3 Insurance contract intangible asset and liabilities related to acquired insurance contracts under IFRS 11-8

11.2.4.4 Postcombination accounting for insurance contract intangible asset and liabilities related to insurance contracts acquired in a business combination 11-8

11.2.5 Other intangible assets recognized in a business combination 11-9

11.2.6 Contingent commissions and sellers' claim liability guarantees 11-10

11.3 Pushdown accounting 11-11

11.3.1 Scope 11-11

11.3.2 Identifying the acquirer is the first step 11-11

11.3.3 Considerations when making the pushdown election 11-12

11.3.4 Change-in-control events 11-12

11.3.5 When to make the pushdown accounting election 11-13

11.3.6 Applying pushdown accounting 11-13

11.3.7 Other considerations 11-14

11.3.7.1 Expenses incurred on behalf of a subsidiary 11-15

11.3.7.2 Foreign currency translation 11-15

11.3.7.3 Tax bases 11-15

Appendices

A **Professional literature** **A-1**

B **Technical references and abbreviations** **B-1**

C **Key terms** **C-1**

D **Summary of significant changes** **D-1**

Chapter 1:
Scope

1.1 Chapter overview

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* (ASC 805), and in International Financial Reporting Standard 3 (revised 2008), *Business Combinations* (IFRS 3) (collectively, the "Standards"). 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 the Standards.

Some differences exist between the definitions of a business combination under US generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRS). The converged definitions use terms that US GAAP and IFRS define differently in other nonconverged standards. For example, the Standards state that for a business combination to occur, an acquirer must obtain control over a business. US GAAP and IFRS define control differently. That difference may lead to divergent accounting results. IFRS 10, *Consolidated Financial Statements* (IFRS 10), incorporates the concepts of effective control and substantive potential voting rights, whereas US GAAP does not.

New guidance

In January 2017, the FASB issued Accounting Standards Update 2017-01, *Clarifying the Definition of a Business*. The changes to the definition of a business will likely result in more transactions being accounted for as asset acquisitions rather than business combinations across most industries. The definition of a business also affects many other areas of accounting, including disposals, consolidation, and reporting unit determinations.

For public business entities, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. Prospective application is required.

Guidance on whether an acquired group is an asset acquisition or a business combination before and after adoption of ASU 2017-01 is covered in BCG 1.2 and 1.3, respectively.

Note about ongoing standard setting

As of the content cutoff date of this guide (December 2017), active FASB and IASB (collectively, the "Boards") projects may result in amendments to existing guidance. This includes the third phase in the definition of a business project in which the FASB may revisit the accounting differences between asset and business acquisitions and disposals.

Additionally, the IASB issued an exposure draft in June 2016 proposing to clarify the definition of a business under IFRS 3, *Business Combinations*. The proposed amendments are substantially the same as the amendments issued by the FASB in ASU 2017-01. A key distinction is the screen test (discussed in BCG 1.3), which is required under US GAAP is optional in the IASB's proposal. The proposed amendments will likely result in more acquisitions being classified as asset acquisitions although the impact is expected to be less significant compared to US GAAP. The new definition cannot be applied under IFRS until guidance is issued and must be applied in accordance with the transition provisions.

Financial statement preparers and other users of this publication are encouraged to monitor the status of these projects, evaluate the effective dates and determine the implications on accounting, presentation and disclosure.

1.2 Definition of a business — before adoption of ASU 2017-01

All transactions in which an entity obtains control of one or more businesses qualify as business combinations. The Standards establish the following principle for identifying a business combination:

Excerpts from ASC 805-10-25-1 and IFRS 3.3

An entity shall determine whether a transaction or other event is a business combination by applying the definition in this Subtopic [IFRS], 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.

It is straightforward in most cases to determine whether a group of acquired assets and assumed liabilities (i.e., an integrated set of activities and assets) is a business. However, this determination can be complicated in some instances, including when the fair value of the acquired group is concentrated in just one or a few assets, or when the acquired group produces little or no revenue.

As discussed in ASC 805-10-55-5 and IFRS 3.B7, an acquired group must have inputs and processes that make it capable of generating a return or economic benefit for the acquirer's investors to be considered a business. Economic benefits can occur in many forms, such as dividends, capital appreciation, or cost reductions.

The Standards define a business, inputs, processes, and outputs as follows:

Excerpts from ASC 805-10-20, ASC 805-10-55-4 and IFRS 3.A, IFRS 3.B7

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.

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

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

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

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

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 and IFRS 3.B7, 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.

Not all of the inputs and associated processes used by the seller need to be transferred to be considered a business. Under ASC 805-10-55-5 and IFRS 3.B8, a business exists if a market-participant (see BCG 1.2.4) is capable of continuing to manage the acquired group to provide a return (e.g., the buyer would be able to integrate the acquired group with its own inputs and processes). Inputs and associated processes used by the seller that were not transferred, but that can be easily obtained, indicate the acquired group is a business. See BCG 1.2.4 for further information.

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. A new or developing business may not have or need as many inputs, processes, or outputs as a larger established business. Additionally, the absence of an element generally found in a business does not mean that the acquired group does not constitute a business. As discussed in ASC 805-10-55-6 and IFRS 3.B9, while nearly all businesses have liabilities, an acquired group need not have any liabilities to be considered a business. An acquired group or acquired input that contains no processes is not a business.

ASC 805-10-55-5 and IFRS 3.B8

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

The acquirer's intended use of an acquired group of activities and assets is not a factor in the determination of whether an acquired group constitutes a business. As detailed in ASC 805-10-55-8 and IFRS 3.B11, it is also not relevant whether the seller operated the acquired group as a business. For example, the fact that the acquirer intends to split the acquired group into components, sell some of the components, and integrate the remaining ones, does not impact the determination of whether the acquired group as a whole is a business.

1.2.1 *Development stage enterprises*

Development stage enterprises that have no revenues may still be considered businesses. ASC 805-10-55-7 and IFRS 3.B10 include key factors to consider to determine if a development stage enterprise is a business, including whether:

- Planned principal operations have begun
- Employees, intellectual property, and other inputs and processes are present
- A plan to produce outputs is being pursued
- Access to customers that will purchase the outputs can be obtained

Not all of these conditions need to exist for a development stage enterprise to qualify as a business. For example, under previous US GAAP, a development stage enterprise typically was not considered a business until it had commenced its planned principal operations. Although a factor to consider, that would not be a prerequisite under the Standards. Generally, a development stage enterprise that has employees capable of developing a product will be considered a business.

1.2.2 *The presence of goodwill*

Under ASC 805-10-55-9 and IFRS 3.B12, it is presumed that a business exists when goodwill is present in the acquired group. Evidence to the contrary would be needed to overcome this presumption. Therefore, the presence of goodwill in the acquired group implies 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, recognised, 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).

1.2.3 *Distinguishing a business from an asset or group of assets*

Uncertainty may exist as to whether a transaction is the acquisition of a business or a group of assets. The Standards provide a framework for making this determination. Under this framework, an entity:

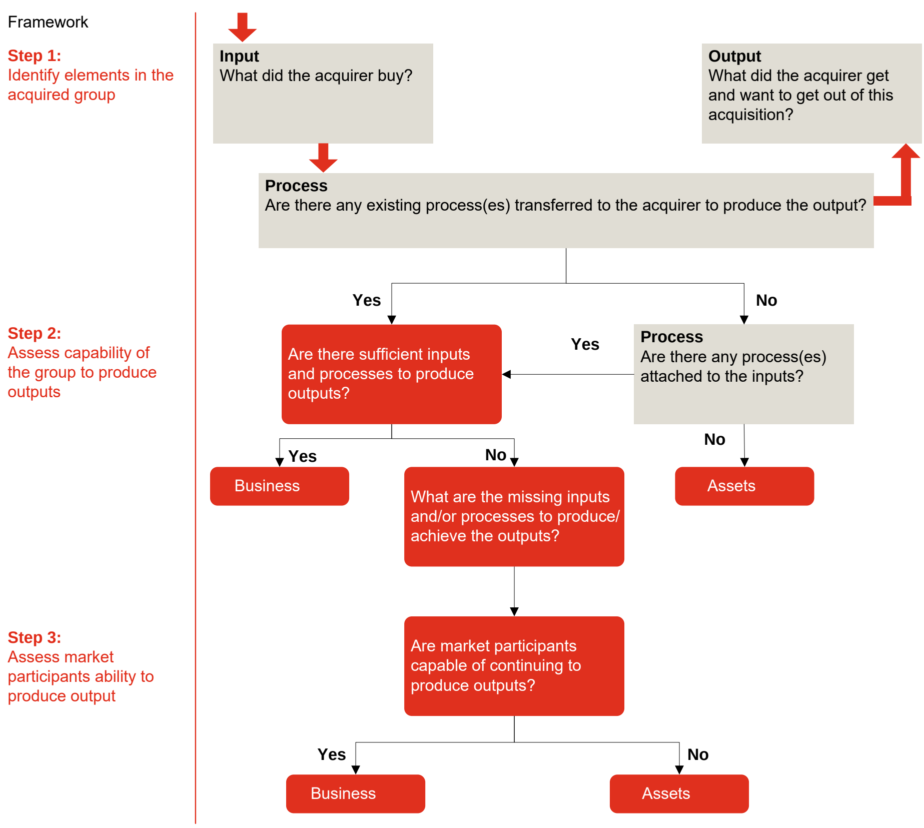
- Identifies the elements in the acquired group
- Assesses the capability of the acquired group to produce outputs
- Assesses the impact that any missing elements have on a market participant's ability to produce outputs with the acquired group

An entity should first identify the elements in the acquired group. If an asset or group of assets (physical or intangible) is not accompanied by any associated processes, the acquired group is likely a group of assets, not a business. Identifying the accompanying inputs and associated processes might be difficult. For example, a company that purchases a hotel might consider the purchase to be a single asset. However, in most cases, the company also acquires other inputs (e.g., employees, computer equipment, furniture and fixtures, and other assets) and associated processes (e.g., a reservation system, operating systems, procedures, and policies). Also, the acquired hotel may be a longstanding operation that has a recognised name and regular customers. These factors taken together indicate that the hotel is a business.

Next, the entity should analyze the acquired group's capability to produce outputs—that is, to generate a return to its investors, which may include dividends, capital appreciation, and cost reductions. If it is determined that the acquired group is not capable of producing outputs, the entity would need to identify the missing elements that will make the acquired group capable of doing so. After identifying the missing elements, the entity should determine whether those elements can be provided by market participants. As described in ASC 805-10-55-5 and IFRS 3.B8, a market participant may be able to replace the missing elements by integrating the acquired group into its own operations. Missing elements that can be easily replicated or obtained should be considered replaceable by market participants. If market participants are not expected to be able to replace the missing elements and, thus, manage the acquired group in a way that would provide a return to its investors, ASC 805-10-55-5 and IFRS 3.B8 indicate that the acquired group would not be considered a business. The ability of market participants to continue to manage the acquired group to provide a return without the missing inputs and processes is a matter of judgment and is based on the individual facts and circumstances.

Figure 1-1 provides a framework to help determine whether a transaction is the acquisition of a business or a group of assets.

Figure 1-1
Distinguishing a business from an asset or group of assets



1.2.4 *Identifying market participants when determining whether an acquired group is a business*

Missing elements in the acquired group should be evaluated from a market participant's perspective. A market participant must be able to operate the acquired group to provide an economic return for a business to exist. Both US GAAP (ASC 820-10-20) and IFRS (IFRS 13.A) define market participants as buyers and sellers in the principal (or most advantageous) market for an asset or a liability that are independent, knowledgeable, able, and willing parties. FV 4 further discusses the determination of market participants for this purpose and for the purpose of valuing certain assets acquired and liabilities assumed in a business combination (see FV 4).

1.2.5 *Distinguishing a business from an asset or group of assets*

Examples 1-1 through 1-9 may be helpful in determining whether a transaction involves the acquisition of a business or an asset (or a group of assets).

EXAMPLE 1-1

Distinguishing a business from an asset or group of assets: acquired assets and operations without outputs

Video Game Software Company has been formed to design video games. The current activities of the company include researching and developing its first product and creating a market for the product. Since its inception, the company has not generated any revenues and has received funding from third parties. With a workforce composed primarily of engineers, the company has the intellectual property needed to design the video game, as well as the software and fixed assets required to develop it. The company does not have commitments from customers to buy any games. The company is being purchased by a financial investor, a venture capital fund, which intends to take the company public.

Has the financial investor acquired a business or a group of assets?

Analysis

It is likely that the company would be considered a business. The elements in the acquisition contain both inputs and processes. The inputs include the intellectual property used to design the software, fixed assets, and employees. The processes include strategic and operational processes for developing the software. It is likely that the acquired group (i.e., the company) includes all of the inputs and processes necessary to manage and produce outputs. The lack of outputs, such as a product, does not prevent the company from being considered a business.

EXAMPLE 1-2

Acquired assets and operations missing an element

Company A purchases the organic food operations of Company B, a large multinational conglomerate, with the intent of continuing the organic food operations as a separate division. Company B is organised so that the organic food operations are separate legal entities in some countries and separate divisions in other countries. Management, employees, product distribution agreements, brand names, copyrights, and key systems (e.g., ordering, billing, inventory) are included in the acquired organic food operations. However, the sales force that sells Company B's products is not part of the transaction.

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

Analysis

It is likely that the organic food operations would be considered a business. The elements in the acquisition include both inputs (namely, product distribution agreements, brand names, management, and some employees) and processes (e.g., key operating systems, procedures, and protocols). Since the sales force was not acquired, the acquired group did not include all of the inputs and associated processes necessary to manage and produce outputs. The lack of a sales force (one capable of initiating sales and creating revenues) impacts the acquired group's ability to produce economic benefits.

Company A may determine that the likely market participants would be strategic buyers that have an existing sales force. Therefore, the missing sales force would not prevent the acquired group from being a business. Company A's intent to continue the organic food operations as a business does not affect the evaluation of whether the acquired group is a business. The acquired group would still be considered a business, even if Company A entered into the transaction with the intent to eliminate a competitor and cease the operations of the acquired group.

Even if the market participant does not have an existing sales force, the acquired group might still be considered a business if the missing input (i.e., sales force) can be easily replicated or obtained. This will require judgment and will be based on the facts and circumstances in each situation.

EXAMPLE 1-3

Acquired assets and operations using an outsourcing arrangement

Outsource Company provides information technology outsourcing services. State Utility generates and supplies electricity. State Utility's billing and other information technology systems consume significant computer and staff resources. State Utility also uses these systems to provide billing and accounting services to a number of smaller utilities. The company and State Utility have entered into an agreement under which the company will provide all of State Utility's information technology services for 15 years. The company will acquire all of State Utility's back-office computer equipment, related buildings, and third-party service contracts. All staff currently employed by State Utility in its information technology function will transfer to the company. The company will, in addition to providing information technology services, restructure the information technology operations to improve efficiency and reduce the number of employees.

Has State Utility acquired a business or a group of assets?

Analysis

It is likely that the assets and related operations acquired by the company would constitute a business. The elements in the acquisition include inputs (e.g., buildings, employees, and computer equipment), processes (e.g., computer systems and operating processes), and outputs (e.g., the existing contracts with other utilities and the new service contract with State Utility). As a result, the acquired group is able to generate a return. In this situation, identification of the market participants is unnecessary, because there are no missing elements in the acquired group.

EXAMPLE 1-4

Acquisition in the oil and gas industry

Company C is an oil and gas exploration and production company that owns a proven but undeveloped property. Company C has performed enough exploration activities to determine that the property is proven, but has not yet begun to extract the mineral reserves from the property. Additionally, Company C has constructed transportation infrastructure that will be used to transport the mineral reserves. However, this infrastructure has not yet been placed into operation. Company D is an oil and gas production company that operates a large portfolio of producing properties. Company D acquires Company C.

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

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., proven property and transportation infrastructure) and processes (supporting the exploration activities). However, the acquired group is missing some of the elements required to produce outputs. Company D may determine that the likely market participants would have or could easily obtain the necessary operational processes to manage the acquired group in a way that would provide a return to investors. Therefore, the missing elements would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-5

Acquisition in the pharmaceutical industry

Company E is a pharmaceutical company that owns the rights to several product candidates (drug compounds). Company E's current activities include researching and developing the product candidates. Company E does not have a manufacturing facility and has no revenues or commitments from customers if and when any of the product candidates become marketable. Company E employs management and administrative personnel, as well as scientists who conduct product testing and development and have established protocols and procedures to carry out these functions. Company F is an established pharmaceutical company with a large sales force. Company F acquires certain assets of Company E, including the rights to the product candidates and related testing and development equipment. Company F also hires the scientists formerly employed by Company E.

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

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., the rights to the product candidates and the related testing and development equipment) and processes (e.g., operating protocols and procedures developed and applied by the scientists). While certain elements were not acquired (e.g., manufacturing capabilities, management and sales personnel), Company F may determine that the likely market participants would be strategic buyers that have these missing elements or could easily obtain them. Therefore, these missing elements would not prevent the acquired group from being a business. In addition, the determination of whether Company E is a development stage enterprise would not preclude an assessment that the acquired group constitutes a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-6

Acquisition in the hotel industry

A multinational hotel group enters into a purchase agreement with a local hotel group in country A. The local hotel group owns and operates hotels in country A and wishes to refocus its operations to concentrate on key hotels. The local hotel group agrees to sell a number of non-core hotels to the multinational hotel group. Customer lists, fixtures and fittings, and staff employed at each property will be transferred to the multinational hotel group. The multinational group will be entitled to all revenue on any bookings existing at the agreement date. The multinational hotel group will rebrand the hotels and transfer the systems of the hotels to its own systems and processes.

Has the multinational hotel group acquired a business or a group of assets?

Analysis

It is likely that the acquired group would be a business. The acquired group contains inputs (e.g., properties accompanied by fixtures and fittings, customer lists, and an existing order book) and processes (e.g., management and operational processes as a result of acquiring staff required to operate each hotel). The key elements present that enable the acquired group to produce outputs are the internal structure of each property as a hotel with the appropriate fixtures and fittings, staff, customer lists, and processes. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-7

Acquisition in the real estate industry

Company W owns and manages a group of commercial real estate rental properties. Company W purchases a commercial office property in a large city. The purchased property is 90% occupied, and Company W will become a party to the lease agreements upon acquisition. Company W will replace existing security, cleaning, and maintenance contracts with new contracts. In addition, the existing property management agreement will be terminated and Company W will undertake all property management functions, such as collecting rent and supervising work. In connection with the transaction, Company W will also hire the current leasing and other personnel involved with the operations of the property.

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

Analysis

It is likely that the acquired group would be a business. Company W acquired inputs (e.g., commercial property, lease agreements, and key leasing and management personnel) and processes (e.g., personnel with requisite skills and experience). Further, rental income (i.e., an output) is present immediately after the acquisition. Company W concluded that other market participants would have existing property management expertise. Therefore, the missing elements would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-8

Acquisition in the port industry

An international shipping company purchased a storage and warehouse facility at an Asian port, including all of the related assets except software. The warehouse earned rental income on storage units and associated service fees by using its existing assets and workforce prior to the acquisition. The international shipping company retained the management team and workforce for their experience and relationship with local port authorities, but did not retain any customers as the warehouse will only be used by the acquirer to offer extended services to its own customers.

Has the international shipping company acquired a business or a group of assets?

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., facility infrastructure and machinery and equipment) and some processes (e.g., operational procedures and expertise and industry knowledge through the retention of the management team and workforce). Though the software may be considered fundamental to the business, the international shipping company determined that likely market participants could easily purchase new software or replicate the existing software. Therefore, the missing software would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-9

Acquisition in the shipping industry

A shipping and warehousing company provides shipping and storage services to various third parties. A consumer retail company plans to purchase several warehouses from the shipping and warehousing company and intends to use the warehouses to enhance its inventory distribution system. The acquired group includes only the land and warehouses. It does not include warehousing contracts with third parties, nor does it include employees, warehouse equipment, or information technology systems, such as inventory-tracking systems.

Has the consumer retail company acquired a business or group of assets?

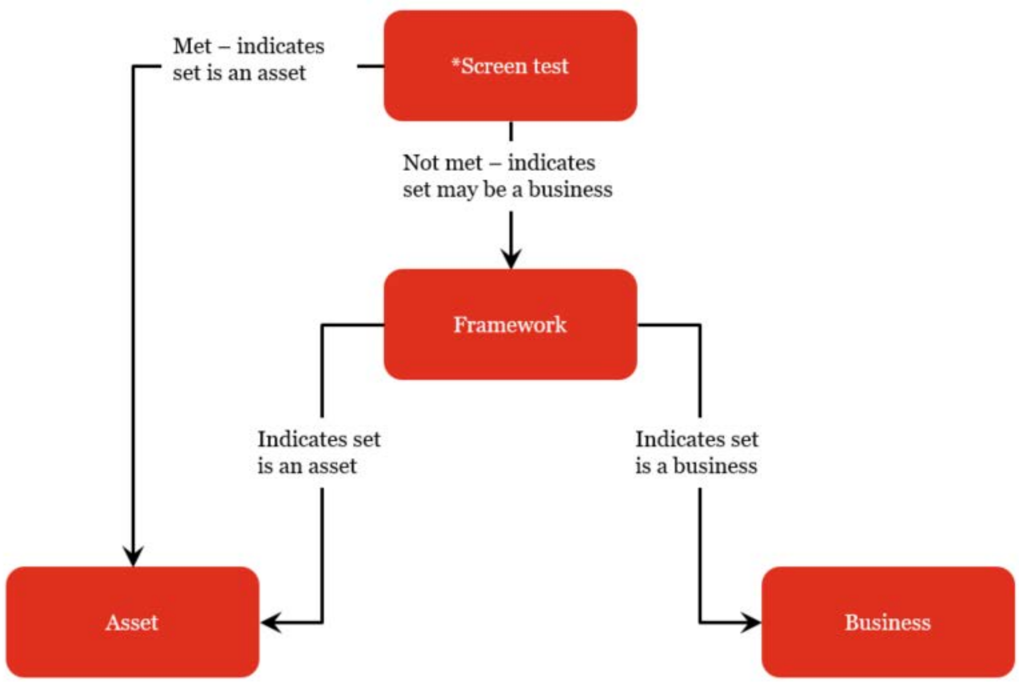
Analysis

It is unlikely that the acquired group would be a business. The acquirer will purchase only inputs (i.e., the physical assets) and no accompanying processes. The acquired group is missing significant inputs and processes. Without these missing elements, the acquired group is not likely to meet the definition of a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

1.3 Definition of a business – after adoption of ASU 2017-01

ASU 2017-01 created a new 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 added 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 new framework also specifies the minimum required inputs and processes necessary to be a business and removes the need to consider a market participant's ability to replace missing elements. Refer to BCG 1.1 for discussion of the IASB project related to the definition of a business. Figure 1-2 provides a summary of the new US GAAP framework.

Figure 1-2
Framework summary for evaluating whether an acquired set is a business or a group of assets



*An entity may bypass the screen test and first evaluate the set under the more detailed framework. However, if the framework indicates that the acquired set is a business, an entity should be comfortable that the acquired set would not meet the threshold in the screen to be considered an asset acquisition. An entity can evaluate the set in the most cost-effective manner.

1.3.1 *The screen test*

The new definition of a business was developed as many stakeholders believed the definition of a business was being applied too broadly. The screen test provides an element of simplification meant to reduce the number of transactions needing to be evaluated. It was 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%.

The initial screen may be performed qualitatively in situations when it is apparent that performing a quantitative test would indicate the transaction is an asset acquisition. For example, assume an acquisition of 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 while, 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 entity could qualitatively determine that the threshold is not met.

1.3.1.1 Single asset

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). For example, ASC 805 allows certain complementary intangible assets with similar useful lives to be grouped as a single asset.

The guidance specifies certain assets that must be grouped for purposes 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 current US GAAP.

Below are two scenarios in which separately recorded assets must be grouped into a single asset for the purpose of 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).

1.3.1.2 Similar assets

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 will require significant judgment. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets. 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.

The guidance states that the following should not be considered similar assets for the purpose of performing the screen:

- A tangible asset and separate intangible asset

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

Question 1-1

When two or more assets are combined as similar for purposes of the screen test, how should the assets be recorded within the company's books and records?

PwC response

The assets used for the screen test can be different than the assets recorded for financial reporting. Assets that are attached and inseparable should be considered a single asset for purposes of 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 purposes of the screen test. However, for financial reporting purposes, three separate assets would be recorded in the company's financial statements. The three separate assets would be accounted for separately under their respective accounting guidance.

EXAMPLE 1-10

Acquisition of Real Estate

Company XYZ is a real estate company that owns and manages a group of rental properties. In order to grow its business, Company XYZ 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 XYZ purchased a business or a group of assets?

Analysis

The acquired assets should be considered similar for purposes of 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 lease is 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.

1.3.1.3 *Gross assets*

For purposes of the screen, the fair value of the gross assets acquired 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.

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.

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.

EXAMPLE 1-11

Acquisition of a pharmaceutical company

Company P is a pharmaceutical company. Company P acquires a 60% controlling interest in Company D in a nontaxable transaction for $240. The fair value of Company D's net assets include $200 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 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.

1.3.2 *The framework*

The new guidance presents a more robust framework for determining whether an acquired set is a business. The framework is intended to increase consistency and reduce the cost of applying the guidance. 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 guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). It includes more stringent criteria for sets without outputs to be considered businesses. The new guidance narrows the definition of "outputs" to be consistent with how it is described in ASC 606, *Revenue from Contracts with Customers*. For additional details on what is considered an output, refer to RR 1.2.

The assessment of whether a set is capable of being conducted and managed as a business should be performed using a market participant view. Therefore, how the seller previously managed and how the buyer intends to manage the acquired set is not 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.

1.3.2.1 *Evaluating the framework when outputs are 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 as follows:

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.

Inputs that employees who form an organized workforce could develop or convert into outputs could include:

- intellectual property that could be used to develop a good or service,
- resources that could be developed to create outputs, and
- access to necessary materials or rights that enable the creation of future outputs.

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.

1.3.2.2 *Evaluating the framework when outputs are 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).

EXAMPLE 1-12

Acquisition of brands

Company A is a global producer of food and beverages. Company A sells the worldwide rights of Yogurt Brand F, including all related intellectual property, to Company B. Company B also acquires (1) existing customer contracts, and (2) an at-market supply contract with the producer of the yogurt, but it does not acquire any employees.

Has Company B 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 B 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 yogurt production process is not considered a substantive process, therefore, no 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 1-13

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 arrangements (for development and clinical trials).

Is the arrangement the acquisition of a business?

Analysis

No. The acquired group is not a business. Pharma Co. would conclude that the license agreement would be accounted for as a single asset in a business combination. 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 1-14

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. The set also 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 arrangements (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. As a result, the set does not meet the screen and the framework must be assessed.

Although the set does not have outputs, the acquirer would likely conclude that the workforce has the necessary skills, knowledge, and experience to continue or expand existing R&D activities. This workforce represents both an input and a substantive process that together significantly contribute to the ability to create outputs.

EXAMPLE 1-15

Acquisition of office buildings

Company A manages a portfolio of office buildings. Company A has a contract with a property management company. The executives of Company A 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 A has 25 domestic properties across five different states and each office building is diversified in terms of design construction.

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

Has Company B 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.

1.3.3 The presence of goodwill

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

[T]he 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.

IFRS 3.B12

IFRS 3.B12 in the absense of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be 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. See the discussion of bargain purchases in BCG 2.6.2).

1.4 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 and IFRS 3.B5 address the determination of whether a transaction or event is a business combination.

ASC 805-10-55-2 and IFRS 3.B5

Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. [This IFRS defines a business combination as a transaction or other event in which the acquirer obtains control of one or more businesses]. In a business combination, an acquirer might obtain control of an acquiree in a variety of ways, including any of the following [for example]:

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 [or]

e. Without transferring consideration including by contract alone (see paragraph 805-10-25-11).

ASC 805-10-55-3 and IFRS 3.B6

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.

Examples 1-16 through 1-18 illustrate transactions (other than purchase transactions) that are considered business combinations.

EXAMPLE 1-16

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 1-17

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).

Analysis

Is this transaction a business combination?

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 1-18

Contracts or other arrangements

Company A and Company B 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 B.

Is this transaction a business combination?

Analysis

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

1.4.1 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; IFRS 3.43).

1.4.2 Merger of equals, mutual enterprises, and "roll-up" or "put-together" transactions

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 and IFRS 3. As described in FAS 141(R).B35 and IFRS 3.BC35, the Boards 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 should account for the transaction using the acquisition method.

Combinations of mutual enterprises are also within the scope of ASC 805 and IFRS 3. The Boards also 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 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 Boards 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 should account for the transaction using the acquisition method.

1.4.3 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 or IFRS.

1.4.4 Multiple transactions that result in the acquisition of a business

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.

EXAMPLE 1-19

Determining whether a series of transaction is a single business combination

Company A (an international media group) has agreed to acquire Entity P's television broadcast and production operations. For tax reasons, Company A will not acquire Entity P'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 Entity P's television broadcast and production operations into several transactions does not affect the substance of the arrangement, which is a single business combination.

A mandatory tender offer for the purchase of noncontrolling interests must be assessed to determine whether it is embedded or freestanding. For guidance on determining whether an instrument is embedded or freestanding, refer to the FG 5.3.

Question 1-2

When a company temporarily obtains control of a business (e.g., a financial institution taking temporary control in a bankruptcy proceeding or an entity acquired for resale), must business combination accounting be followed by the acquiring company?

PwC response

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 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. No similar industry scope exception exists under IFRS.

1.4.5 Transactions excluded from the scope of ASC 805 and IFRS 3

The following types of transactions are specifically excluded from the scope of ASC 805 and IFRS 3:

- **Formation of joint ventures [joint arrangements–IFRS]:** By definition, no one party obtains control in the creation of a joint venture [joint arrangement]. The key characteristic is participants' joint control over the decision-making process through equal ownership (e.g., 50% each) or through the unanimous consent of all parties regarding strategic and operating decisions (see BCG 1.5 for further discussion of joint ventures and joint arrangements).

- **Acquisition of an asset or a group of assets that does not constitute a business:** Consistent with the principles governing the accounting for business combinations, the acquisition of an asset or a group of assets that is not a business should not be accounted for as a business combination (accounting for asset acquisitions is discussed in BCG 7).

- **Combinations involving entities or businesses under common control:** When entities or businesses that already share a parent company (i.e., are under common control) combine, there is no business combination at the parent company level, even though there is a combination for the combining businesses. The accounting for such a transaction under US GAAP and IFRS is discussed further in BCG 6.

- ***For US GAAP only*—combinations between not-for-profit organisations and acquisitions made by not-for-profit organisations:** Combinations between and acquisitions by not-for-profit organisations 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*.

1.5 Identifying a joint venture [joint arrangement]

The scope exception for the creation or formation of a joint venture [joint arrangement] applies only if the transaction meets the definition of a joint venture under the applicable US GAAP or joint arrangement under IFRS. ASC 323, *Investments-Equity Method and Joint Ventures*, defines a corporate joint venture.

Excerpt from ASC 323-10-20

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group…A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture.

While ASC 323 deals only with corporate arrangements, joint ventures may also include partnerships, arrangements involving undivided interests, and project-financing arrangements. However, they do not include arrangements between entities under common control because the joint venture would be considered a subsidiary for purposes of the consolidated financial statements. ASC 323 also specifies that joint control over the decision-making process is the most significant attribute of joint ventures, regardless of the form of legal ownership or the voting interest held.

The SEC staff historically has objected to the use of joint venture accounting (i.e., carryover basis) if two operating businesses are combined and the only distinguishing feature of whether the transaction is a business combination or the formation of a joint venture is the presence of joint control. However, joint control is not the only factor that defines a joint venture; and there must be other factors present to distinguish a joint venture formation transaction from a business combination. Other relevant factors include the purpose behind the formation of the joint venture and the economic benefits that each joint venturer expects to achieve. The SEC staff has suggested that combining two or more operating companies merely to generate synergies from economies of scale, cost reductions and/ or to generate future growth opportunities is not, in and of itself, sufficient to apply joint venture accounting.

For IFRS companies, IFRS 11 applies to all entities that are a party to a joint arrangement. A joint arrangement is defined as an arrangement in which two or more parties contractually agree to share control. Joint control exists only when the decisions about activities that significantly affect the returns of an arrangement require the unanimous consent of the parties sharing control.

All parties to a joint arrangement must recognize their rights and obligations arising from the arrangement. The focus is not on the legal structure of joint arrangements, but rather on how the rights and obligations are shared by the parties to the joint arrangement.

There are two types of joint arrangements: joint operations and joint ventures. A joint operation gives the parties to the joint arrangement direct rights to the assets and obligations for the liabilities. A joint operator will recognise its interest based on its involvement in the joint operation (e.g., based on its direct rights and obligations), rather than on the participation interest it has in the joint arrangement.

A joint venture, in contrast, gives the parties rights to the net assets or outcome of the arrangement. A joint venturer does not have rights to individual assets or obligations for individual liabilities of the joint venture. Instead, joint venturers share in the net assets and, in turn, the outcome (profit or loss) of the activity undertaken by the joint venture. Equity accounting is mandatory for participants in joint ventures.

New guidance

In February 2017, the FASB issued ASU 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, which clarifies how to account for contributions of nonfinancial assets to form joint ventures. Contributions of nonfinancial assets to form a joint venture may give rise to gain recognition, depending on the circumstances. In order for an entity to derecognize nonfinancial assets and recognize a gain or loss, the entity must lose control of the assets while also satisfying the criteria for transfer of control to another party under the revenue recognition guidance in ASC 606. An assessment about whether the transferee has gained control must also be made for transfers of nonfinancial assets to joint ventures when the transferor has lost control. If the joint venture is not a customer in the transaction and is determined to have gained control of nonfinancial assets, full gain or loss is recognized by the transferor. For further details, refer to PPE 5.

1.6 Common control business combinations

As discussed in ASC 805-50-15-6 and IFRS 3.B1, 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. The extent of a noncontrolling interest is not relevant.

The accounting for common control transactions can differ between US GAAP and IFRS. Under US GAAP, companies are required to account for these transactions by using the carryover basis. In contrast, IFRS allows companies to make an accounting policy election to consistently account for these types of transactions. Most companies choose either the acquisition method or the predecessor-values method, which is similar to using the carryover basis under US GAAP. BCG 6 defines common control business combinations and describes the appropriate method of accounting in more detail under US GAAP and IFRS.

1.7 US GAAP and IFRS differences: definition of control

The guidance for determining when control is achieved differs under US GAAP and IFRS. Consequently, the same transaction may be accounted for as a business combination under US GAAP but not under IFRS, or vice versa.

1.7.1 US GAAP

Under ASC 805, control is defined as a controlling financial interest, as discussed in ASC 810. According to ASC 810, control is based on one of two common transaction characteristics. The transaction characteristics determine whether the applicable accounting approach is the variable-interest-entity approach or the voting interest approach.

The variable-interest-entity approach should be applied if the entity is determined to be a variable interest entity (VIE). ASC 810 provides specific rules for determining whether an entity is considered a VIE.

The reporting entity has control of the VIE if the reporting entity has both of the following:

- The power over those decisions that most significantly impact the economic activities of the VIE.
- The potential to receive significant benefits or absorb significant losses of the VIE.

Therefore, a reporting entity that has the above characteristics should consolidate the VIE under the variable-interest entity approach. The reporting entity could be a debt investor, an equity investor or the counterparty to a contractual arrangement with the VIE. ASC 810 requires a detailed analysis of which reporting entity, if any, should consolidate the VIE under the variable-interest-entity approach.

The voting interest approach should be applied if the entity is not a VIE. When the reporting entity has a majority voting interest and there are no agreements to the contrary, the reporting entity can exert control by:

- Appointing a majority of the board members
- Hiring and firing management
- Making strategic and operational decisions

Therefore, a reporting entity that has the above characteristics should consolidate the entity under the voting interest approach.

Companies reporting under US GAAP must use the acquisition method upon the consolidation of a VIE when control is obtained if the VIE is determined to be a business.

ASC 810 provides guidance on determining whether a majority owner or a general partner controls an investee based upon rights granted to the investee's minority shareholders or limited partners.

1.7.2 *IFRS*

Under IFRS 10, an entity has control over an investee when all of the following elements are present:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of the investor's returns

A reporting entity holding less than half of the voting rights in an investee might have control based on other factors, including:

- A contractual arrangement between the reporting entity and other vote holders
- Rights arising from other contractual arrangements

- Potential voting rights
- Holding sufficient voting rights to give it control based on other factors (de facto control)

Substantive potential voting rights are taken into account. A potential voting right is substantive if it is exercisable when decisions that significantly affect the returns need to be made.

IFRS 10 provides further guidance on whether a decision-maker is an agent or a principal. The assessment is made based on the overall relationship between the decision-maker, the investee, and the other parties involved with the investee. The factors to consider include:

- Scope of decision-maker's authority over the investee
- Rights held by other parties
- Remuneration of the decision-maker
- The decision-maker's exposure to variability of returns from other interests in the investee

Figure 1-3 highlights various considerations in determining control under US GAAP and IFRS.

Figure 1-3
Determining control

ASC 810 **US GAAP**	**IFRS 10** **IFRS**
◻ Consolidation decisions are evaluated first under the VIE model ◻ Qualitatively assess if the variable interest meets both criteria: ○ Power to direct activities that most significantly impact economic performance ○ Potential to receive significant benefits or absorb significant losses ◻ All other entities are evaluated under the voting interest model	◻ Must have all of the following: ○ Power ○ Exposure, or rights, to variable returns ○ Ability to use power to affect the returns

1.7.3 *Investment entity—IFRS*

Under IFRS, investment entities are not required to consolidate certain subsidiaries. Instead, investment entities report all investments at fair value. Therefore, such entities do not apply business combination accounting. There are specific disclosure requirements related to an investment entity's unconsolidated interest in a subsidiary.

Excerpt from ASC 946-10-15-6

An investment company has the following fundamental characteristics:

a. It is an entity that does both of the following:

1. Obtains funds from one or more investors and provides the investor(s) with investment management services

2. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.

b. The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

Entities are also required to consider whether they have the typical characteristics of an investment entity, such as multiple investments and investors, non-related party investors, and ownership in the form of equity or similar interests. The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, an investment entity that does not have all of these typical characteristics is required to disclose the reasons it concluded it is an investment entity.

Entities meeting the definition of an investment entity account for their portfolio investments at fair value, even where they have significant influence or a controlling financial interest in the investee. However, the exception from consolidation is not available to a non-investment entity parent with a controlling interest in an investment entity. Rather, a non-investment entity parent of an investment entity must consolidate all entities it controls, including those controlled through an investment entity.

1.7.4 Investment companies—US GAAP

In order to qualify as an investment company under US GAAP, an entity needs to obtain funds from one or more investors and provide those investors with investment management services, and its business purpose and only substantive activities needs to be investing for capital appreciation, investment income, or both. Furthermore, an investment entity (and its affiliates) does not obtain returns or benefits that are not normally attributable to ownership interests.

To be an investment company, in addition to the requirements on the nature of the investment activity noted above, ASC 946 defines the additional characteristics that the entity will also need to have.

Excerpt from ASC 946-10-15-7

An investment company also has the following typical characteristics:

a. It has more than one investment.

b. It has more than one investor.

c. It has investors that are not related parties of the parent (if there is a parent) or the investment manager.

d. It has ownership interests in the form of equity or partnership interests.

e. It manages substantially all of its investments on a fair value basis.

While the definition requires an entity must meet the “business purpose” requirement noted above, an entity will need to apply judgment in situations where one or more typical characteristics are not present. If an entity is missing a characteristic, it does not automatically preclude it from qualifying as an investment company.

Chapter 2: Acquisition method

2.1 Chapter overview

The Standards require the application of the acquisition method to all business combinations. 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).

The Standards are mostly converged, but some differences remain between US GAAP and IFRS pertaining to: (1) the definitions of control, (2) recognition of certain assets and liabilities based on the reliably measurable criterion, (3) accounting for acquired contingencies, and (4) accounting for the noncontrolling interest. In addition, the interaction of other US GAAP and IFRS standards may cause differences in, for example, the classification of contingent consideration, the recognition and measurement of share-based payment awards, and deferred taxes. The Boards' have established a single source of guidance on fair value measurements and a converged definition of fair value. See FV 7 for more information on the fair value standards.

Active and recently completed FASB and IASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter.

In addition to the projects highlighted in BCG 1, possible amendments also include:

- The Boards' projects on financial instruments are intended to address the classification and measurement, impairment of financial instruments, and hedge accounting. In November 2013, the IASB issued a final standard on hedge accounting and amendments to IFRS 9. The timing for exposure of the remaining financial instrument standards is uncertain at this time.

2.2 The acquisition method

The Standards provide the following principle with regard to the application of the acquisition method:

ASC 805-10-25-1, ASC 805-10-05-4 and IFRS 3.4, 5

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

Applying 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; and

d. Recognizing and measuring goodwill or a gain from a bargain purchase.

Each of the above will be discussed in detail in this chapter.

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

2.3 Identifying the acquirer

The Standards provide the following principle with regard to identifying the acquirer:

ASC 805-10-25-4 and IFRS 3.6

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 standards. Those standards are ASC 810-10 for US GAAP and IFRS 10 for IFRS. See BCG 1.7.2 for further information on guidance of IFRS 10.

For US GAAP, 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.

For IFRS, a party that has power over the investee; exposure, or rights, to variable returns from its involvement in the investee; and the ability to use that power over the investee to affect the amount of the investor's returns has control. See BCG 1.7.2 for further information on IFRS 10.

If the accounting acquirer is not apparent when considering the guidance in ASC 810-10 and IFRS 10, the following additional guidance is provided in the Standards to assist in the identification of the acquirer:

- The entity that transfers cash or other assets, or incurs liabilities to effect a business combination is generally identified as the acquirer, as discussed in ASC 805-10-55-11 and IFRS 3.B14.

The entity that issues equity interests is usually the acquirer in a business combination that primarily involves the exchange of equity interests. However, it is sometimes not clear which party is the acquirer if a business combination is effected through the exchange of equity interests. In these situations, 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. The Standards provide the following additional factors:

Excerpt from ASC 805-10-55-12 and IFRS 3.B15

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., split of 75% and 25% may be more determinative than a split of 51% and 49%).

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. 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:

- The combining entity whose relative size is significantly larger than the other combining entity or entities usually is the acquirer. Assessing relative size may include an understanding of the combining entities' assets, revenues, or earnings [profit].
- An acquirer should be identified in a business combination involving more than two entities. The identification of the acquirer should consider which entity initiated the business combination, the relative size of the combining entities, and any other pertinent information.
- A new entity formed to effect a business combination is not necessarily the acquirer. One of the existing combining entities should be determined to be the acquirer in a business combination involving the issuance of equity interests by a newly formed entity (Newco). However, a Newco that transfers cash or other assets, or that incurs liabilities as consideration may be deemed to be the accounting acquirer in certain situations. See BCG 2.3.1 for further information on Newcos.

2.3.1 New entity formed to effect a business combination

It is not uncommon for a company to use a Newco (newly formed entity) in a business combination. A Newco may be used in a business combination for legal, tax, or other business purposes.

A Newco may be determined to be the acquirer in certain situations if the Newco is considered to be substantive (i.e., when the Newco is not disregarded for accounting purposes). This determination is based on the facts and circumstances and is highly subjective. 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. For example, a Newco that has assets, liabilities, or operating activities may be determined to be substantive. Neither US GAAP nor IFRS provides guidance on this determination.

A Newco that is established solely to issue equity interests to effect a business combination generally will not be substantive and should normally be "looked through" to determine the acquirer. Therefore, in this case, if 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 and IFRS 3.B18.

For US GAAP companies, see BCG 11.3 for further information on pushdown accounting for certain Newco transactions.

Examples 2-1 through 2-3 illustrate how to determine whether a Newco is the acquirer.

EXAMPLE 2-1

Determining the acquirer

A 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 2-2

Determining the acquirer

As part of an integrated transaction, a seller contributes net assets that constitute a business to Newco in exchange for shares of Newco. A short time thereafter, Newco issues 60% of its common shares to an unrelated investor for cash.

Is Newco the accounting acquirer?

Analysis

Yes. Newco would be identified as the accounting acquirer. ASC 805-10-20 [IFRS 3.A] 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 an 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.

EXAMPLE 2-3

Determining the acquirer

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 the combining companies in exchange for all of their outstanding equity interests.

Is Newco the accounting acquirer?

Analysis

No. The transaction is, in substance, no different than a transaction in which one of the combining entities directly acquires the other. Newco is not considered substantive in this situation and would be disregarded for accounting purposes. Therefore, Newco would not be identified as the accounting acquirer; rather, one of the other combining entities would be.

2.3.2 *Other considerations in identifying the acquirer*

The Standards provide general guidance for identifying the acquirer. Certain circumstances can complicate the identification of the acquirer. For example:

- Acquisitions involving companies with overlapping [ordinary] 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 the Standards.

- 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.

- 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.

Examples 2-4 and 2-5 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 2-4

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 2-5

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.

2.4 Determining the acquisition date

The Standards provide the following principle with regard to determining the acquisition date:

Excerpts from ASC 805-10-25-6 and IFRS 3.8

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

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 and IFRS 3.9, all pertinent facts and circumstances surrounding a business combination should be considered in assessing when the acquirer has obtained control of the acquiree.

2.4.1 *Determining the acquisition date for a business combination achieved without the transfer of consideration*

An acquirer may 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.

2.5 *Recognizing and measuring the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree*

The Standards provide the following recognition principle for assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree:

Excerpts from ASC 805-20-25-1 and IFRS 3.10

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 [IFRS 3.11 and 12].

An acquirer should recognize the identifiable assets acquired and the liabilities assumed on the acquisition date if they meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements,* for US GAAP, and the *Framework for the Preparation and Presentation of Financial Statements* for IFRS. 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 and IFRS 3.11. 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 or IFRS. 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 or IFRS.

The Standards provide the following 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.

IFRS 3.18

The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

IFRS 3.19

For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either: (a) fair value; or (b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

The measurement of the identifiable assets acquired and liabilities assumed is at fair value, with limited exceptions as provided for in the Standards. For US GAAP, 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. Under IFRS 13, the definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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 following table provides a summary of the exceptions to the recognition and fair value measurement principles in the Standards, along with references to where these exceptions are discussed in this chapter.

Summary of exceptions to the recognition and fair value measurement principles

Measurement principle	▫ Reacquired rights (BCG 2.5.6) ▫ Assets held for sale (BCG 2.5.9) ▫ Share-based payment awards (BCG 2.6.3.1)
Recognition and measurement principles	▫ Income taxes (BCG 2.5.8) ▫ Employee benefits (BCG 2.5.10) ▫ Contingencies (BCG 2.5.13) ▫ Indemnification assets (BCG 2.5.14)

The recognition and measurement of particular assets acquired and liabilities assumed are discussed in BCG 2.5.1 through BCG 2.5.20.2.

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 not use an acquired asset or 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). The Standards specify that the intended use of an asset by the acquirer does not affect its fair value. See BCG 4.3 for further information on the subsequent measurement of assets that the acquirer does not intend to use.

2.5.1.1 *Defensive intangible assets*

A company may acquire intangible assets in a business combination that it has no intention to actively use but intends to hold (lock up) to prevent others from obtaining access to them (defensive intangible assets). Defensive intangible assets may include assets that the entity will never actively use, as well as assets that will be actively used by the entity only during a transition period. In either case, the company will lock up the defensive intangible assets to prevent others from obtaining access to them for a period longer than the period of active use. Examples of defensive intangible assets include brand names and trademarks. A company should utilize market-participant assumptions, not acquirer-specific assumptions, in determining the fair value of defensive intangible assets.

Determining the useful life of defensive intangible assets can be challenging. The value of defensive intangible assets will likely diminish over a period of time as a result of the lack of market exposure or competitive environment or other factors. Therefore, the immediate write-off of defensive intangible assets would not be appropriate. It would also be rare for such assets to have an indefinite life. See BCG 4.3, BCG 8.4, and BCG 10.4.7 for further information on the initial and subsequent measurement of defensive intangible assets.

2.5.2 *Asset valuation allowances*

Separate valuation allowances are not recognized for acquired assets that are measured at fair value, as any uncertainties about future cash flows are included in their fair value measurement, as described in ASC 805-20-30-4 and IFRS 3.B41. This precludes the separate recognition of an allowance for doubtful accounts or an allowance for loan losses. Companies may need to separately track contractual receivables and any valuation losses to comply with certain disclosure and other regulatory requirements in industries such as financial services. In accordance with ASC 805-20-50-1(b) and IFRS 3.B64(h), in the reporting period in which the business combination occurs, the acquirer should disclose the fair value of the acquired receivables, their gross contractual amounts, and an estimate of cash flows not expected to be collected.

The use of a separate valuation allowance is permitted for assets that are not measured at fair value on the acquisition date (e.g., certain indemnification assets). Consequently, for US GAAP companies, a valuation allowance for deferred income tax assets is allowed.

New guidance

Upon adoption of ASU 2016-13, *Financial Instruments—Credit Losses*, purchased financial assets with credit deterioration will no longer be recognized at fair value, an exception to the measurement principle in ASC 805. Instead, the acquirer will recognize an allowance with a corresponding increase to the amortized 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 paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

The revised guidance will be effective for public business entities that are SEC filers for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other public business entities, the revised guidance will be effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For all other entities, the revised guidance will be effective for fiscal years beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021. All entities may early adopt the revised guidance as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

2.5.3 Inventory

Acquired inventory can be in the form of finished goods, work in progress, and raw materials. The Standards require that inventory be measured at its fair value on the acquisition date. 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 for further information on valuation methods.

2.5.4 Contracts

Contracts (e.g., leases, 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.

2.5.4.1 Loss contracts

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

A loss [onerous] contract should be recognized as a liability at fair value if the contract is a loss [onerous] contract to the acquiree at the acquisition date. Amortization of the loss [onerous] contract is usually recognized as contra revenue. 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 [onerous] contract is recognized. For example, Company A acquires Company B in a business combination. Company B is contractually obligated to fulfil 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 [onerous] contract that is assumed by Company A in the acquisition. Therefore, Company A would record a liability for the loss [onerous] contract assumed in the business combination.

When measuring a loss [onerous] contract, an acquirer should consider whether the amount to be recognized should be adjusted for any intangible assets or liabilities already recognized for contract terms that are favorable or unfavorable compared to current market terms. A contract assumed in a business combination that becomes a loss [onerous] contract as a result of the acquirer's actions or intentions should be recognized through earnings [profit or loss] in the postcombination period based on the applicable framework in US GAAP or IFRS.

2.5.5 Intangible assets

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). See BCG 4 for guidance on the recognition and measurement of intangible assets.

2.5.6 Reacquired rights

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 and IFRS 3.B35. The reacquisition must be evaluated separately to determine if a gain or loss on the settlement should be recognized. See BCG 2.7.3.1 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 2.7.3.1 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 the 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 and IFRS 3.29, 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; IFRS 3.BC309. 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 Boards 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 and IFRS 3.55.

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 is not an indefinite-lived intangible asset, then the reacquired right should be amortized over its economic useful life. See PPE 3.2.1 for guidance on identifying the useful life of an intangible asset.

Example 2-6 illustrates the recognition and measurement of a reacquired right in a business combination.

EXAMPLE 2-6

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

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

2.5.7.1 *Government grants*

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 *Consideration of decommissioning and site restoration costs*

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., retirement obligations). If a retirement obligation exists, it must be recognized at fair value (using market-participant assumptions), which may be different than the amount recognized by the acquiree. If the fair value of the asset is based on a quoted market price, and that market price implicitly includes the costs that will be incurred in retiring the asset, then the fair value of the asset retirement obligation will need to be added back to the net fair value of the asset.

For example, a nuclear power plant is acquired in a business combination. The acquirer determines that a retirement obligation of CU100 million (fair value) associated with the power plant exists. The appraiser has included the expected cash outflows of the retirement obligation in the cash flow model, establishing the value of the plant at CU500 million. That is, the appraised value of the power plant would be CU100 million higher if the retirement obligation is disregarded. The acquirer would record the power plant at its fair value of CU600 million and a liability of CU100 million for the retirement obligation.

2.5.8 *Income taxes*

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 (US GAAP) of the acquiree that are related to any temporary differences, tax carryforwards, and uncertain tax positions in accordance with ASC 740, *Income Taxes,* or IAS 12, *Income Taxes,*).

Deferred tax liabilities are not recognized for nontax-deductible goodwill under US GAAP or IFRS. However, 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 [profit or loss] 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.

2.5.9 *Recognition of assets held for sale—US GAAP [IFRS]*

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 [noncurrent 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*, or IFRS 5, *Non-current Assets Held-for-sale and Discontinued Operations*, are met.

ASC 360-10-45-12 and IFRS 5.11 provide 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 [highly probable] that the acquirer will meet the other held-for-sale criteria within a short period of time after the acquisition date (usually within three months). The other criteria in ASC 360-10-45-9 and IFRS 5.7-8 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 4 for further information on accounting for assets held-for-sale under US GAAP.

2.5.10 *Employee benefit plans*

Employee benefit plans are an exception to the recognition and fair value measurement principles. In accordance with ASC 805-20-25-23 and IFRS 3.26, employee benefit plan obligations are recognized and measured in accordance with the guidance in applicable US GAAP and IFRS, rather than at fair value. Applicable guidance under US GAAP and IFRS includes:

- ASC 420, *Exit or Disposal Cost*
- ASC 710, *Compensation—General*
- ASC 712, *Compensation—Nonretirement Postemployment Benefits*
- ASC 715, *Compensation—Retirement Benefits*
- IAS 19, *Employee Benefits*

For companies applying US GAAP, an acquirer should recognize an asset or liability on the acquisition date for the funded status of any single-employer defined-benefit plan sponsored by the acquiree that the acquirer will assume as part of a business combination. These plans include defined-benefit pension plans and other postretirement and postemployment benefit plans. The funded status is measured as the difference between the projected benefit obligation and the fair value of the plan assets. ASC 805 amends ASC 715 to require that when measuring the funded status of these plans, the acquirer exclude the effects of expected amendments, curtailments, or terminations that the acquirer has no obligation to make in connection with the business combination. However, the measurement of the projected benefit obligation (pensions) or accumulated postretirement benefit obligation (postretirement benefits other than pensions) and the fair value of the plan assets on the acquisition date should reflect any other necessary changes in discount rates or other assumptions based on the acquirer's assessment of relevant future events. As a result, acquiree balances for unrecognized prior service costs, actuarial gains or losses, or any remaining transition obligations should not be carried forward on the acquisition date.

For US GAAP 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.

For multiemployer plans, ASC 805-20-25-23 clarifies that the acquirer recognizes a withdrawal liability on the acquisition date under ASC 450 if it is probable at that date that the acquirer will withdraw from a multiemployer plan in which the acquiree participates. The FASB acknowledged in the Basis for Conclusions in FAS141(R) that the provisions for single-employer and multiemployer plans are not necessarily consistent.

For IFRS, if a business combination involves the assumption of defined-benefit pension plans or other similar postretirement benefit plans, the acquirer should use the present value of the defined-benefit obligations less the fair value of any plan assets to determine the net employee benefit assets or liabilities to be recognized. Similar to US GAAP, acquiree balances should not be carried forward on the acquisition date.

In accordance with IAS 19.64(b) and IFRIC 14, if there is a net employee-benefit asset, it is recognized only to the extent that it will be available to the acquirer in the form of refunds from the plan or a reduction in future contributions.

Under IAS 19.110-111, settlements or curtailments are recognized in the measurement of the plan's benefit obligations only if the settlement or curtailment event has occurred by the acquisition date. A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for all or part of the benefits provided under a defined-benefit plan. A curtailment occurs when an entity is demonstrably committed to make a material reduction in the number of employees covered by a plan, amends a defined-benefit plan's terms such that a material element of future service by current employees will no longer qualify for benefits or will qualify only for reduced benefits. Consistent with the guidance in IAS 19, it would not be appropriate to recognize a settlement or curtailment on the basis that it was probable. That is, expected settlements or curtailments by the acquirer of the acquiree's plans would not be recognized until the relevant requirements in IAS 19 are met.

Question 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

The Standards generally require employee compensation costs for future services, including pension costs, to be recognized in earnings [profit or loss] 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 the Standards 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 and IFRS 3.B50 provide 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

An acquiree's payables and debt assumed by the acquirer are recognized at fair value in a business combination. Short-term payables may be recorded based on their settlement amounts in most situations since 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 for further discussion of the measurement of debt at fair value.

Question 2-2

How should unamortized deferred financing costs of the acquiree be accounted for in a business combination?

PwC response

The accounting treatment for debt issue costs in the periods before and after a transaction depends on whether the debt is assumed by the acquirer. This is primarily a legal determination and should consider the requirements of the debt and acquisition agreements and the timing of repayment relative to the acquisition. Debt legally assumed by the acquirer should be recorded at fair value. Any existing deferred financing costs would be eliminated.

2.5.12 Guarantees

All guarantees assumed in a business combination are recognized at fair value. Under US GAAP, the acquiree may not have recognized all of its guarantees under ASC 460, *Guarantees*, as a result of the standard's transition requirements, which applied prospectively to guarantees issued or modified after 31 December 2002. The transition provision does not apply to business combinations occurring after 31 December 2002 since all assumed guarantees are considered new arrangements for the acquirer. Under ASC 460, an acquirer would relieve the guarantee liability through earnings [profit or loss] using a systematic and rational manner as it is released from risk unless the guarantee is not subject to the recognition provisions of ASC 460.

IFRS companies follow IAS 39, *Financial Instruments: Recognition and Measurement*. Unless they are measured at fair value with changes in fair value reported through profit or loss, IAS 39 requires guarantees to be subsequently reported at the higher of (1) the amount determined in accordance with IAS 37 and (2) the amount initially recognized, less, when appropriate, amortization recognized in accordance with IAS 18, *Revenue*.

2.5.13 Contingencies

Contingencies are 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. The following is a summary of the accounting for acquired contingencies under the Standards.

Summary of accounting for contingencies

US GAAP	Assets and liabilities
Initial accounting (acquisition date):	Record at fair value if the acquisition-date fair value can be determined during the measurement period. If the acquisition-date fair value cannot be determined during the measurement period, the asset or liability should be recognized at the acquisition date if both of the following criteria are met: □ Information available before the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur. □ The amount of the asset or liability can be reasonably estimated. The above recognition criteria should be applied using guidance provided in ASC 450 for the application of the similar criteria in ASC 450-20-25-2. If the above criteria are not met using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer should not recognize an asset or liability at the acquisition date.
Subsequent accounting (postcombination):	If recognized at fair value on the acquisition date, the acquirer should develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. If recorded under ASC 450 on the acquisition date, continue to follow the guidance in ASC 450. If the acquirer does 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 accordance with other GAAP, including ASC 450, as appropriate.

Summary of accounting for contingencies

IFRS	Liabilities only
Initial accounting (acquisition date):	Record at fair value if it meets the definition of a present obligation and is reliably measurable. Recognized regardless of whether it is probable that an outflow of resources will be required to settle the obligation.
Subsequent accounting (postcombination):	Recognized at the higher of (1) best estimate or (2) acquisition-date fair value less amortization at the end of each reporting period, with changes in value included in profit or loss until settled.

2.5.13.1 *Initial recognition and measurement—US GAAP*

Assets acquired and liabilities assumed in a business combination that arise from contingencies will be recognized at fair value at the acquisition date if fair value can be determined during the measurement period.

An acquirer often will 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 leasing agreement. In contrast, the fair value of most legal contingencies assumed in a business combination is not likely to be determinable.

If the acquisition-date fair value of such assets acquired or liabilities assumed cannot be determined during the measurement period, the asset or liability should be recognized at the acquisition date if both of the following criteria are met:

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

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

The above recognition criteria should be applied using guidance provided in ASC 450 for the application of the similar criteria in ASC 450-20-25-2.

If the above criteria are not met based on information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer cannot recognize an asset or liability at the acquisition date. In periods after the acquisition date, the acquirer should account for such assets or liabilities in accordance with other GAAP, including ASC 450, as appropriate. Contingent assets generally do not meet the ASC 450 recognition criteria.

Question 2-3

For an acquirer that expenses legal fees as incurred, should future costs to defend litigation assumed in a business combination be recognized in acquisition accounting?

PwC response

No. It is not appropriate to accrue for future legal costs even though the related litigation existed as of the acquisition date. Such costs should be expensed as incurred.

2.5.13.2 Subsequent measurement—US GAAP

The acquirer should develop a systematic and rational approach for subsequently measuring and accounting for assets and liabilities arising from contingencies that may have been recognized at fair value on the date of acquisition. The approach should be consistent with the nature of the asset or liability. 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. Judgment is required to determine the method for subsequently accounting for assets and liabilities arising from contingencies. However, 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.

Examples 2-7 to 2-9 illustrate the recognition and measurement of acquired contingencies under three scenarios.

EXAMPLE 2-7

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

On 30 June 20X4, 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 20X4 and in 20X5 and that all will be incurred by the end of 20X6. 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 2-8

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

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 2-9

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

Assume the same fact pattern in Example 2-8 above, except that Company C has decided to pay CU1 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

Company C would record the liability on the acquisition date at CU1 million. Company C's decision to pay a settlement amount indicates that it is now probable that Company C has incurred a liability on the acquisition date and that the amount of the liability can be reasonably estimated in accordance with ASC 450.

2.5.13.3 Contingent liabilities—IFRS

Contingent liabilities are either possible or present obligations as defined in IAS 37. In accordance with IFRS 3.22, possible obligations are obligations that arise from past events whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of any entity. Present obligations are legal or constructive obligations that result from a past event.

An acquirer recognizes at fair value on the acquisition date, in accordance with IFRS 3.23, all contingent liabilities assumed that are present obligations that also are reliably measurable. Contingent assets and possible obligations assumed are not recognized by the acquirer on the acquisition date.

In the reporting periods subsequent to the acquisition date, contingencies recognized at the acquisition date are measured at the higher of (1) the amount that would be recognized under IAS 37 (i.e., best estimate) or (2) the amount initially recorded less cumulative amortization recognized in accordance with IAS 18.

2.5.14 Indemnification assets

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. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer should recognize the indemnification asset at its acquisition-date fair value on the acquisition date. If an indemnification asset is measured at fair value, a separate valuation allowance is not necessary because its fair value measurement will reflect any uncertainties in future cash flows resulting from collectibility considerations. 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 2-4

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

The Standards state 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 2-5

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

PwC response

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 2-6

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.

EXAMPLE 2-10

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 CU100 million. There are no issues surrounding the collectibility of the arrangement from the seller. A contingent liability of CU110 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 CU115 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 CU10 million (CU110–CU100), is recognized. At the next reporting period after the acquisition date, the indemnification asset is increased to CU15 million (CU115 less CU100), with the CU5 million adjustment offsetting the earnings [profit or loss] impact of the CU5 million increase in the contingent liability.

2.5.15 Recognition of 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. Absent these conditions, including a plan for restructuring or exit activities in the purchase agreement does not 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 [profit or loss] in the postcombination period when all applicable criteria of ASC 420 or IAS 37 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 was 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 and IFRS 3.B50 paragraph B50 of IFRS 3 for more guidance on separate transactions.

Examples 2-11 and 2-12 illustrate the recognition and measurement of liabilities related to restructuring or exit activities.

EXAMPLE 2-11

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

On the acquisition date, an acquiree has an existing liability/obligation related to a restructuring that was initiated one year before the business combination was contemplated. In addition, in connection with the acquisition, the acquirer identified several operating locations to close and selected employees of the acquiree to terminate to realise certain anticipated synergies from combining operations in the postcombination period. Six months after the acquisition date, the obligation for this restructuring action is recognized, as the recognition criteria under ASC 420 and IAS 37 are met.

How should the acquirer account for the two restructurings?

Analysis

The acquirer would account for the two 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.

- Restructuring initiated by the acquirer: The acquirer would recognize the effect of the restructuring in earnings [profit or loss] 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 definition of a liability and is not a liability assumed in the business combination.

EXAMPLE 2-12

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 *Deferred or unearned revenue*

The acquirer recognizes a liability related to deferred revenue only to the extent that the deferred revenue represents an obligation assumed by the acquirer (i.e., obligation to provide goods, services, or the right to use an asset or some other concession or consideration given to a customer). The liability related to deferred revenue should be based on the fair value of the obligation on the acquisition date, which may differ from the amount previously recognized by the acquiree. See FV 7.3.3.6 for further information on deferred or unearned revenue.

2.5.17 *Deferred charges arising from leases*

The balance sheet of an acquiree before the acquisition date may include deferred or prepaid rent related to an operating lease, resulting from the accounting guidance in ASC 840-20-25-2 and IAS17.33 to generally recognize operating lease income (lessor) or expense (lessee) on a straight-line basis if lease terms include increasing or escalating lease payments. The acquirer should not recognize the acquiree's deferred rent using the acquisition method because it does not meet the 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.

Example 2-13 illustrates the recognition of deferred rent in a business combination.

EXAMPLE 2-13

Recognition of deferred rent

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

- Four-year lease term
- Lease payments are:
  - Year 1: CU100
  - Year 2: CU200
  - Year 3: CU300
  - Year 4: CU400

On the acquisition date, the lease had a remaining contractual life of two years, and the acquiree had recognized a CU200[1] 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 CU50[2] at the end of the first year after the acquisition.

[1] Deferred rent of the acquiree: straight-line expense of CU500 (((CU100 + CU200 + CU300 + CU400) / 4) × 2 years) less cash payments of CU300 (CU100 + CU200).

[2] Deferred rent of the acquirer: straight-line expense of CU350 (((CU300 + CU400) / 2) × 1 year) less cash payments of CU300 (year 3 of 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 for additional guidance on the accounting for leases in a business combination.

2.5.18 *Classifying or designating identifiable assets and liabilities*

The Standards provide the following principle with regard to classifying or designating the identifiable net assets acquired:

Excerpts from ASC 805-20-25-6 and IFRS 3.15

At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP [IFRSs subsequently]. 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 and IFRS 3.15, 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 2.5.9, 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 or equity securities: Investment securities are classified based on the acquirer's investment strategies and intent in accordance with ASC 320, *Investments—Debt and Equity Securities*, or IAS 39/ IFRS 9.

- 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.

The Standards provide two exceptions to the classification or designation principle:

- Classification of leases as operating or capital [finance] in accordance with ASC 840, and IAS 17.

- Classification of contracts as an insurance or reinsurance contract or a deposit contract within the scope of ASC 944, *Financial Services—Insurance*, and IFRS 4, Insurance Contracts. See BCG 11 for further information.

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 or IFRS.

2.5.19 Financial instruments—classification or designation of financial instruments and hedging relationships

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, or IAS 39, (2) used in hedging relationships, (3) used in an "economic hedging relationship," or (4) used in trading operations. Generally, the pre-acquisition 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:

- Reevaluation of the acquiree's contracts: All contracts and arrangements of the acquiree need to be reevaluated 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— US GAAP: 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 Long-term construction contracts

An acquiree may have long-term construction contracts that are in process on the acquisition date. These contracts should be recognized at fair value, as defined in ASC 820 [IFRS 13]. Under ASC 820 [IFRS 13], the price that would be paid (received) to transfer the obligations (rights) to a market-participant should be utilized to measure the contracts at fair value. The fair value of acquired long-term construction 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). Subsequent to the acquisition, the acquirer should account for the acquired contracts in accordance with ASC 605-35, *Construction-Type and Production-Type Contracts,* or IAS 11, *Construction Contracts* or, upon adoption, in accordance with the new revenue standards, ASC 606 and IFRS 15. For US GAAP companies not yet applying ASC 606, the method chosen by the acquirer under ASC 605-35 is not an accounting policy election and should be determined based on the facts and circumstances of each contract. Intangible assets and liabilities may also arise from acquired contracts. See BCG 4 for further discussion of the accounting for contract-related intangible assets.

The new revenue standards will replace substantially all revenue guidance under US GAAP and IFRS, including the industry-specific guidance for construction-type and production-type contracts. Upon adoption of ASC 606 or IFRS 15, the acquirer in a business combination should continue to recognize the contract at fair value, which is the price that would be paid (received) to transfer the obligations (rights) to a market-participant as described in ASC 820 and IFRS 13. Revenue should be recognized post-acquisition in accordance with ASC 606 or IFRS 15.

2.5.20.1 Percentage of completion method—prior to adoption of ASC 606 [IFRS 15]

In applying ASC 605-35 [IAS 11], the estimate of the acquired contract's percentage of completion used to recognize revenue and costs should be based upon the acquirer's estimate of the remaining effort required after the acquisition date to complete the contract. Contract-related intangible assets or liabilities recognized in the business combination should be amortized over the remaining term of the contract after acquisition.

2.5.20.2 Completed contract method—US GAAP only prior to adoption of ASC 606

ASC 605-35 requires billings and costs to be accumulated on the balance sheet while the contract is in progress. Once the project is complete, or substantially complete, the revenue and costs of revenue should be recognized. Upon the completion of the project, revenue recognized should equal total billings after the acquisition less the amortization of the intangible contract asset (or liability). Costs recognized upon contract completion (costs of revenues) should equal costs incurred in the postcombination period. The intangible asset that arises as a result of the delayed revenue and costs of revenue should generally not be amortised until the project is completed. IFRS does not allow for the use of the completed contract method.

2.6 Recognising and measuring goodwill or a gain from a bargain purchase

This section will discuss the computation of goodwill, which continues to be measured as a residual. The computation of bargain purchase gains is discussed in BCG 2.6.2.

2.6.1 Goodwill

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. 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).

The Standards provide the following principle to measure goodwill:

Excerpts from ASC 805-30-30-1 and IFRS 3.32

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 [IFRS], which generally requires acquisition-date fair value ([see] paragraph 805-30-30-7 [37])

2. The fair value [amount] of any noncontrolling interest in the acquiree [measured in accordance with this IFRS; and]

3. In a business combination achieved in stages [(see paragraphs 41 and 42)], 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 [IFRS].

Goodwill acquired in a business combination is recognized as an asset and is not amortised. 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*, and IAS 36, *Impairment of Assets*. See BCG 9 and BCG 10 for a discussion of goodwill impairment testing for US GAAP and IFRS companies, respectively.

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. The Standards require the recognition of a gain for a bargain purchase. The Boards believe that a bargain purchase represents an economic gain, which should be immediately recognized by the acquirer in earnings [profit or loss].

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. Once completed, the acquirer should review the procedures used to measure the following items:

- 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. If after this review, a bargain purchase is still indicated, it should be recognized in earnings [profit or loss] and attributed to the acquirer in accordance with ASC 805-30-25-2 and IFRS 3.34. The Standards require 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.

For example, Company A acquires 100% of Company B for CU150 million in cash. The preliminary fair value of the identifiable net assets acquired is CU160 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 CU155 million. Company A, as part of the acquisition accounting, should recognize a CU5 million bargain purchase gain (CU155–CU150), which is the amount that the acquisition date amounts of the identifiable net assets acquired exceeds the consideration transferred.

2.6.3 Measuring and recognizing consideration transferred

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 and IFRS 3.37 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.

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 for a discussion of valuation techniques.

2.6.3.1 Share-based payment awards

An acquirer may exchange its share-based payment awards for awards held by employees 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, for US GAAP, and IFRS 2, Share-Based Payment, for IFRS. Recognition and measurement of share-based payments is discussed further in BCG 3.

2.6.3.2 Consideration transferred includes other assets and liabilities 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 [profit or loss] on assets or liabilities it controls before and after the business combination.

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.

2.6.4.1 *Contingent consideration—US GAAP*

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. Excluding adjustments to contingent consideration that qualify as measurement period adjustments (see BCG 2.9), 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.

- 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 where contingent consideration is settled by issuing an entity's own equity securities, but the arrangement is accounted for as a liability. These situations include arrangements that are settled with a variable number of an acquirer's equity shares and that create (1) a fixed obligation known at inception, (2) an obligation, the amount of which varies inversely to changes in the fair value of the acquirer's equity shares, or (3) an obligation, the amount of which varies based on something other than the fair value of the acquirer's equity shares. For example, a fixed monetary amount to be settled in a variable number of shares determined by reference to the share price on the settlement date would be a liability. See FV 7.3.3.5 for further information regarding the measurement of share-settled contingent consideration.

Question 2-7

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

PwC response

Contingent consideration is defined in ASC 805-10-20 [IFRS 3] 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. As such, payments for the settlement of consideration based on facts and circumstances that existed on the acquisition date would not meet this definition. Absent evidence to the contrary, general representations and warranties would be expected to be valid as of the acquisition date. Therefore, in most cases, the amounts held in escrow should be included in the acquisition accounting as part of the consideration transferred by the acquirer. In addition, an acquirer should carefully evaluate the legal terms of the escrow arrangement to determine whether it should present the amounts held in escrow as an asset on its balance sheet.

Question 2-8

Should consideration that will be transferred or received based on changes in working capital be considered contingent consideration?

PwC response

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 acquired) on the acquisition date. Similar to general representation and warranty provisions, the subsequent determination of working capital that existed on 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 is not 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.

Contingent consideration arrangements 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 2-14

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 CU200 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 CU50.

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.

Determining classification of contingent consideration arrangements between liabilities and equity—US GAAP

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 required to be (or at the issuer's option can be) settled in shares is classified as a liability or as equity. Determining the classification of a contingent consideration arrangement that is expected to be settled in an entity's own shares as a liability or equity at the acquisition date 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,[1] and ASC 815-40-15.[2] The accounting guidance described below is not meant to establish a hierarchy or specific steps in the decision making process. All appropriate authoritative guidance should be considered in determining the classification of a contingent consideration arrangement.

A financial instrument in the scope of ASC 480 should be classified as a liability. 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

As it relates to the third point, an obligation to issue a variable number of shares relates to 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

[1] Originally EITF 00-19

[2] Originally EITF 07-5

a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly[3] on any of the following:

- A fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares

- Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares

- 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

If a financial instrument is not classified as a liability under ASC 480, it is not automatically classified in shareholders' equity. The financial instrument may be classified as a liability under other US GAAP, such as the guidance in ASC 815, which applies to both freestanding instruments and certain embedded features. If the arrangement is in the scope of ASC 815, it would be considered a derivative instrument and classified as a liability. The arrangement would have the characteristics of a derivative instrument if it (1) has one or more underlyings and notional amounts, (2) has an initial investment that is less by more than a nominal amount[4] than the initial net investment that would be required to acquire the asset and (3) can be settled net by means outside the contract such that it is readily convertible to cash (or its terms implicitly or explicitly require or permit net settlement).

Many equity-settled arrangements are in the scope of ASC 815; however, there are exceptions. The primary exception that would impact contingent consideration arrangements is found in ASC 815-10-15-74, which states that arrangements that are both (1) indexed to an entity's own shares and (2) classified in shareholders' equity in the entity's financial statements are not considered derivative instruments and would not be classified as a liability. ASC 815-40-15 provides guidance for determining whether an instrument (or embedded feature) is indexed to an entity's own shares. ASC 815-40 provides guidance for determining whether the instrument (or embedded feature), if indexed to an entity's own shares, should be classified in shareholders' equity.

Determining whether an instrument is indexed to an entity's own shares

In determining whether the instrument (or embedded feature) is indexed to an entity's own shares, ASC 815-40-15 requires an entity to apply a two-step approach. The first step relates to the evaluation of the arrangement's contingent exercise provision. 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. Provisions that permit, accelerate, extend, or eliminate the entity's (or the counterparty's) ability to exercise an instrument are examples of contingent exercise provisions. The second step relates to the evaluation of the arrangement's settlement provisions.

---

[3] Our view is that "predominantly" may be interpreted as either a threshold equivalent to "more likely than not" or may be interpreted as a relatively high threshold, provided that once a position is adopted by an entity, the position is applied consistently across all instruments and from period to period.

[4] The FASB did not provide guidance on what constitutes an initial investment that is "less by more than a nominal amount." In practice, however, an initial net investment equal to or less than 90% to 95% of the amount that would be exchanged to acquire the asset or incur the obligation would generally satisfy the initial net investment criterion for inclusion as a derivative in the scope of ASC 815. We believe many contingent consideration arrangements would satisfy this criterion.

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 entity's own shares, 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 shares.

For example, an exercise contingency based on the price of gold exceeding a certain price over a two-year period would not be considered indexed to the entity's own shares because the price of gold is an observable market, other than the market for the entity's own shares. Another example would be an exercise contingency based on the S&P 500 increasing 500 points within any given calendar year for a three-year period. This arrangement would not be considered indexed to the entity's own shares because the S&P 500 is an observable index other than an index calculated solely by reference to the entity's own operations.

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 shares. 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. If the instrument's exercise price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own shares 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. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's share price, the exercise price of the instrument, the term of the instrument, expected dividends or other dilutive activities, costs to borrow shares, interest rates, share price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. If the settlement amount incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument (or embedded feature) contains a leverage factor that increases the exposure to an otherwise acceptable additional variable in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, then the instrument (or embedded feature) would not be considered indexed to the entity's own shares.

Settlement adjustments designed to protect a holder's position from being diluted will generally not prevent an instrument (or embedded feature) from being considered indexed to the entity's own stock provided the adjustments are limited to the effect that the dilutive event has on the shares underlying the instrument. Adjustments for events such as the occurrence of a stock split, rights offering, dividend, or a spin-off would typically be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

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 arrangements 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. 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 has 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.

Determining whether an instrument indexed to an entity's own shares should be classified in shareholders' equity

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

- The arrangement permit settlement in unregistered shares, or if the delivery of shares at settlement are registered at the inception of the agreement, that there are no further timely filing or registration requirements of the issuer
- The arrangement contain an explicit limit on the number of shares to be delivered
- The entity has a sufficient number of authorised and unissued shares available to settle the arrangement
- The arrangement not provide the counterparty with rights that rank higher than existing shareholders
- The arrangement not contain any requirements to post collateral at any point for any reason
- The arrangement not contain any restricted cash payments to the counterparty in the event the entity fails to make timely filings with the SEC
- The arrangement not contain any cash settled top-off or make-whole provisions

All of the above noted criteria that are relevant to the instrument must be met before the arrangement could meet the criteria to be classified in shareholders' equity.

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 assessed at each financial statement reporting date 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.

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 determining whether a sufficient number of authorized shares are available, the entity will need to consider all outstanding potentially dilutive instruments (e.g., warrants, options, convertible instruments, and contingent consideration arrangements). 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. Accordingly, the company's policy (e.g., LIFO, FIFO, or proportionate) for determining which derivative instruments or portions of derivative instruments, should be classified or reclassified should there be an overall shortage of available shares will be critical to determining whether the instant arrangement or a previously issued instrument should be classified as a liability.

2.6.4.2 Contingent consideration—IFRS

In accordance with IFRS 3.39-.40, contingent consideration is recognized and measured at fair value as of the acquisition date. 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.

An acquirer's obligation to pay contingent consideration should be classified as a liability or equity based on the definition of an equity instrument and a financial liability in IAS No. 32, *Financial Instruments: Presentation*. Under IAS 32.11, an equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. A financial liability is a (1) contractual obligation to deliver cash or another financial instrument or exchange financial assets or liabilities under conditions that are potentially unfavorable; or (2) contract that will or may be settled in its own equity instruments and is a:

- Nonderivative for which an entity is or may be obliged to deliver a variable number of its own equity shares; or
- Derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

The accounting for contingent consideration in the postcombination period is impacted by its classification as an asset, a liability, or equity. Excluding adjustments to contingent consideration that qualify as measurement period adjustments (see BCG 2.9), accounting for contingent consideration in the postcombination period is as follows:

- Contingent consideration classified as a liability or an asset: Contingent consideration classified as either an asset or a liability (financial or nonfinancial) should be remeasured to fair value at each reporting date and changes in fair value should be included in profit or loss in accordance with IAS 39 or IFRS 9.
- 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 contingent consideration arrangement on the acquisition date is not adjusted, even if the fair value of the arrangement on the settlement date is different.

Determining classification of contingent consideration arrangements between liabilities and equity—IFRS

A contingent consideration arrangement that is required to be settled in cash or other assets should be classified as a liability. There may be situations where a contingent consideration arrangement is settled with an entity's own equity shares, yet the arrangement is accounted for as a liability (e.g., a fixed amount to be paid in a variable number of shares). The classification of contingent consideration under IFRS is based primarily on the following criteria:

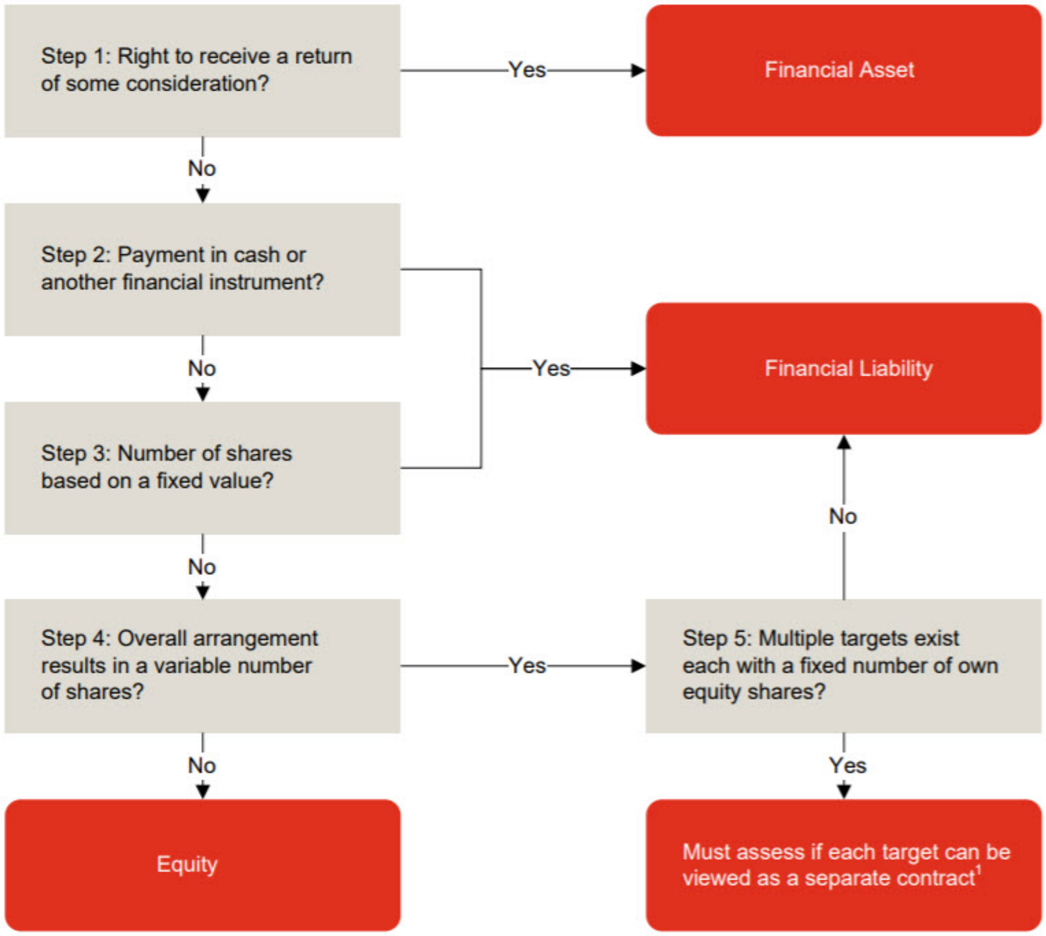
- Contingent consideration arrangements that will be settled in a fixed number of the issuer's equity instruments would be classified as equity. Otherwise, if the arrangement results in the delivery of a variable number of shares, the arrangement would be classified as a liability under IAS 32.16b.

- For arrangements 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. To be assessed as separate contracts, those performance targets must be readily separable and independent of each other and relate to different risk exposures in accordance with IAS 39.AG29. If separable, these contracts may then individually result in the delivery of a fixed number of shares and as a result be classified as equity. Otherwise, the arrangement must be viewed as one contract that results in the delivery of a variable number of shares (and would be classified as a liability) because the number of shares that will be delivered depends upon which performance target is met.

- Equity classification is precluded for contingent consideration arrangements that meet the definition of a derivative if the arrangement has a settlement choice (e.g., net share or net cash), even if it is the issuer's exclusive choice (see IAS 32.26).

Figure 2-1 illustrates the framework to determine the classification of contingent consideration arrangements.

Figure 2-1
Contingent consideration classification



[1] Judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement.

2.6.5 *Classification of contingent consideration arrangements—US GAAP and IFRS examples*

The examples below consider various contingent consideration arrangements and provide analysis for determining the classification of contingent consideration arrangements as a liability or as equity under US GAAP and IFRS. 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 under US GAAP 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.[5] 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

[5] However, our experience is that most contingent consideration arrangements involving nonpublic companies include net settlement provisions within the contract.

to be indexed to the entity's own shares following the guidance in ASC 815-40-15 to be within the scope of ASC 815-40. Only if the arrangement meets the conditions of ASC 815-40 can it be equity classified. Finally, ASC 480-10-15 indefinitely defers the provisions of ASC 480 for nonpublic entities that issue certain mandatorily redeemable securities. However, in most cases we would not expect nonpublic entities to meet the conditions necessary to be able to apply this limited scope exception. For IFRS companies, the analysis in the examples below would not differ, regardless of whether the fact pattern related to public or private companies.

See Examples 2-15 through 2-20 for determining the initial classification of contingent consideration arrangements executed in connection with a business combination.

EXAMPLE 2-15

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 CU200 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 the unit of account is the contract as a whole, since there is only one performance target.

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

US GAAP 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 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making determining of whether the arrangement is considered indexed to Company A's own shares, the first step is to determine whether the arrangement 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 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.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the contingent consideration arrangement would result in the issuance of a fixed number of equity shares of Company A, the arrangement would be classified as equity under IAS 32.16.

EXAMPLE 2-16

Issuance of a variable number of shares based on entity's performance—single measurement 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 CU200 million during the one-year period following the acquisition. In addition, if Company's B's revenues exceed CU200 million, Company A will issue an additional 1,000 shares for each CU2 million increase in revenues in excess of CU200 million, not to exceed 100,000 additional shares (i.e., 200,000 total shares for revenues of CU400 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 fixed number of shares based on entity's performance be recognized?

US GAAP 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 appears to vary 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 predominately 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 predominately on the revenue target. If the arrangement is determined to be predominately based on revenues, it would be considered a liability under ASC 480. However, even if the settlement of the variable number of shares was based on revenues, but not predominately, 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.

IFRS Analysis

The ordinary 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's 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 under IAS 39.AG29. Since the arrangement will result in the issuance of a variable number of shares, it should be classified as a liability in accordance with IAS 32.16.

EXAMPLE 2-17

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 CU40 per share. Company A also provides Company B's former shareholders contingent consideration whereby if the common shares of Company A are trading below CU40 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 CU40 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 authorised 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 recorded?

US GAAP 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 CU40 per share to CU35 per share one year after the acquisition date, the amount of the obligation would be CU5 million. Therefore, the freestanding guarantee would be recorded as a liability at its fair value following the guidance in ASC 805-30-25-6 and ASC 480-10-25-8. Further, changes in the liability will be recognized in Company A's earnings until the arrangement is resolved.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the guarantee feature of the contingent consideration arrangement would result in the issuance of a variable number of equity shares of Company A (i.e., the number of shares to be delivered will vary depending on the issuer's share price), this arrangement should be classified as a liability under IAS 32.11.

EXAMPLE 2-18

Issuance of a variable number of shares based on issuer's share price

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 up to 100,000 additional common shares to the former shareholders of Company B for increases in Company A's share price on the one-year anniversary of the acquisition date (Company A's share price at the acquisition date was CU40). The arrangement specifies that Company A will issue 50,000 additional shares if the share price is equal to or greater than CU45 but less than CU50 or 100,000 additional shares if the share price is equal to or greater than CU50 on the one year anniversary of the acquisition date.

Company A has sufficient authorised 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 the unit of account is one contract with multiple performance targets.

How should the issuance of a variable number of shares based on the issuer's share price be recorded?

US GAAP 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 since the obligation to issue a variable number of shares is not based solely or predominantly on any one of the following: (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, (c) variations inversely related to changes in the fair value of the Company's equity shares and the arrangement does not obligate the Company to transfer cash or other assets. Although the arrangement may be settled with a variable number of shares, because the number of Company A's (the issuer's) common shares are indexed directly to increases in its own share price, the arrangement would not require liability classification under ASC 480-10-25-14(b).

The contingent consideration arrangement meets the three characteristics of a derivative because it (1) has an underlying (Company A's share price) and 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 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 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the arrangement is considered indexed to Company A's own shares, the first step would be to determine whether the arrangement 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. In this case, since the number of shares used to calculate the settlement amount is based upon Company A's share price, step one does not preclude the arrangement from being considered indexed to Company A's own shares. In performing step two under ASC 815-40-15, although settlement of the number of shares is variable, the variable input to the settlement amount is Company A's share price, which is an input for valuing a fixed-for-fixed forward or option on equity shares. Accordingly, the arrangement is considered indexed to Company A's own shares. The arrangement is for the issuance of common shares of Company A which are classified as shareholders' equity.

Based on the analysis performed, the contingent consideration arrangement would be classified as equity.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the number of Company A's shares that could be issued under the contingent consideration arrangement is variable (i.e., depends on the share price of Company A), the arrangement would be classified as a liability under IAS 32.16.

EXAMPLE 2-19

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 CU1 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 the unit of account is the contract as a whole since there is only one performance target.

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

US GAAP 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 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 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the arrangement is considered indexed to Company A's own shares, the first step would be to determine whether the arrangement 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 requires Company B's operating revenues to exceed Company X's (largest third party competitor) operating revenues by CU1 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 shares. 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 shares under ASC 815-40-15, the arrangement is a liability and should be accounted for as a derivative under the provisions of ASC 815-40.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the contingent consideration arrangement would result in the issuance of a fixed number of Company A's equity shares, the arrangement would be classified as equity under IAS 32.16 as there is no contractual obligation to deliver a variable number of shares.

EXAMPLE 2-20

Issuance of a variable number of shares based on entity's performance—multiple measurement 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 CU200 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 CU300 million during the second one-year period following the acquisition. The achievement of the earn-outs are independent of each other (i.e., outcomes could be zero, 50,000, 100,000 or 150,000 additional shares issued).

Company A has sufficient authorised 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 the entity's performance be recorded?

US GAAP 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 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 (i.e., the arrangements are indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the independent arrangements are considered indexed to Company A's own shares, the first step would be to determine whether each separate, independent contract 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 is not an observable market or index. 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 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, each independent contract within the contingent consideration arrangement would be classified as equity.[1]

IFRS Analysis

The ordinary 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 year one and year two arrangements are independent and relate to different risk exposures under IAS 39.AG29, each performance target can be viewed as a separate contract that would individually result in the issuance of a fixed number of equity shares of Company A. Therefore, each individual contract within the contingent consideration arrangement would be classified as equity under IAS 32.16 as there is no contractual obligation to deliver a variable number of shares.[1]

[1] 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 CU200 million in the one-year period following the acquisition or 110,000 shares if revenues equal or exceed CU220 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 arrangements 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 for additional discussion of compensation arrangements.

EXAMPLE 2-21

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.

In order to meet certain debt obligations, Company B is selling BU1 to Company A in exchange for a CU10 million upfront payment with additional consideration up to CU4 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

Absent the side arrangement, the additional consideration would likely be considered contingent consideration. In the example, the additional consideration is directed to the three owner employees, providing the individuals with contingent consideration that is not consistent with the majority shareholder on a per-share basis. This may indicate that the arrangement is compensation and not contingent consideration.

The previous example illustrates the importance of understanding the terms of the business combination, including any side arrangements. Refer to BCG 3.3 for additional considerations when determining whether amounts represent consideration or compensation.

2.6.5.2 Existing contingent consideration arrangements of an acquiree—US GAAP

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination should be recognized initially at fair value and subsequently measured in accordance with the guidance for contingent consideration under the existing provisions of ASC 805 regardless of whether the acquiree had accounted for its business combination using the guidance in ASC 805 or prior guidance (i.e., FAS 141). The subsequent acquisition does not change the nature of the contingent consideration arrangement.

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.

2.6.5.3 Existing contingent consideration arrangement of an acquiree—IFRS

Existing contingent payment arrangements of the acquiree are contingent consideration under IFRS 3. Contingent consideration arrangements of the acquiree would be liabilities (or in some instances, assets) of the acquired business. These arrangements would almost always be established by contract and fall within the scope of IAS 39/ IFRS 9 and be recognized at fair value on the acquisition date. The subsequent accounting would be driven by the classification of the asset or liability under IAS 39/ IFRS 9.

2.6.5.4 *Effect of contingent equity issued in a business combination on earnings per share*

When contingent consideration arrangements are in the form of common shares [ordinary shares], 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 45-57, and paragraphs 52–57 of IAS 33, Earnings Per Share. Contingently issuable shares (including shares placed in escrow) are shares whose issuance is contingent upon the satisfaction of certain conditions, and are considered outstanding and included in the computation of EPS as follows:

- If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares must be included in basic and diluted EPS as of the date that such conditions were satisfied.
- If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares is excluded from basic EPS but may be included in the calculation of diluted EPS. The number of contingently issuable shares included in diluted EPS is based on the number of shares, if any, that would be issuable if the end of the reporting period was the end of the contingency period (e.g., the number of shares that would be issuable based on current period earnings [profit or loss] or period-end market price), assuming the effect is dilutive. These contingently issuable shares are included in the denominator of diluted EPS as of the beginning of the period or as of the acquisition date, if later, in accordance with ASC 260-10-45-48 and IAS 33.52.

Figure 2-2 provides guidance on the effect of certain types of contingencies on EPS if all necessary conditions have not been satisfied by the end of the reporting period.

Figure 2-2
EPS guidance for specific types of contingencies

Earnings [profit] contingency	The number of contingently issuable shares depends upon meeting or maintaining a specified amount of earnings [profit or loss]. In accordance with ASC 260-10-45-51 and IAS 33.53, the diluted EPS computation should include those shares that would be issued under the conditions of the contract based on the actual earnings [profit], if the end of the reporting period was the end of the contingency period and their effect is dilutive. Because the amount of earnings [profit] may change in a future period, basic EPS should not include such contingently issuable shares, because all necessary conditions (i.e., end of the contingency period) have not been satisfied.
Market price contingency	The number of contingently issuable shares depends upon the market price of the shares at a future date. The computation of diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period being reported, if the end of the reporting period were the end of the contingency period and their effect is dilutive. If the condition is based on an average of market prices over some period of time, the average should be used. Because the market price may change in a future period, basic EPS should not include such contingently issuable shares since all necessary conditions (i.e., end of the contingency period) have not been satisfied (see ASC 260-10-45-52 and IAS 33.54).

Both earnings [profit] and market price contingency	If the number of shares contingently issuable depends on both future earnings [profit] and future market prices of the shares, the determination of the number of shares included in diluted EPS must be based upon both conditions—that is, earnings [profit] to date and current market price—as they exist at the end of the reporting period. In accordance with ASC 260-10-45-53 and IAS 33.55, contingently issuable shares should be included in diluted EPS if both conditions are met at the end of the reporting period and the effect is dilutive. Because the amount of earnings [profit] and the market price may change in a future period, basic EPS should not include such contingently issuable shares because all necessary conditions (i.e., end of the contingency period) have not been satisfied.
Other performance contingency	If the contingency is based on a condition other than earnings [profit] or market price (e.g., opening a certain number of retail stores), the contingent shares should be included in the computation of diluted EPS, based on the current status of the condition and the assumption that the current status will remain unchanged until the end of the contingency period, in accordance with ASC 260-10-45-54 and IAS 33.56. Until the condition has been satisfied and the number of shares to be issued is no longer contingent, basic EPS should not include such contingently issuable shares.

2.6.5.5 Contingent consideration—seller accounting

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 under US GAAP. ASC 815-10-15-83 defines a derivative instrument as a financial instrument or other contract with all of the following characteristics:

ASC 815-10-15-83

A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

1. One or more underlyings

2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:

1. Its terms implicitly or explicitly require or permit net settlement.

2. It can readily be settled net by a means outside the contract.

3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

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 the Basis for Conclusions in 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 it does not meet the definition of a derivative, then 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 seller may elect the fair value option or account for it as an interest bearing financial instrument.

Under IFRS, a contract to receive contingent consideration that gives the seller the right to receive cash or other financial assets when the contingency is resolved meets the definition of a financial asset. When the contingent consideration arrangement meets the definition of a financial asset, it should be included as part of consideration received and should be measured using one of the four measurement categories specified in IAS 39/ IFRS 9. Determining the contingent consideration arrangement's classification will require judgment and will be based on the specific facts and circumstances of each arrangement.

Example 2-22 provides an example of how to account for a contingent consideration arrangement from a seller perspective.

EXAMPLE 2-22

Contingent consideration—seller accounting

Company A sells its entire controlling stake in wholly owned Subsidiary B. The proceeds of the sale include CU150 million in cash paid up front plus contingent payments of 5% of revenue for the next 3 years. Net assets of Subsidiary B were CU100 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 or IAS 39.

- For US GAAP, 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 realisable. 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 CU10 million (assessed based on expected sales over the next 3 years of CU70 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).

- 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 US GAAP, Company A elects the fair value option for subsequent accounting.

- For IFRS, the contingent consideration arrangement is considered an available for sale debt asset.

- Interest income is recognized using the effective interest method.

How should Company A record the contingent proceeds?

Analysis

The following analysis evaluates how Company A should account for the contingent proceeds (excluding the accounting for any tax effects of the transaction).

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

Cash	CU150	
Contingent consideration—asset	CU10	
Net assets		CU100
Gain on sale		CU60

Company A records the following journal entries at the end of year one. Similar journal entries would be recorded for years two and three. For ease of illustration, this example assumes that there is a 100% probability of the annual growth rates noted above will be achieved (companies would have to consider multiple scenarios and probability weight each scenario to determine the fair value).

The journal entry to record cash received from the contingent consideration arrangement after year one is as follows (in millions):

Cash (A)	CU3.5	
Contingent consideration—asset		CU3.5

Under US GAAP, the journal entry to record interest income and the remeasurement of contingent consideration due to the change in growth rate expectation for year one is as follows (in millions):

Contingent consideration—asset	CU2.5	
P&L—changes in fair value (B)		CU2.5

Under IFRS, the journal entries to record interest income and the remeasurement of contingent consideration due to the change in growth rate expectation are as follows (in millions):

Contingent consideration—asset	CU1.0	
Interest income (C)		CU1.0

Contingent consideration—asset	CU1.5	
Gain (D)		CU1.5

Expected revenues at sale date (15% growth rate and 10% discount rate):

	Revenue	**5% of revenue**	**Present value**
Year 1	CU70.0	CU3.5	CU3.2
Year 2	80.5	4.0	3.3
Year 3	92.6	4.6	3.5
Total		**CU12.1**	**CU10.0**

Expected revenues after year 1 (30% growth rate and 10% discount rate):

	Revenue	**5% of revenue**	**Present value**
Year 2	CU91.0	CU4.6	CU4.1
Year 3	118.3	5.9	4.9
Total		**CU10.5**	**CU9.0**

[A] CU70 × 5%

[B] (CU10 × 10%) + (CU9 – (10 – 3.5 + (CU10 × 10%)))

[C] CU10 × 10%

[D] CU9 – (10 – 3.5 + 1.0)

If Company A had elected to record the contingent consideration portion of the arrangement when the consideration is determined to be realizable under US GAAP, 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.

Under IFRS, since the contingent consideration asset was classified as an available-for-sale debt asset and there are no changes in the market discount rate during the three years, fair value would not differ from amortized cost and therefore there is nothing to recognize in OCI.

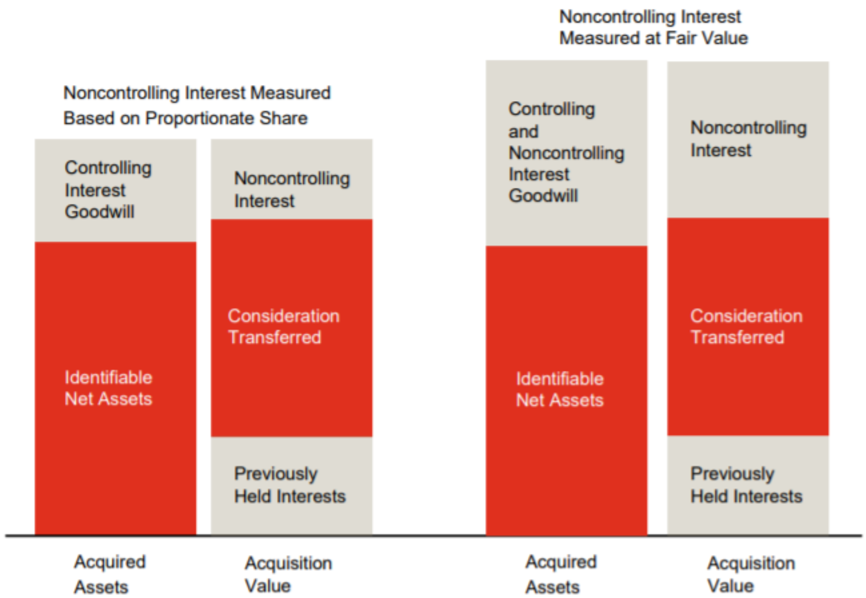
2.6.6 Noncontrolling interest

The noncontrolling interest is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent (see ASC 810-10-45-15 and IFRS 10, Appendix A). Only financial instruments issued by a subsidiary that are classified as equity in the subsidiary's financial statements for financial reporting purposes can be classified as noncontrolling interest in the consolidated financial statements. A financial instrument that a subsidiary classifies as a liability is not a noncontrolling interest in the consolidated financial statements. However, not all financial instruments that are issued by a subsidiary and classified as equity will be recognized as a noncontrolling interest within equity in consolidation. Certain preferred shares, warrants, puts, calls, and options may not form part of noncontrolling interest within equity in consolidation by the parent company. For example, instruments indexed to a subsidiary's shares issued to investors do not create NCI if those instruments do not meet the requirements for equity classification. See FG 7.2 for the analysis of equity-linked instruments. See BCG 5.2 for further information on the guidance to determine whether such instruments are considered noncontrolling interests in consolidation.

For all US GAAP companies, the noncontrolling interest is recognized and measured at fair value on the acquisition date in accordance with ASC 805-20-30-1. IFRS companies, on the other hand, have the option of measuring the noncontrolling interest at fair value or at its proportionate share of the recognized amount of the acquiree's identifiable net assets in accordance with IFRS 3.19. This accounting choice may be made on a transaction-by-transaction basis and does not require a company to make an accounting policy election. See BCG 5 for additional guidance on the accounting for the noncontrolling interest and FV 7 for guidance on measuring the noncontrolling interest at fair value.

The accounting election related to the measurement of the noncontrolling interest in a partial acquisition can impact the amount of goodwill recognized under IFRS. However, goodwill is the same for a full or partial acquisition under US GAAP. Figure 2-3 provides a diagram showing the impact of the accounting election on the measurement of goodwill.

Figure 2-3
Measurement of goodwill based on accounting election for the noncontrolling interest under IFRS



2.6.6.1 *Redeemable noncontrolling interest—US GAAP*

US GAAP public companies with securities that are redeemable upon the occurrence of an event that is not solely within the control of the issuer are subject to the guidance issued in ASC 480-10-S99-3A. US GAAP public companies would continue to classify these securities as mezzanine equity in the consolidated financial statements but still consider these securities a noncontrolling interest. As a result, these securities would be subject to the accretion requirements in ASC 480-10-S99-3A in addition to the accounting guidance in ASC 810-10. However, companies should consider the SEC staff's views in ASC 480-10-S99-3A regarding the interaction between that guidance and ASC 810-10. The staff's views:

- Clarify that ASC 480-10-S99-3A applies to the noncontrolling interests that are redeemable or may become redeemable 1) at a fixed or determinable price on a fixed or determinable date, 2) at the option of the holder, or 3) upon occurrence of an event that is not solely within the control of the issuer. This may be a change in practice for certain companies that previously did not accrete noncontrolling interests that meet these criteria.

- Provide guidance for the reclassification of securities to permanent equity if they are no longer required to be classified as mezzanine equity under ASC 480-10-S99-3A.

- Require the measurement of any gains and losses in the deconsolidation of a subsidiary to exclude any accretion included in the carrying amount of the noncontrolling interest.

- Provide guidance for the calculation of EPS if:

  a. Preferred shares issued or guaranteed by the parent: Increases or decreases in the carrying amount of the preferred shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. Increases or decreases in the carrying amount of the preferred shares should reduce or increase income available to common shareholders of the parent.

b. Preferred shares issued by the subsidiary: Increases or decreases in the carrying amount of the preferred shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. Increases or decreases in the carrying amount of the preferred shares should be attributed to the parent and the noncontrolling interest in accordance with ASC 260-10-55-20 (i.e., attributed to the parent based on its holdings in the subsidiary).

c. Common shares: Increases or decreases in the carrying amount of the common shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. If the adjustment to the carrying value of the common shares is not fully considered in the attribution of net income to the parent and noncontrolling interest under ASC 810-10-45, application of the two-class method described in ASC 260-10-45-59A at the subsidiary level is necessary to determine net income available to common shareholders of the parent. If the adjustment to the carrying value of the common shares is fully considered in the attribution of net income to the parent and noncontrolling interest under ASC 810-10-45, application of the two-class method is unnecessary.

Generally the guidance in ASC 480-10-S99-3A was effective upon the adoption of ASC 810-10. Although technically not required for non-public entities, mezzanine equity presentation of a redeemable noncontrolling interest is strongly encouraged. For further discussion refer to FSP 5.

Initial measurement

Upon issuance, redeemable equity securities are generally recorded at fair value. If the securities are issued in conjunction with other non-derivative financial instruments, such as debt or equity instruments, the sales proceeds from the issuance should be allocated to each instrument based on their relative fair values.

Subsequent measurement

The objective in accounting for redeemable equity securities subsequent to issuance is to report the securities at their redemption value no later than the date they become redeemable by the holder.

A discount may arise from a redeemable equity security when it is issued:

- On a stand-alone basis with a fair value less than its redemption value.

- In conjunction with other securities, and the proceeds are allocated between the redeemable equity security and the other securities issued.

A redeemable equity security recorded at an amount less than its redemption value should be accreted to its redemption value in some cases. Accretion of a redeemable equity security is recorded as a deemed dividend, which reduces retained earnings and earnings available to common shareholders in calculating basic and diluted EPS.

- If the equity security is currently redeemable (e.g., at the option of the holder), it should be adjusted to its maximum redemption amount as of each reporting period.

- If the equity security is not currently redeemable and it is probable the instrument will become redeemable, then it should be either (1) accreted to its redemption value over the period from the date of issuance to the earliest redemption date or (2) recognized immediately at its redemption value.

- If the equity security is not currently redeemable (e.g., the contingency that triggers the holder's redemption right has not been met) and it is not probable that it will become redeemable, subsequent adjustment is not necessary until redemption is probable. The parent company should disclose why redemption of the equity security is not probable.

A reduction in the carrying value of a redeemable equity security is appropriate only to the extent the carrying value had previously been increased. Thus, if the redemption price of an instrument decreases, it should not be adjusted below its initial carrying value. An exception to this rule exists for redeemable securities that participate in the earnings of the subsidiary. In that case, the adjustment to the carrying value is determined after the attribution of net income or loss of the subsidiary pursuant to the consolidation procedures in ASC 810.

EXAMPLE 2-23

Adjustment to the carrying value of redeemable equity securities

Parent Company A acquires 80% of the common shares of Subsidiary B from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary B. 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 B, in its entirety, to Parent Company A for CU100 million at any time. The fair value of the noncontrolling interest at the acquisition date is CU100 million.

Parent Company A concludes that the put option is embedded in the noncontrolling interest (i.e., it is a puttable noncontrolling interest). As a result, the noncontrolling interest is recorded as mezzanine equity because the interest is redeemable at the option of the minority shareholder.

At the end of the first year, Subsidiary B records a net loss of CU50 million. The amount of the net loss attributable to the noncontrolling interest shares is CU 10 million (CU50 million × 20%).

The redemption value of CU100 million does not change as a result of Subsidiary B generating a net loss.

How should the adjustment to the carrying value of redeemable equity securities be recorded?

Analysis

Since the redemption value of the noncontrolling interest remains unchanged, the CU10 million net loss attributable to the noncontrolling interest shares should be offset by a deemed dividend to the noncontrolling interest holder. The dividend is deducted from earnings available to common shareholders in calculating Parent Company A's basic and diluted earnings per share.

2.6.7 *Calls and puts related to the noncontrolling interest*

The entity may have the right to purchase the noncontrolling interest (i.e., a call right) or the noncontrolling interest holder may have the right to sell its interest (i.e., a put right) to the entity. These rights to purchase or sell the noncontrolling interest may be at a fixed or variable price, or at fair value, and may be exercisable on a fixed date or any time at some point in the future. The existence of these rights impacts (1) whether separate assets or liabilities should be recognized for these rights, (2) the classification of any minority ownership as a liability or equity (including mezzanine equity under US GAAP), and (3) the amount of earnings [profit or loss] recognized in the financial statements.

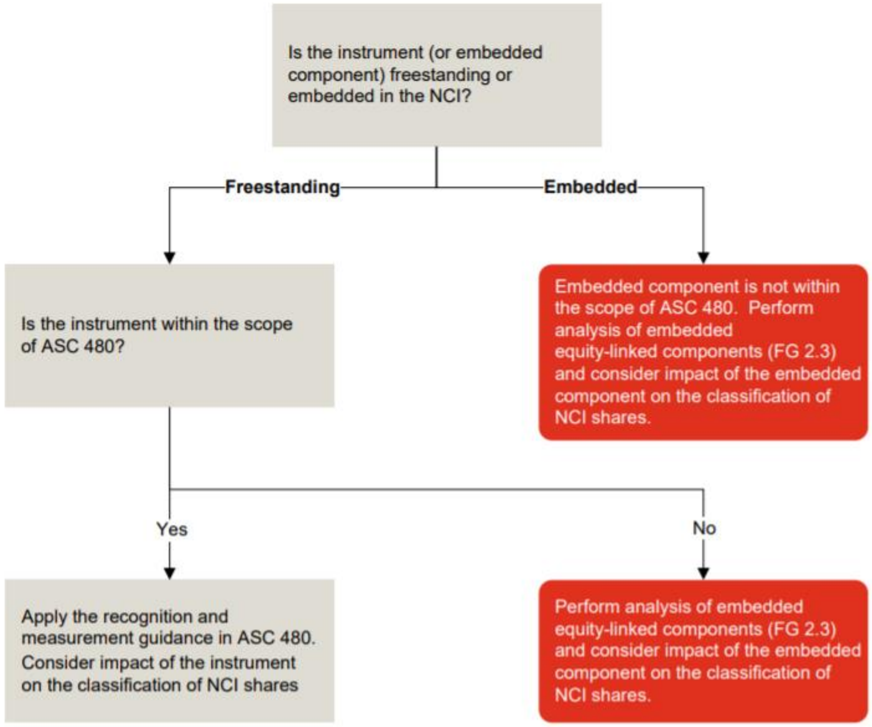
The complexity surrounding the accounting for call and put rights is due to the difficulty in determining whether these rights are accounted for separately or as part of the noncontrolling interest. An in-depth analysis of equity-linked instruments as well as share repurchase contracts can be found in PwC's accounting and financial reporting guide for *Financing transactions* (FG). This section provides an overview of the accounting for options related to the noncontrolling interest with specific references to relevant FG sections.

2.6.7.1 *Calls and puts related to the noncontrolling interest—US GAAP*

An instrument indexed to the stock of a consolidated subsidiary should be considered indexed to its own stock (provided the subsidiary is a substantive entity) based on the guidance in ASC 815-40-15-5C. This is the case whether an instrument that is executed with a noncontrolling interest holder is entered into by the parent or by the subsidiary. Therefore, the analysis to determine the appropriate accounting treatment for an instrument issued by a parent indexed to the stock of a consolidated subsidiary is similar to the analysis to determine the accounting treatment for an equity-linked instrument on a company's own stock. FG 7 provides an overview of equity-linked instruments.

Figure 2-4 illustrates the steps used to assess whether an instrument indexed to a subsidiary's shares and executed with noncontrolling interest holders is embedded in the noncontrolling interest or is a freestanding instrument.

Figure 2-4
Analysis of instruments indexed to a subsidiary's shares executed with noncontrolling interest holders



Freestanding vs. embedded

To determine the appropriate accounting treatment of an instrument indexed to a subsidiary's shares executed with a noncontrolling interest holder, it is necessary to first determine whether the instrument is freestanding or embedded in the noncontrolling interest. A freestanding financial instrument is defined as:

A financial instrument that meets either of the following conditions:

- It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.

- It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Separately and apart

Factors to consider in determining whether an instrument is entered into separately and apart from the transaction that created the noncontrolling interest include:

- Whether the counterparty to the instrument is unrelated to the noncontrolling interest holder—a counterparty that is unrelated to the noncontrolling interest holder would be an indicator that the instrument was entered into separately and apart from the noncontrolling interest.

- When the counterparty to the instrument is the noncontrolling interest holder, (1) whether the instrument is documented separately from the transaction that gave rise to the noncontrolling interest, and (2) the length of time between the creation of the noncontrolling interest and the execution of the instrument—execution with the noncontrolling interest holder may occur separately and apart from the noncontrolling interest if the instrument is separately documented (and there is no linkage between the two instruments) and there is a reasonable period of time between the transaction that created the noncontrolling interest and the execution of the instrument.

Legally detachable and separately exercisable

Oftentimes an instrument indexed to a subsidiary's shares will be executed in connection with the transaction that created the noncontrolling interest. Thus, in determining whether the instrument is freestanding or embedded, the analysis generally hinges on whether the instrument is legally detachable and separately exercisable.

Figure 2-5 highlights indicators and considerations when determining whether an instrument is legally detachable and separately exercisable from the noncontrolling interest.

Figure 2-5
Embedded vs. freestanding indicators

Indicator	Indicates freestanding	Indicates embedded	Considerations
Transferability of either (1) the shares that represent the NCI or (2) the instrument	Shareholder and/or purchase agreements do not limit the transfer of either instrument (i.e., the instrument can be transferred while the underlying shares are retained)	Shareholder and/or purchase agreements do limit the transfer of either instrument (i.e., the instrument cannot be transferred without the underlying shares)	Significant indicator if separately transferable; however, not a significant indicator if shares/instrument cannot be separately transferred as stapled/attached securities can still be freestanding
Continued existence of the NCI after the instrument is settled	Instrument can be settled while the NCI remains outstanding	Once the instrument is settled, the NCI is subject to redemption or is no longer outstanding	Significant indicator
Settlement	Instrument can be or is required to be net settled	Instrument can only be settled on a gross physical basis	Significant indicator
Counterparty	If the parent is the counterparty, then from the perspective of the NCI holder the instrument could be viewed as separate from or attached to the NCI	If the subsidiary is the counterparty, then the equity comprising the NCI and the instrument are with the same counterparty. From a consolidated perspective, a subsidiary's equity is also the parent's equity	Not a significant freestanding indicator

Indicator	Indicates freestanding	Indicates embedded	Considerations
Specific shares	The shares that represent the NCI to be delivered upon settlement of the instrument are not specifically identified	The shares that represent the NCI to be delivered upon settlement of the instrument are specifically identified	If the shares issued by the subsidiary are not publicly traded, this indicator is less significant because it may not be possible for the NCI holder to obtain the issuer's shares in the open market

Example 2-24 illustrates an example of an embedded put option.

EXAMPLE 2-24

Analysis of put right

Parent Company A acquires 80% of the common shares of Subsidiary B from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary B.

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 B, 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 B shares to a third party.

Should the put right be separately recorded?

Analysis

The put option is embedded in the noncontrolling interest recorded in Parent Company A's financial statements because it does not meet either of the conditions of a freestanding financial instrument.

- The put option was executed as part of the acquisition, therefore it was not entered into separately and apart from the transaction that created the noncontrolling interest.

- The put option is not legally detachable and separately exercisable as it is non-transferrable and terminates if Company Z sells its shares.

Accounting for a freestanding instrument executed with noncontrolling interest holders

A freestanding instrument should be accounted for on a separate basis. The appropriate accounting treatment will be determined by the type of instrument and its terms. The issuer should also consider what impact, if any, the freestanding instrument has on the parent company's accounting for the noncontrolling interest. In many cases, the noncontrolling interest continues to be reported in the parent company's financial statements based on the contractual terms of the shares that represent the noncontrolling interest. In other cases, the noncontrolling interest is derecognized and a liability is recognized even though the instrument indexed to the subsidiary's shares is considered freestanding from the noncontrolling interest.

Figure 2-6 summarizes the parent company's accounting treatment for (1) various instruments indexed to a subsidiary's shares and (2) noncontrolling interest.

Figure 2-6

Accounting impacts of freestanding derivatives on NCI shares

Freestanding derivative on NCI shares	Accounting for the instrument(s)	Accounting for NCI
Written put option	Generally, a written put option is recorded at fair value with changes in fair value recorded in earnings.	Recorded as a separate component of equity.
Purchased call option	A purchased call option is recorded at fair value with no subsequent remeasurement if the option meets the requirements for equity classification. A purchased call option is recorded at fair value with subsequent remeasurement in earnings if the option does not meet the requirement for equity classification.	Recorded as a separate component of equity.
Forward-purchase for a fixed number of shares for cash	Generally, physically settled forward-purchase contracts are initially recorded at fair value. If the amount to be paid and the settlement date are fixed, the liability should be accreted to the settlement date payment amount. If the amount to be paid or the settlement date vary, ASC 480 requires the instrument to be remeasured each reporting date. Subsequent remeasurement should be recognized in interest cost.	The NCI is derecognized and a liability is recognized because it is certain that the parent will purchase the remaining shares.
Collar comprised of a purchased call option and a written put option	Generally, a collar is recorded at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480.	Recorded as a separate component of equity.
Freestanding written put and purchased call	Generally, a written put option and a purchased call option are accounted for separately unless they are economically equivalent to a forward-purchase contract.	Recorded as a separate component of equity.

See FG 7.6 for further discussion of the accounting treatment for these instruments.

Combination of written put and purchased call options freestanding from the noncontrolling interest

Generally, a written put option and a purchased call option are accounted for separately; however, a written put option and a purchased call option with the same exercise price and exercise dates are economically equivalent to a forward-purchase contract. The accounting treatment of both (1) the instrument and (2) the corresponding noncontrolling interest differ based on whether the options are accounted for separately (i.e., as a written put option and a purchased call option) or in combination (i.e., as a forward-purchase contract). Thus, a parent company should determine whether a written put option and a purchased call option that are freestanding from a noncontrolling interest are also freestanding from each other.

If the written put option and purchased call option with the same exercise price and exercise dates are issued as a single instrument and are freestanding from the noncontrolling interest, the single instrument is economically equivalent to a forward-purchase contract and is recorded as an asset or liability at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480.

As discussed in ASC 480-10-25-15, a freestanding written put option that is accounted for as a liability within the scope of ASC 480 should not be combined with a freestanding purchased call option that is outside the scope of ASC 480. A written put option is recorded as a liability at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480. A purchased call option may be recorded as (1) equity, which is not remeasured, or (2) an asset recorded at fair value with changes in fair value recorded in earnings depending on its terms (see FG 7.5 and 7.6).

Classification of an instrument embedded in a noncontrolling interest

Once the parent company determines that an instrument is embedded in a noncontrolling interest, it should assess whether the agreement meets the requirements to be accounted for separately from the host noncontrolling interest. FG 7.4 provides an analysis of embedded equity-linked components. Frequently, embedded components in a noncontrolling interest are not required to be accounted for as derivatives and thus are not accounted for separately.

If a parent company determines that an embedded component should not be accounted for separately, it should assess whether the embedded component has an impact on the classification of and accounting for the noncontrolling interest shares.

Figure 2-7 summarizes the potential effect that various embedded components may have on the classification of noncontrolling interest shares.

Figure 2-7

Impacts of embedded components on the classification of NCI

Embedded component	Impact on classification of NCI
Written put option	▫ Typically, for public companies, the puttable shares will result in classification as mezzanine equity. ▫ See BCG 2.6.6.1 for a discussion of redeemable NCI.

Embedded component	Impact on classification of NCI
Purchased call option	□ A purchased call option typically will not affect the classification of the NCI shares.
Forward-purchase	□ A forward contract embedded in a NCI results in mandatorily redeemable NCI shares. The parent company should eliminate the NCI shares from equity and recognize a liability for the mandatorily redeemable shares. □ See FSP 7 for a discussion of mandatorily redeemable shares.
Collar	□ The impact of a collar is generally determined by the terms of the options. See written put option and purchased call option discussions above.
Written put and purchased call with the same fixed exercise price and exercise date	□ Based on the guidance in ASC 480-10-55-59 and 55-60, the written put option and purchased call option should be viewed on a combined basis with the NCI and accounted for as a financing of the parent's purchase of the NCI. □ The parent consolidates 100% of the subsidiary. The instrument is recorded as a liability and accreted, through interest cost, to the exercise price over the period until settlement.
Written put and purchased call with floating exercise prices	□ A NCI with an embedded put and purchased call with a floating exercise price is not considered a mandatorily redeemable instrument under ASC 480. Therefore, the NCI shares are contingently redeemable rather than mandatorily redeemable and typically, for public companies, the puttable shares will result in classification as mezzanine equity. □ See FSP 7 for a discussion of contingently redeemable securities.

2.6.7.2 Calls and puts related to the noncontrolling interest—IFRS

An acquirer may purchase a call option and/or write a put over a noncontrolling interest in connection with the acquisition of a controlling interest in a business combination. IFRS 3 does not provide guidance on how such contracts should be accounted for in a business combination and there is also a lack of guidance when such contracts are entered into by a parent subsequent to the business combination. In determining the appropriate accounting treatment, IFRS 10, IAS 32 and IAS 39 need to be considered. The main accounting principles are as follows:

- The ownership risks and rewards of the shares relating to the forward or option should be analysed to determine whether they remain with the noncontrolling interest or have transferred to the parent. The noncontrolling interest is recognized to the extent the risks and rewards of ownership of those shares remain with them.

- Irrespective of whether the noncontrolling interest is recognized, a financial liability (redemption liability) is recorded to reflect the forward or put option. All subsequent changes to the liability are recognized in profit or loss. Where the risks and rewards of ownership remain with the noncontrolling interest, the financial liability recognized reduces the controlling interest equity. The noncontrolling interest continues to be recognized and is allocated its share of profits and losses in the normal way. Where significant risks and rewards of ownership reside with the controlling interest, the financial liability recognized is offset against the noncontrolling interest balance:

    - If the liability is greater than the noncontrolling interest (which will generally be the case) the difference is debited to controlling interest equity. This is to avoid the noncontrolling interest becoming negative.

    - If the liability is less than the noncontrolling interest, it is likely that the noncontrolling interest has retained some residual rights, which might be, for example, to future dividends. In this situation, the balance is shown as a noncontrolling interest.

    - Dividends paid to the noncontrolling interest that do not reduce the contracted future purchase price are deducted from the noncontrolling interest carrying value. Profits and losses are allocated to the noncontrolling interest to the extent it is necessary to cover the dividend payment so that the noncontrolling interest does not become negative.

    - If the forward or put option states that dividend payments reduce the contracted future purchase price, then the dividend amount should be deducted from the redemption liability.

Analysis of contract terms

The terms of the forward and option contracts should be analysed to assess whether they provide the parent with access to the economic benefits and risks associated with the actual ownership of the shares during the contract period. The noncontrolling shareholder may have substantially retained the risks and rewards associated with the continued ownership until such time as the contract is settled. Factors to consider in making this assessment include, for example, the pricing of the forward contract or options and whether share price movements during the contract period result in benefits and losses being borne by the parent or by the noncontrolling shareholder.

Typically, forwards or options that will be settled with a transfer of the noncontrolling interest's shares for a fair value price do not result in a transfer of the risks and rewards or ownership to the parent until the contract is settled. However, fixed price forwards do result in a transfer of risks and rewards of ownership of the shares to the parent from the date the contract is written. Written put options with a fixed exercise price that are accompanied by a similarly priced call option, exercisable at the same future date, are similar, in substance, to a fixed price forward. If symmetrical put and call options exist, it is often virtually certain that either the parent or the noncontrolling shareholder will exercise the option given it will be in one of their economic interests to do so. If the share price falls below the fixed exercise price, the noncontrolling shareholder will exercise the put option and sell the shares (that is, the parent has retained the risks of decline in value during the option period). If the share price increases above the fixed exercise price, the parent will exercise the call option and buy the shares (that is, the parent has retained access to the benefits from increases in value during the option period).

Accounting for option and forward contracts related to noncontrolling interests

A noncontrolling interest is recognized in equity to the extent that the risks and rewards of ownership substantially remain with the noncontrolling interest during the contract period. Where all the risks and rewards of ownership have transferred to the parent, a noncontrolling interest is not recognized. If the forward or symmetrical put and call options are entered into at the same time as the business combination and an amount is recognized for noncontrolling interest, in accordance with IFRS 3, it is recorded either at fair value or at its proportionate share of the fair value of identifiable net assets of the subsidiary. If the contracts are entered into subsequent to the date of the business combination, then the noncontrolling interest is derecognized to the extent the risks and rewards of ownership have transferred to the parent.

Evaluating whether the risk and rewards of ownership transfer to the parent or remain with the noncontrolling interest is judgmental and requires consideration of all contracts' terms and conditions. There may also be circumstances when the exercise price of the forward or symmetrical put and call options to acquire the noncontrolling interest is based on a formula that is not akin to a fair value price. These are complex situations, and determining where the risks and rewards of ownership lie depends on the facts and circumstances.

An entity that enters into a contract that contains an obligation for the entity to deliver cash or another financial asset in exchange for its own equity shares is a financial liability in accordance with IAS 32.23. This liability is recorded irrespective of whether that contract meets the definition of an equity instrument. Under a forward contract, the entity has an obligation to deliver cash or a financial asset, but an issue arises as to whether an obligation exists for an entity that enters into a written put option over its own shares. The financial liability is recognized at the present value of the redemption amount and accreted through finance charges in the income statement over the contract period up to the final redemption amount. Any adjustments to the redemption amount are recognized as finance charges in the income statement in accordance with IAS 39.AG8. The initial redemption liability is a reduction of parent's equity if the risks and rewards of ownership remain with the noncontrolling interest or a reduction of noncontrolling interest equity if the risks and rewards of ownership transfer to the parent. If the present value of the redemption amount exceeds the carrying value of the noncontrolling interest, any excess is recorded against parent's equity.

A noncontrolling interest may receive dividends during the period of the contract. Dividends are deducted from the noncontrolling interest; however, if the dividend amount exceeds the carrying value of the noncontrolling interest, then an allocation of the entity's profits is made to bring the noncontrolling interest to zero. Dividends paid should only reduce the redemption liability if the forward or put and call options stipulate that such payments reduce the exercise price. Profits should be allocated to the noncontrolling interest to the extent they retain risks and rewards of ownership.

If the contract is exercised, any noncontrolling interest equity is allocated to parent equity. No adjustments are made to goodwill upon settlement of the contract. The redemption liability is offset by the cash payment.

If the contract lapses unexercised where the risks and rewards of ownership have transferred to the parent, a noncontrolling interest equity is reinstated. In substance, the parent has sold those shares back to the noncontrolling interest and it is a transaction with a noncontrolling interest. The noncontrolling interest equity amount is reinstated at an amount equal to its share of the carrying values of the subsidiary's net assets at the date of lapse plus the goodwill from the subsidiary's initial acquisition. Any difference between the redemption liability and the noncontrolling interest equity adjustment is recognized against the parent's equity. No adjustments are made to goodwill.

If the contract lapses unexercised where the risks and rewards of ownership remain with the noncontrolling interest, then no adjustment is made to the carrying value of the noncontrolling interest and the redemption liability is derecognized against the parent's equity.

2.6.8 Treatment of a previously held equity interest in an acquiree

The acquirer may hold an equity interest in the acquiree prior to a business combination. In the Basis for Conclusions in FAS 141(R) (B384) and IFRS 3 (BC384), the Boards 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 Boards believe 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 in earnings [profit or loss] based on the remeasurement of any previously held equity interest in the acquiree to fair value. If a previously held equity interest had been classified as an available-for-sale security under ASC 320 or IAS 39, prior adjustments to its fair value would have been recognized in other comprehensive income [directly in equity]. In these situations, the amount recognized in other comprehensive income [directly in equity] should be reclassified and included in the calculation of any gain or loss for US GAAP, or recognized on the same basis that would be required if the acquirer had directly disposed of the previously held equity interest for IFRS.

The 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. Example 2-25 illustrates the recognition and measurement of a gain on a previously held equity interest in the acquiree in a business combination.

EXAMPLE 2-25

Gain on a previously held equity interest in an acquiree

Company T (acquirer) previously held a 10% equity interest in Company U (acquiree) with an original investment of CU6 million. Company T pays CU90 million in cash for the remaining 90% interest outstanding. The 10% equity interest held in the acquiree is classified as an available-for-sale security. On the acquisition date, the identifiable net assets of the acquiree have a fair value of CU80 million, the 10% equity interest of the acquiree has a fair value of CU10 million, and CU4 million of unrecognized gains related to the previously held equity interest was recorded in other comprehensive income [directly in equity].

How should the gain on the previously held equity interest in an acquiree be recorded?

Analysis

Excluding any income tax effects, Company T would record the following entry to recognize a gain and the acquisition of Company U (in millions):

Identifiable net assets	CU80	
Goodwill	CU20[1]	
Equity—unrecognized gains	CU4	
Cash		CU90
10% equity interest in acquire		CU10
Gain		CU4[2]

[1] Goodwill: Fair value of consideration transferred, plus the fair value of the previously held equity interest in acquiree, less identifiable net assets = (CU90 + CU10) – CU80.

[2] Gain: Fair value of previously held equity interest in acquiree, less carrying value of previously held equity interest in acquiree, plus / less amount recognized in other comprehensive income [directly to equity] = CU10 – CU10 + CU4.

2.6.9 *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.

2.7 *Assessing what is part of a business combination transaction*

The Standards provide the following principle for determining what is part of a business combination transaction:

Excerpts from ASC 805-10-25-20 and IFRS 3.51

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, [ie] 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 GAAP [IFRSs].

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. The Standards provide three factors to consider that are neither mutually exclusive nor individually conclusive. Those factors are:

Excerpts from ASC 805-10-55-18 and IFRS 3.B50

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; IFRS 3.52, transactions that are recognized separately from the business combination are accounted for based on the applicable guidance in US GAAP or IFRS. Specific guidance is provided for the following transactions in connection with a business combination:

- Employee compensation arrangements
- Reimbursement provided to the acquiree or former owners for paying the acquirer's acquisition costs
- Settlement of preexisting relationships between the acquirer and acquiree

These types of transactions are discussed in the next sections of this chapter.

2.7.1 *Employee compensation arrangements*

Employees of the acquiree may receive replacement awards or be provided with other agreements that represent compensation for past services to the acquiree or future services to the combined entity, or both. Employee compensation arrangements should be reviewed to determine what amount, if any, is considered part of the business combination and recognized as a component of consideration transferred. Amounts that are not part of the consideration transferred are recognized separately from a business combination and accounted for in accordance with the applicable US GAAP or IFRS. Additional guidance on the accounting for employee compensation arrangements can be found in BCG 3.

Examples 2-26 and 2-27 illustrate the accounting treatment for certain employee compensation arrangements that are not recognized as a component of the consideration transferred in a business combination.

EXAMPLE 2-26

Employee compensation arrangements—prefunded retention agreement

Company A acquires Subsidiary B from Company C for CU200 million. As part of the transaction, Company A hires five employees of Subsidiary B who were deemed critical to Subsidiary B's business due to their knowledge and expertise. Also as part of the transaction, Company C agreed to fund an escrow arrangement under which these five individuals would receive a retention bonus aggregating CU15 million if they remain employed by Company A for the three years following the acquisition. If any of the five individuals terminate employment, they forfeit their bonus and these amounts will revert to Company C.

How should the prefunded retention agreement be recorded by Company A?

Analysis

The retention arrangement represents compensation for postcombination services rendered to Subsidiary B, even though it is funded by Company C. Accordingly, the retention arrangement is a separate transaction from the business combination and should be reflected as expense in Company A's consolidated financial statements during the three-year employment period to the extent paid to the employees in accordance with ASC 805-10-25-20 [IFRS 3.51]. Therefore, Company A would allocate the amount paid of CU200 million between prepaid compensation and consideration transferred to acquire Subsidiary B.

EXAMPLE 2-27

Agreement conditioned upon a dual trigger consisting of change in control and termination

Company D acquires Company E in a business combination. Company E has an existing employment agreement in place with one of its key employees that states that the employee will be paid CU1 million upon a change of control and termination of employment within 18 months following the acquisition date (sometimes referred to as a "dual trigger"). The employee receives the stated amount only if the employee is subsequently terminated without cause or leaves for good reason as defined in the employment contract. At the date of the business combination, Company D had determined it would not offer employment to the key employee of Company E, effectively terminating employment on the acquisition date, and would pay CU1 million to the former employee of Company E.

How should Company E account for the termination of the key employee based upon a dual trigger?

Analysis

The termination payment to the employee is only incurred when both of the two conditions outlined in the employment agreement are met (i.e., a change of control and termination of employment). Since the decision to terminate the employee is out of Company E's control, only one of the two conditions is met by Company E at the acquisition date. Therefore, it would not be appropriate for Company E to record a liability in connection with the effective termination of the key employee.

Company D should recognize CU1 million of expense in its postcombination period as a transaction separate from the business combination. As noted above, the payment to the employee is conditioned upon both a change in control of the acquiree and a termination of employment by the acquirer. At the acquisition date, both conditions were triggered. The decision by Company D was made for its own benefit and should be recorded separately from the business combination in accordance with ASC 805-10-55-18 and IFRS 3.B50. Therefore, Company D would not record a liability in acquisition accounting but instead would recognize the expense in the period after the business combination.

2.7.2 Reimbursement arrangements between the acquiree and the acquirer for transaction costs incurred

Consistent with the guidance for acquisition costs (see BCG 2.7.5), acquisition costs embedded in the consideration transferred should be accounted for separately from the business combination. For example, consideration transferred by the acquirer that includes amounts to reimburse the acquiree or its former owners for payments made on behalf of the acquirer for its acquisition-related costs should be recognized separately from the business combination.

In contrast, costs incurred by an acquiree to sell a business are not acquisition-related costs. Such costs may include legal, accounting, or advisory fees and should be recognized in the period incurred. Consideration transferred by the acquirer that includes amounts to reimburse the acquiree for the acquiree's costs incurred to sell the business generally would be accounted for by the acquirer as part of the consideration transferred, as illustrated in Example 2-28.

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 2-28

Accounting for assumed liabilities 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. As of the acquisition date, Company B 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.

Should Company A recognize the outstanding payables of Company B as assumed liabilities in acquisition accounting?

Analysis

Yes. Acquisition-related costs incurred by an acquirer are considered separate transactions and should be expensed as incurred. However, in this fact pattern, these 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.

If Company A and Company B did negotiate for Company B to pay the transaction costs of Company A, such costs would be outside of the business combination. Therefore, the reimbursement provided by Company A would not be consideration transferred and an expense would be recognized by Company A in the period the costs were incurred.

2.7.3 Settlement of preexisting relationships between the acquirer and acquiree

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 and IFRS 3.B52. 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 2-29 illustrates the settlement of a preexisting debtor/creditor relationship between an acquirer and acquiree.

EXAMPLE 2-29

Settlement of a preexisting relationship recorded at current market rates

Company A has accounts payable of CU100 to Company B and Company B has accounts receivable of CU100 from Company A. Both the recorded payable and corresponding receivable approximate fair value. Company A acquires Company B for CU2,000 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 CU100 to account for the effective settlement of the payable to Company B.

2.7.3.1 *Calculating the gain or 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 and IFRS 3.B52.

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 and IFRS 3.B52. 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 and IFRS 3.B52.

Examples 2-30 through 2-32 reflect the settlement accounting for certain preexisting relationships in a business combination. The examples illustrate the accounting for settlement of a noncontractual relationship, settlement of a contractual relationship that includes a settlement provision, and settlement of a contractual relationship that does not include a settlement provision. Additional examples are provided in the Standards in ASC 805-10-55-30 through 55-32 and IFRS 3.IE54-IE57.

EXAMPLE 2-30

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 CU50 million to acquire Company B and effectively settles the lawsuit. The fair value of the settlement of the lawsuit is estimated to be CU5 million, and Company A had previously recorded a CU3 million litigation liability in its financial statements before the acquisition.

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 CU2 million, excluding the effect of income taxes. This represents the CU5 million fair value of the settlement after adjusting for the CU3 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):

Litigation liability	CU3	
Loss on settlement of lawsuit with Company B	CU2	
Acquired net assets of Company B	CU45	
Cash		CU50

If, however, Company A had previously recorded a liability greater than CU5 million, then a settlement gain would be recognized for the difference between the liability previously recorded and the fair value of the settlement.

EXAMPLE 2-31

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 CU10 million. The contract contains a settlement provision that allows Company C to terminate the contract at any time for CU6 million. Company C acquires Company D for CU100 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 CU6 million, excluding the effect of income taxes.

A settlement loss of CU6 million is recognized because it is the lesser of the fair value of the unfavorable contract terms (CU10 million) and the contractual settlement provision (CU6 million). The CU100 million in cash paid by Company C is attributed as CU6 million to settle the services contract and CU94 million to acquire Company D. The CU4 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):

Loss on settlement of services contract with Company D	CU6	
Acquired net assets of Company D	CU94	
Cash		CU100

EXAMPLE 2-32

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

Company E acquires Company F for CU100 million. 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 CU10 million. The services contract is silent on a settlement provision in the event that either party terminates the contract.

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

Analysis

Company E would recognize a CU10 million settlement loss, excluding the effect of income taxes, for the unfavorable amount of the contract. The CU100 million that Company E pays Company F's shareholders is attributed CU10 million to settle the preexisting relationship and CU90 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):

Loss on settlement of services contract with Company F	CU10	
Acquired net assets of Company F	CU90	
Cash		CU100

2.7.4 *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*, and IAS 39 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 [profit or loss] 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 and IAS 39.41. For example, if the acquiree has an investment in debt securities of the acquirer with a fair value of CU110 million and the carrying amount of the acquirer's debt is CU100 million, the acquirer would recognize a settlement loss of CU10 million on the acquisition date (based on the assumption that the debt was settled at CU110 million).

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 Standards' guidance for settling a preexisting relationship. See BCG 2.7.3.1 for further information.

2.7.5 Acquisition-related costs

An acquirer in a business combination typically incurs acquisition-related costs, such as finder's fees; advisory, legal, accounting, valuation, other professional or consulting fees; and general and administrative costs. Acquisition-related costs are considered separate transactions and should not be included as part of the consideration transferred but, rather, expensed as incurred or when the service is received in accordance with ASC 805-10-25-23 and IFRS 3.53. These costs are not considered part of the fair value of a business and, by themselves, do not represent an asset. Acquisition-related costs represent services that have been rendered to and consumed by the acquirer.

Costs related to the issuance of debt are capitalized and amortized into earnings [profit or loss] over the term of the debt in accordance with ASC 835-30-45-1 through 45-4, IAS 39R.43, and IAS 39R.47. Costs related to the issuance of equity reduce the proceeds received from the issuance.

Question 2-9

Are fees paid to an investment banker to handle the financing of the business combination considered acquisition-related costs?

PwC response

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 business combination. For example, assume Company A acquired Company B for 70% cash and the balance in preferred shares and debt and Company A hired an investment banker to handle the financing and underwriting services. The costs paid to the investment banker should be allocated between those that related to financing or underwriting the business combination (generally recorded as part of the cost of the debt or equity issuance) and all other services that should be expensed as incurred.

Question 2-10

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

Under US GAAP, 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, therefore, would not be reflected as expense in the separate financial statements of the acquiree.

In situations when predecessor and successor financial statements are presented with a blackline resulting from the effects of push down accounting, a question often arises as to which period expenses should be recorded in if such amounts are contingent upon the closing of a business combination. These types of costs are typically recorded in the predecessor period, immediately prior to the closing date. 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 staff has not objected to the presentation of such items in neither the predecessor or successor periods, provided that transparent and disaggregated disclosure of the nature and amount of such expenses is made. Such amounts are considered to be "on the line."

2.7.6 Financial instruments entered into by the acquirer in contemplation of a business combination

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 under US GAAP and IFRS, 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 and IAS 39, with the exception that IAS 39 does allow companies to achieve hedge accounting for the foreign currency exchange risk embedded in a firm commitment.

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 and IAS 39 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.

2.7.7 Transaction service arrangements

Transaction service arrangements (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 2-33 illustrates the accounting for a TSA.

EXAMPLE 2-33

Transaction service arrangements

Company A agrees to sell a business for CU100 million to Company B. Company A's net book value of the assets acquired and liabilities assumed by Company B is CU70 million. Concurrent with the acquisition agreement, Company A and Company B enter into a transition services agreement, under which Company A agrees to provide certain services to Company B for a period of one year after the acquisition at no cost to Company B. Company A estimates the fair value of the services to be provided under the TSA to be CU5 million, at a cost of CU3 million.

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

Analysis

On the date of sale of the business, Company A should allocate CU5 million of the proceeds (the fair value of the services less the fee assessed, in this case zero) to the TSA. The remaining CU95 million represents the consideration paid for the business.

Although the TSA agreement stipulates that the services will be performed by Company A at no cost to Company B, the substance of the transaction is that a portion of the consideration for the sale of the business relates to the transition services that will be provided in the future. Company B should recognize an asset for the prepayment of the services of CU5 million to be realized as the services are provided.

2.8 Example of applying the acquisition method

Example 2-34 provides an example of the general application of the acquisition method in a business combination.

EXAMPLE 2-34

Applying the acquisition method

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

- Company A pays CU100 million in cash to acquire all outstanding equity of Company B.
- Company A incurs CU15 million of expenses related to the acquisition. The expenses incurred include legal, accounting, and other professional fees.
- Company A agreed to pay CU6 million in cash if the acquiree's first year's postcombination revenues are more than CU200 million. The fair value of this contingent consideration arrangement at the acquisition date is CU2 million.
- The fair value of tangible assets and assumed liabilities on the acquisition date is CU70 million and CU35 million, respectively.
- The fair value of identifiable intangible assets is CU25 million.
- Company A intends to incur CU18 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 and IFRS 10.

Determining the acquisition date (BCG 2.4)

The acquisition date is the closing date.

Purchase accounting (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 CU60 million (CU95 million of assets less CU35 million of liabilities), excluding goodwill, as follows (in millions):

Tangible assets	CU70
Intangible assets	25
Liabilities	35
Acquired net assets	**CU60**

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 US GAAP or IFRS 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):

Acquisition costs	CU15	
Cash		CU15

The consideration transferred is CU102 million, which is calculated as follows (in millions):

Cash	CU100
Contingent consideration—liability	2[1]
	CU102

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

The acquisition results in goodwill because the CU102 million consideration transferred is in excess of the CU60 million identifiable net assets acquired, excluding goodwill, of Company B. Goodwill resulting from the acquisition of Company B is CU42 million and is measured, as follows (in millions):

Total consideration transferred	CU102
Less: acquired net assets of Company B	(60)
Goodwill to be recognized	CU42

2.9 Measurement period adjustments

The Standards require 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 and IFRS 3.46, 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

IFRS 3 provides the following principle for measurement period adjustments:

Excerpt from IFRS 3.45

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, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

US GAAP 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 includes 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 and IFRS 3.48.

Under IFRS 3.49, comparative prior period information included in subsequent financial statements would be revised to include the effect of the measurement period adjustment as if the accounting for the business combination had been completed on the acquisition date. The effects of a measurement period adjustment may cause changes in depreciation, amortization, or other income or expense recognized in prior periods.

Under ASC 805-10-65-3, the cumulative impact of the measurement period adjustments on current and prior periods is required to be recognized in the period that the adjustment amount is determined.

All changes that do not qualify as measurement period adjustments are included in current period earnings [profit or loss] under both the US GAAP and IFRS.

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* for US GAAP and IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, for IFRS.

Paragraphs ASC 805-10-55-27 through 55-29 and paragraphs IE51–IE53 of IFRS 3 provide an example that illustrates the application of the measurement period guidance where an appraisal is completed after the initial acquisition. Example 2-35 provides an example of the assessment of whether new information gives rise to a measurement period adjustment.

EXAMPLE 2-35

Identifying measurement period adjustments

On January 1, 20X0, Company C acquires Company D. As part of the initial acquisition accounting, Company C recognizes CU50 million of goodwill and a CU5 million intangible asset for the customer relationship related to Company D's largest customer. The useful life of the customer relationship is deemed to be four years. On June 30, 20X0, 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 CU7 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, 20X0 financial statements, Company D would make the following measurement period adjustment to the year-to-date financial information, excluding income tax effects (in millions):

Customer relationship	CU2	
Goodwill		CU2

To increase the value of the customer relationship

Amortization expense	CU0.25[1]	
Customer relationship		CU0.25

[1] Amortization expense based on the appraised value, less amortization expense recorded based on initial value: CU0.875 (6 months / 48 total months × CU7) less CU0.625 (6 months / 48 total months × CU5).

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

Under IFRS, the financial statements for the quarter ended March 31, 20X0 should be adjusted to include the impact of the measurement period adjustment. The results of operations would reflect the amortization expense of the intangible asset as if the adjustment had been recorded on the acquisition date.

Under US GAAP, 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, 20X0). Accordingly, under the revised Standard, the financial statements for the quarter ended March 31, 20X0 would not be restated.

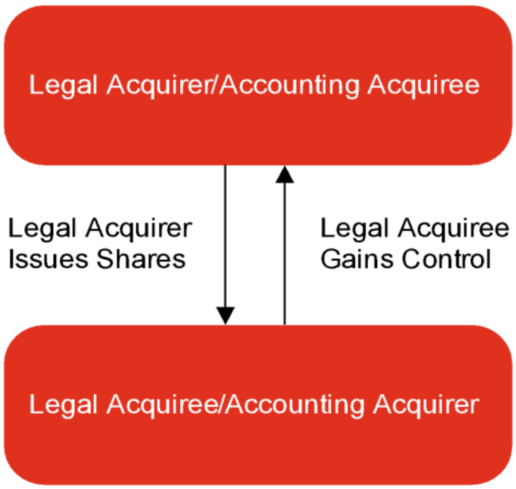
2.10 Reverse acquisitions

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 6.2.1.1 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 the Standards. 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 the Standards. 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 2-8 provides a diagram of a reverse acquisition.

Figure 2-8

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 and IFRS 3.B21.

2.10.1 Reverse acquisition (merger) involving a nonoperating public shell and a private operating entity

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 the Standards. 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.

Under US GAAP, 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.

Under IFRS, any difference in the fair value of the shares issued by the private entity over the value of the net monetary assets of the public shell corporation represents a service, and the cost of the service should be recognized as an expense by the acquirer.

2.10.2 *Consideration transferred in a reverse acquisition*

ASC 805-40-30-2 and IFRS 3.B20

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 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 are more reliably measurable than the value of the accounting acquirer's equity interest. This may occur if 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 accounting acquiree's equity interests in accordance with ASC 805-30-30-2 through 30-3 and IFRS 3.33.

Example 2-36 illustrates the measurement of the consideration transferred in a reverse acquisition.

EXAMPLE 2-36

Valuing consideration transferred in a reverse acquisition (adapted from ASC 805-40-55-8 through 55-10 and IFRS 3.IE5)

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

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 CU16
- Estimated fair value of a share of Company B is CU40

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. The consideration effectively transferred of CU1600 is measured using the market price of Company A's shares (100 shares times CU16).

Otherwise, 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 owners 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 shares[1] to Company A shareholders, increasing Company B's outstanding shares to 100 shares. Consideration effectively transferred would be CU1,600 (40 shares times the fair value of Company B's shares of CU40).

[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 shares / 60%) × 40%.

2.10.3 Presentation of consolidated financial statements

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 acquiring company.

The Standards provide the following financial statement presentation guidance for reverse acquisitions:

Excerpts from ASC 805-40-45-2 and IFRS 3.B22

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 [IFRS].

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 [IFRS]. However, the equity structure (that is, [ie] 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 [IFRS3.B23 and B24] and illustrated in Example 1, Case B (see paragraph 805-40-55-18).

Examples 2-37 and 2-38 illustrate the presentation of shareholders' equity following a reverse acquisition.

EXAMPLE 2-37

Presentation of shareholders' equity immediately following a reverse acquisition (adapted from ASC 805-40-55-13 and IFRS 3.IE7)

Company B, a private company, acquires 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	CU800	CU1,400
Issued equity		
100 common shares	300	
60 common shares		600
Total shareholders' equity	CU1,100	CU2,000

On the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares
- Fair value of consideration transferred is CU1,600
- 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]	CU1,400
Issued equity	
250 common shares[2]	2,200
Total shareholders' equity	**CU3,600**

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

[2] The amount recognized for issued equity (i.e., common shares outstanding) is the sum of the value recognized for issued equity interests of Company B immediately before the acquisition, plus the value of the consideration transferred: CU600 + CU1,600.

EXAMPLE 2-38

Restated presentation of shareholders' equity following a reverse acquisition

Company B, a private company, acquires 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 (CU1 par)
- Company A has total shareholders' equity of CU125
- Company B has 100 shares outstanding (CU2 par)
- Company B has total shareholders' equity of CU1,850

On the acquisition date:

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

After the acquisition date:

- The recapitalized entity has net income of CU300 for the period 4/1/X2 to 12/31/X2

How should the statement of shareholders' equity be restated in a reverse acquisition?

Analysis

Shareholders' equity (Company B) immediately before the acquisition date:

	Shares at par (CU2)	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' at 12/31/X2:

	Shares at par (CU1)	APIC	Retained earnings	Total shareholders' equity
1/1/X1	240	480	300	1,020
Shares issued 7/1/X1	80	70		150
Net income			250	250
12/31/X1	320	550	550	1,420
Shares issued 2/1/X2	80	150		230
Net income			200	200
3/31/X2	400	700	750	1,850
Recapitalization 4/1/X2	100	25		125
Net income			300	300
12/31/X2	500	725	1,050	2,275

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 [profit or loss] of only the legal acquiree and not the earnings [profit or loss] of the combined entity. As mentioned in the previous section, 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 [profit or loss] 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 and IFRS 3.B24.

Example 2-39 illustrates the measurement of a noncontrolling interest in a reverse acquisition.

EXAMPLE 2-39

Measurement of noncontrolling interest (adapted from ASC 805-40-55-18 through 55-21 and IFRS 3.IE12)

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 CU2,000

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 CU134. This is based on a 6.7% ownership (4 shares / 60 issued shares) in Company B and Company B's net assets of CU2,000.

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.

The Standards provide the following guidance on EPS:

Excerpts from ASC 805-40-45-4, ASC 805-40-45-5 and IFRS 3.B26, B27

In calculating the weighted-average number of common [ordinary] shares outstanding (the denominator of the earnings-per-share calculation) during the period in which the reverse acquisition occurs:

a. The number of common [ordinary] 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 [ordinary] 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 [ordinary] shares outstanding from the acquisition date to the end of that period shall be the actual number of common [ordinary] shares of the legal acquirer (the accounting acquiree) outstanding during that period.

The basic earnings per share 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 [profit or loss] of the legal acquiree attributable to common [ordinary] shareholders in each of those periods

b. The legal acquiree's historical weighted average number of common [ordinary] shares outstanding multiplied by the exchange ratio established in the acquisition agreement.

Example 2-40 illustrates the computation of EPS in a reverse acquisition.

EXAMPLE 2-40

Computation of EPS (adapted from ASC 805-40-55-16 and IFRS 3.IE9)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition on September 30, 20X6.

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, 20X6 through the acquisition date

On September 30, 20X6, 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 [profit] for the consolidated entity for the year ended December 31, 20X6 are CU800

How should earnings per share be computed?

Analysis

EPS for the year ended December 31, 20X6 is computed as follows:

Earnings [profit] for the year ended December 31, 20X6	CU800
Number of common shares outstanding of Company B	60
Exchange ratio	2.5
Number of shares outstanding from January 1, 20X6 through September 30, 20X6	150
Number of shares outstanding from acquisition date through December 31, 20X6	250
Weighted-average number of shares outstanding (150 shares × 9 / 12) + (250 shares × 3 / 12)	175
Earnings per share for year ended December 31, 20X6 (CU800 / 175 shares)	CU4.57

2.11 Applying the acquisition method for variable interest entities and special purpose

The guidance in ASC 805 is also applicable to the consolidation of 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 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 2-9 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 considerations highlighted in BCG 7 figure 7-1 on how to account for common differences between a business combination and an asset acquisition should also be considered in accounting for a VIE.

Figure 2-9
Variable interest entities and business combinations

Scenario	Application of ASC 805
Acquired group is a: Variable interest entity Business	The consolidation of a VIE when control is obtained is considered a business combination. Apply the acquisition method in ASC 805. In this situation, the date a 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 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; 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 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 BCG 7 for further information.

IFRS does not include the concept of VIEs. Prior to the adoption of IFRS 10, SIC 12 provided an interpretation of IAS 27 (2008). Special purpose entities (SPEs) are those that are set up to achieve a narrow or specifically defined outcome, and it is often difficult to change their activities [SIC 12.1]. An entity may have no ownership interest in an SPE, but it may, in substance, control it. SIC 12 lists factors that may indicate control. These are, in substance:

- The SPE's activities are being conducted for the benefit of the entity.
- The entity has substantive decision-making powers to realize benefits or it has delegated the powers through an "autopilot" mechanism.

- The entity has access to the majority of the rewards of the SPE and may, therefore, be exposed to the majority of the risks.
- The entity has the majority of ownership or residual risks so that it obtains the majority of the rewards from the SPE.

An entity should apply IFRS 3 if it gains control of an SPE that is a business and account for the transaction as a business combination. An entity that acquires control over an SPE that is not a business and consolidates the SPE, accounts for the transaction as an acquisition of assets in accordance with BCG 7.

IFRS 10 superseded SIC 12. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities. The application of IFRS 10 includes situations where control is gained through a contract (i.e., structured entities). See BCG 1.7.2 for further information on IFRS 10.

2.12 Conforming accounting policies of the acquiree to those of the 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.

The acquirer may 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 and IAS 8 must be considered.

2.13 Continuing transition requirements

US GAAP and IFRS companies should generally apply the provisions of the Standards prospectively to business combinations for which the acquisition date was on or after the Standards' effective date. Adjustments to most assets acquired and liabilities assumed that arose from business combinations consummated prior to the effective date of the Standards continue to be accounted for under previous US GAAP or IFRS. However, the Standards should be applied to certain income tax matters (e.g., valuation allowance releases and changes to uncertain tax positions) that arose from business combinations consummated prior to the effective date of the Standards. These continuing transition considerations are discussed in more detail below.

2.13.1 Income tax transition provisions

The release of a valuation allowance [initial recognition of acquired deferred tax assets] that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to equity as required by ASC 740 or IAS 12). The release of a valuation allowance [initial recognition of acquired deferred tax assets] within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase in accordance with ASC 805-740-45-2 and IAS 12.68.

The acquirer must consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date or are due to events arising in the postcombination period. Discrete events or circumstances that arise within the measurement period and that did not exist at the acquisition date generally would not be recorded in acquisition accounting in accordance with ASC 805-10-25-13 and IFRS 3.45.

Unlike the general transition provisions of the Standards, whereby the guidance is applied only to business combinations consummated after the effective date of the Standards, the guidance related to the release of a valuation allowance (ASC 740) or recognition of assets (IAS 12) subsequent to the date of acquisition also applies to business combinations consummated prior to the effective date of the Standards in accordance with ASC 805-10-65-1 (for business combinations entered into before 2009) and IFRS 3.67. Therefore, changes to acquired deferred tax balances that are not measurement period adjustments are no longer recorded as adjustments to purchase accounting and are instead reflected in income tax expense.

Measurement period adjustments to uncertain tax positions are recorded first as an adjustment to goodwill, and then as a bargain purchase. Other adjustments are recorded in earnings [profit or loss] directly impacting a company's income tax expense and effective tax rate. This guidance related to adjustments to acquisition-related tax uncertainties also applies to business combinations consummated prior to the effective date of the Standards. Under IFRS, adjustments related to tax uncertainties recorded in a business combination that (1) were made within one year of the acquisition date and (2) related to matters existing at the acquisition date, are generally recorded as an adjustment to purchase accounting. Otherwise, adjustments are recognized in the income statement.

Question 2-11

How should excess tax-deductible goodwill from acquisitions made prior to the effective date of ASC 805 be accounted for under US GAAP?

PwC response

In general, when specific transition guidance is not provided, companies should continue to follow the previous guidance for acquisitions consummated prior to the adoption of ASC 805.

Under historical US GAAP guidance,[6] if tax-deductible goodwill exceeded book goodwill as of the acquisition date, no deferred tax asset was recorded. The tax benefit of the excess tax basis is recognized when it is realized on the tax return. ASC 805 amended the guidance for accounting for excess tax-deductible goodwill at the acquisition date. However, no transition guidance was provided for accounting for excess tax-deductible goodwill that arose in acquisitions consummated prior to the effective date of ASC 805.

Therefore, companies should continue to follow the historical guidance for recording the income tax benefit from amortizing component-2 tax-deductible goodwill for acquisitions consummated prior to the effective date of ASC 805. For those acquisitions, the tax benefit from the component-2 tax-deductible goodwill is recorded as the benefit is realized on the tax return, first as a reduction to

[6] FAS 109, par.263 prior to being amended by ASC 805-740.

goodwill from the acquisition, second as a reduction to other noncurrent intangible assets related to the acquisition, and third to reduce income tax expense.

2.13.1.1 *Acquired tax benefits disclosure*

IAS 12.81(k) requires the disclosure of the event or change in circumstances that caused the recognition of a deferred tax benefit that was not initially recognized on the acquisition date.

Under ASC 740, prior to the adoption of the Standards, companies recorded the tax benefit of excess tax-deductible goodwill over book goodwill when realized on the tax return. That tax benefit was applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense. While the Standards are silent as to the accounting treatment for excess tax-deductible goodwill upon transition, current practice is for companies to apply the guidance that was in place at the time the acquisition was completed. For acquisitions that took place prior to the adoption of the Standards, companies should continue to follow the previous guidance for recording the income tax benefit for excess tax-deductible goodwill.

For more discussion on the amendments to ASC 740 and IAS 12, and other income tax accounting matters associated with a business combination, see TX 10.7.

2.14 Contingent consideration of an acquiree

Under US GAAP, a pre-existing contingent consideration arrangement of the acquiree assumed in a business combination should be accounted for by the acquirer in accordance with the guidance for contingent consideration arrangements in ASC 805-30-25-5. This guidance requires that contingent consideration be recognized as part of the consideration transferred in a business combination and measured at its acquisition-date fair value. See BCG 2.6.4.1 for further information on the accounting for contingent consideration in a business combination under US GAAP.

In contrast to US GAAP, a pre-existing contingent consideration arrangement of the acquiree would be accounted for as an assumed liability (or in some instances, an asset) of the acquired business under IFRS. As these arrangements would almost always be established by a contract, they would fall within the scope of IAS 39 and be recognized at fair value on the acquisition date. The IASB concluded that such pre-existing arrangements would not constitute contingent consideration under IFRS 3 because the consideration does not arise from the current transaction between the acquirer and the former owners of the acquiree.

Chapter 3: Employee compensation arrangements

3.1 Chapter overview

The acquirer in a business combination may agree to assume existing compensation arrangements with employees of the acquiree or may establish new arrangements to compensate those employees for postcombination services. These arrangements may involve cash payments to the employees or the exchange (or settlement) of share-based payment awards. These replacement share-based payment awards, in many cases, include the same terms and conditions as the original awards and are intended to keep the employees of the acquiree "whole" (i.e., preserve the value of the original awards at the acquisition date) after the acquisition. The acquirer may, in other situations, change the terms of the share-based payment awards, often to provide an incentive to key employees to remain with the combined entity.

Employee compensation arrangements should be analyzed to determine whether they represent compensation for (1) precombination services, (2) postcombination services, or (3) a combination of precombination and postcombination services. Amounts attributable to precombination services are accounted for as part of the consideration transferred for the acquiree. Amounts attributable to postcombination services are accounted for separately from the business combination and are usually recognized as compensation cost in the post-acquisition period. Under ASC 805-10-25-20 and IFRS 3.51, amounts attributable to a combination of precombination and postcombination services are allocated between the consideration transferred for the acquiree and the postcombination services.

Contingent payment arrangements with an acquiree may represent consideration transferred for the acquiree or compensation for postcombination services. This chapter discusses the analysis that the acquirer should perform to determine if the contingent consideration is accounted for as part of the consideration transferred or as a transaction separate from the business combination (in the postcombination financial statements).

The acquiree may enter into employee related transactions during the negotiations for a business combination. These transactions might include the settlement or acceleration of vesting for share-based payment awards or bonus payments to employees. The acquirer should assess these transactions to determine whether they should be accounted for in the postcombination financial statements or included as part of the consideration transferred for the acquiree. Transactions that benefit the acquiree before the acquisition are included as part of consideration transferred. If it is determined that a transaction was arranged primarily for the economic benefit of the acquirer (or combined entity), the transaction is not deemed to be part of the consideration transferred for the acquiree and should be accounted for separately from the business combination under ASC 805-10-25-20 through 25-22 or IFRS 3.51–52,B52. Factors to consider in this analysis include:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction

The basic principle outlined in ASC 805-10-25-20 and IFRS 3.51 is broadly applicable to other transactions outside of arrangements with employees. This principle and the three factors listed above are discussed in more detail in BCG 2.

This chapter also addresses the accounting for other employee compensation arrangements, such as "stay bonuses" and "golden parachute" agreements with employees of the acquiree.

For guidance on accounting for share-based payment awards under US GAAP, refer to PwC's *Stock-based compensation guide*. For guidance on accounting for share-based payment awards under IFRS 2, refer to the PwC IFRS Manual of Accounting. The accounting for pension and other postretirement benefits in a business combination is addressed in BCG 2.

New guidance

On March 30, 2016, the FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which amends ASC 718, *Compensation – Stock Compensation*. The ASU includes provisions intended to simplify various provisions related to how share-based payments are accounted for and presented in the financial statements.

One provision in ASU 2016-09, allows companies to make an accounting policy election when recognizing share-based compensation expense to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. The fair value of acquiree awards measured in a business combination are not impacted by such an accounting policy election. ASU 2016-09 is effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. For all other entities, it is effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption will be permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption.

IFRS does not allow a similar policy election and there is no current project to converge the accounting standards. Under IFRS, forfeitures must be estimated.

3.2 Assessing what is part of the consideration transferred for the acquiree

Employee compensation arrangements should be analyzed to determine whether they represent compensation for (1) precombination services, (2) postcombination services, or (3) a combination of precombination and postcombination services. Amounts attributable to precombination services are accounted for as part of the consideration transferred for the acquiree. Amounts attributable to postcombination services are accounted for separately from the business combination and are costs in the post-acquisition period. The cost of an arrangement that includes precombination and postcombination services is attributed between the consideration transferred for the acquiree and the postcombination services. This assessment will not always be straightforward and may require significant judgment.

An acquirer may agree to exchange share-based payment awards held by employees of the acquiree for replacement share-based payment awards of the acquirer. The awards held by the employees of the acquiree and the replacement awards are measured using the fair-value-based measurement principles of ASC 718 or IFRS 2 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 and IFRS 3.B57. 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 and IFRS 2. The acquirer should then attribute the fair value of the awards to precombination services and postcombination services, as appropriate, based on the principles in the Standards.

The fair value of the awards attributed to precombination services is included as part of the consideration transferred for the acquiree. The fair value of the awards attributed to postcombination services is recorded as compensation cost in the postcombination financial statements of the combined entity in accordance with ASC 805-30-55-8 through 55-10 and IFRS 3.B57-B59. 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).

An acquirer may enter into a contingent consideration arrangement with the selling shareholders of the acquiree, or the acquiree may enter into a transaction for the benefit of the acquirer or the combined entity. These arrangements need to be analyzed to determine if they should be included in the consideration transferred for the acquiree, accounted for as a separate transaction apart from the business combination, or a combination of both.

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 separately from the business combination in accordance with ASC 805-10-25-20 through 25-22 and IFRS 3.51–52, B50. Factors identified in ASC 805-10-55-18; IFRS 3.B50 to consider in this analysis include:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction [ASC 805-10-55-18; IFRS 3.B50]

The basic principle outlined in the Standards and the three factors listed above are discussed in more detail in BCG 2. Throughout this chapter, the analysis of employee compensation arrangements requires consideration of the basic principle and an assessment of the three factors. See BCG 3.3 for information on the indicators to be considered when analyzing contingent consideration arrangements.

3.3 Contingent payments—determining whether the arrangement is compensation

Arrangements that include contingent payments are assessed to determine if the consideration is for postcombination services. In accordance with ASC 805-10-55-24 and IFRS 3.B54, 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. The nature of the arrangement will dictate whether contingent payments to employees (or selling shareholders) are (1) contingent consideration in a business combination or (2) separate transactions. 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 and IFRS 3.B55 provide eight indicators that should be considered. These criteria need to be applied to all arrangements for payments to employees or selling shareholders, including both cash compensation and share-based payment awards. 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.

All of the indicators in the Standards should be considered when analysing whether consideration is for postcombination services. However, the Standards require the consideration to be accounted for as postcombination compensation cost[1] if the consideration is automatically forfeited upon termination of employment.

Excerpts from ASC 805-10-55-25 and IFRS 3.B55

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 [remuneration] 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 [remuneration].

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 [remuneration].

c. Level of compensation [remuneration]. Situations in which employee compensation [remuneration] 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 [remuneration].

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 [remuneration].

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 [remuneration] 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 [remuneration].

[1] Compensation cost is typically recorded as expense, unless required or permitted to be capitalized by other standards.

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.

Example 3-1 provides an example of a contingent consideration arrangement that is forfeited upon the termination of employment and therefore is treated as postcombination compensation cost.

EXAMPLE 3-1

Contingent consideration arrangement

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 amortisation (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 and IFRS 3.B55, 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.

See Question 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 bonus arrangements

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.

Examples 3-2 and 3-3 include examples of arrangements that compensate for employee services.

EXAMPLE 3-2

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 CU5 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 CU5 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 expense that should be accounted for separately from the business combination. Company A should consider the factors listed in ASC 805-10-55-18 and IFRS 3.B50:

- The reasons for the transaction: The CU5 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.

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 the application of the acquisition method.

EXAMPLE 3-3

Stay bonus arrangements

Company Z acquires Company Y and agrees to provide each of the key officers of Company Y a cash payment of CU1 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 CU1 million will be forfeited. A similar clause was not included in Company Y's key officers' employment agreements prior to the discussions that lead 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 CU1 million cash payment to each of the key officers is (1) consideration transferred for the acquiree or (2) a postcombination expense that should be accounted for outside of the business combination. Company Z should consider the factors listed in ASC 805-10-55-18 and IFRS 3.B50:

- The reasons for the transaction: The CU1 million payment was offered to the key officers of Company Y by Company Z to facilitate the transition process following the acquisition.

- 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 the combined company.

3.4 Exchange of employee share-based payment awards

The acquirer may issue its own share-based payment awards (replacement awards) in exchange for awards held by employees of the acquiree. Generally, in such a transaction, the acquirer will replace the existing awards (under which the employees 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 employees "whole" after the acquisition (i.e., preserve the value of the original awards at the acquisition date) or to provide further incentive for employees to remain with the combined entity. Therefore, replacement awards may represent consideration for precombination services, postcombination services, 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, such as to provide incentives for key employees to remain with the company.

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 employees 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; IFRS 3.B56 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 and IFRS 2. 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 or IFRS 2. 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. However, this chapter addresses share-based payment awards 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 services. To the extent replacement awards are for precombination services, 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 services, 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 30-13, ASC 805-30-55-7 through 55-10 and IFRS 3.B57–B60.

Acquiree awards may expire as a consequence of a business combination and the acquirer may not be obligated (as that term is defined in the Standards) to grant replacement awards. If the acquirer grants replacement awards for awards that would otherwise expire and the acquirer is not obligated to do so, the replacement awards are considered separate from the business combination. Under ASC 805-30-30-10 and IFRS 3.B56, the entire fair value of the replacement awards should be recognized as compensation cost in the postcombination financial statements.

Figure 3-1 summarizes the accounting for different arrangements involving the exchange of employee awards in a business combination.

Figure 3-1
The accounting for different arrangements involving the exchange of employee awards in a business combination

	Scenarios		Accounting	
Acquirer's obligation	**Replacement of awards**	**Expiration of acquiree awards**	**US GAAP**	**IFRS**
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 services.	The awards are considered in the determination of the amount of consideration transferred for the acquiree or for postcombination services.
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 postcombination compensation cost in the post-combination period.	The entire fair value of the replacement awards is recognized as postcombination 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 post-combination period.	The acquirer accounts for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above).
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.	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.	The acquirer accounts for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above).

[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 *Determining the fair value attributable to precombination and postcombination services*

The concepts in ASC 718 and IFRS 2 used to attribute compensation costs differ. ASC 718 uses a service-period concept, whereas IFRS 2 uses a vesting-period concept. For purposes of these standards, the service period and the vesting period include only periods of employee service that directly contribute to meeting the specified vesting conditions of the award. Therefore, for the attribution of fair value to precombination and postcombination service in a business combination, the service period and the vesting period should generally be the same. An exception to this will be deep out-of-the-money awards that under US GAAP are deemed to have a derived service period.

In accordance with ASC 805-30-55-8 through 55-9 and IFRS 3.B58, the portion of the replacement award attributable to precombination service is the fair value of the acquiree awards multiplied by the ratio of the precombination service [vesting] period completed prior to the exchange to the greater of the total service [vesting] period of the replacement awards or the original service [vesting] period of the acquiree awards.

The fair value of the awards to be attributed to postcombination services would then be calculated by subtracting the portion attributable to precombination services from the total fair value of the acquirer replacement awards under ASC 805-30-55-10 and IFRS 3.B59. 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 services. The fair value attributable to precombination services should be reduced to reflect an estimate of future forfeitures, notwithstanding the company's policy for accounting for forfeitures upon adoption of ASU 2016-09.

Figure 3-2 illustrates how to calculate the amount of fair value attributed to precombination and postcombination services.

Figure 3-2
Calculation of amount of fair value attributed to precombination and postcombination services

Precombination services			Postcombination services
Fair value of the acquiree award	×	$\dfrac{\text{Precombination service (vesting) period completed prior to the exchange}}{\text{Greater of: Total service (vesting) period of the replacement award OR Original service (vesting) period of the acquiree award}}$	Total fair value of the acquirer replacement award Less: portion attributable to precombination services

When determining the fair value attributable to precombination and postcombination services, the total service [vesting] period includes both the service [vesting] period of the acquiree's awards completed before the acquisition date and the postcombination service [vesting] period of the replacement awards in accordance with ASC 805-30-55-8 through 55-9 and IFRS 3.B58.

The amount attributable to precombination services should be included in the consideration transferred for the acquiree. The amount attributable to postcombination services, however, is not part of the consideration transferred for the acquired business. The amount attributable to postcombination services should instead be recognized as compensation cost in the postcombination financial statements over the postcombination requisite service [vesting] period in accordance with ASC 805-30-30-12 through 30-13 and ASC 805-30-55-10 and IFRS 3.B58–B59.

The method of attributing the fair value of replacement awards between periods of precombination services and postcombination services is the same for equity- and liability-classified awards. All changes in the fair-value-based measure of the awards classified as liabilities 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 and IFRS 3.B61.

Question 3-1

How should fair value be attributed to postcombination services for share options that are deep out of the money at the acquisition date?

PwC response

Under US GAAP, 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 services and recognized as compensation cost in the postcombination financial statements in accordance with ASC 718-10-35-5, ASC 718-10-55-69 through 55-79, and ASC 805-30-55-8 through 55-9.

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. The postcombination service period should be based on the longer of the explicit service period and 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.

Under IFRS, the awards would be attributed over the one-year service period.

Question 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

The Standards provide that replacement share-based payment awards should be measured using the fair-value-based measurement method of ASC 718 or IFRS 2. Under ASC 718-10-30-11 and IFRS 2.19, 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 service is $100 and the acquirer expects that the requisite service will be rendered for only 95% 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 upon adoption of ASU 2016-09. 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, ASC 805-30-55-11 through 55-12, IFRS 2.20 and IFRS 3.B60. Any postcombination changes in assumptions should be recognized directly in net income.

Question 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

IFRS 2 require companies to recognize compensation cost based on the number of awards expected to vest. Therefore, companies are required to estimate future forfeitures of unvested awards. For awards that are unvested at the acquisition date, the amount of compensation cost recognized in the postcombination financial statements should be reduced to reflect estimated forfeitures. Under IFRS 3.B60, postcombination forfeitures, or changes in the estimated forfeiture rate, should be accounted for as adjustments to compensation cost in the period in which the forfeiture or change in estimate occurred. 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 IFRS 2.20.

Regardless of the accounting policy elected upon adoption of ASU 2016-09, in the event of an acquisition, an estimate of forfeitures is still required under US GAAP. As described above, the amount of compensation cost recognized in the precombination financial statements should be reduced to reflect estimated 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 through 55-12. 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 service and recognized in compensation cost over the requisite service period.

3.4.1.1 *Awards with graded-vesting features*

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."

US GAAP 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. The company's attribution policy should be applied consistently for all awards with similar features in accordance with ASC 805-30-55-12.

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 55-34.

IFRS 2 does not provide companies with the option to use the straight-line attribution method for awards with graded-vesting features. Thus, a graded-vesting attribution approach should be used.

See SC 1.11 for information on awards with graded-vesting features.

Question 3-4

Under US GAAP, how does an acquirer's attribution policy impact the amount attributable to precombination services for awards with graded-vesting features?

PwC response

For awards with graded-vesting features, the amount of fair value attributable to precombination services should be determined based on the acquirer's attribution policy for any of its existing awards in accordance with ASC 805-30-55-12. For example, an acquirer exchanges replacement awards with a fair value of CU100 for the acquiree's awards with a fair value of CU100 (measured at the acquisition date). 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 services 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 services is CU25 (CU100 × 1/4 years).
- Graded-vesting attribution approach: If the acquirer's attribution policy is the graded-vesting approach, the amount attributable to precombination services is CU52. 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	CU25	100%	CU25.00
Tranche 2	25	50%	12.50
Tranche 3	25	33%	8.33
Tranche 4	25	25%	6.25
Total	CU100		CU52.08

Accordingly, if the acquirer's attribution policy is the straight-line approach, CU25 should be included in consideration transferred for the acquiree, and CU75 (CU100 less CU25) should be recognized in the postcombination financial statements. If the acquirer's attribution policy is the graded-vesting approach, CU52 should be included in consideration transferred for the acquiree, and CU48 (CU100 less CU52) 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 awards' fair value attributable to precombination services 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 services. Example 3-4 illustrates the attribution of the fair value of replacement awards to the precombination and postcombination services when a portion of the original awards has been exercised prior to the acquisition date.

EXAMPLE 3-4

Attribution of the fair value of replacement awards with graded-vesting features to precombination and postcombination services as part of a business combination when a portion of the original awards has been exercised

Company A acquires Company B on 1 July 20X9. Company A issues replacement awards with identical terms for Company B's outstanding awards held by employees. The original awards were issued to employees by Company B on 1 January 20X7 and provided employees 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 CU10. 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 services?

Analysis

The first two tranches of the original awards (40 awards with a hypothetical acquisition date fair value of CU400) 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 CU600 and Company A must determine the total amount attributable to precombination services that will be recorded as part of the consideration transferred for Company B. The remainder will be attributable to postcombination services.

One approach to attribute the fair value of the replacement awards to precombination and postcombination services 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 CU1,000 (100 awards multiplied by CU10 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 service 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 1 January 20X9 to 1 January 20Y0. Multiplying the 50% vesting percentage to the awards' entire fair value of CU1,000 results in CU500 attributable to precombination services (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 CU400 have already vested and been exercised (and therefore included as part of consideration transferred for outstanding shares), only CU100 of the CU500 attributable to precombination services is recorded for the replacement awards as part of the consideration transferred for Company B. The aggregate unvested portion (50% or CU500) of the entire awards' fair value of CU1,000 would be attributable to postcombination services. Or, said another way, subtracting the CU100 attributable to precombination services from the CU600 fair value of the 60 replacement awards results in CU500 attributable to postcombination services.

Another approach to attribute the fair value of the replacement awards to precombination and postcombination services may be to determine the hypothetical service inception date for the remaining outstanding awards, as the straight-line method inherently views each tranche as a series of awards with sequential service periods. In this fact pattern, the hypothetical service-inception date would be 1 January 20X9, coincident with the beginning of the vesting period of the third tranche, and the service period would end on 1 January 20Y2, 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 (1 January 20X9 to the acquisition date of 1 July 20X9) out of the 3-year service period from the hypothetical service-inception date until the final vesting date of the original award. Multiplying the CU600 fair value of the 60 replacement awards exchanged as of the acquisition date by 16.7% results in CU100 to be attributed to precombination services (consideration transferred for Company B). The remaining CU500 (CU600 - CU100) would be attributable to postcombination services.

Additional analyses may be necessary to attribute the fair value of the replacement awards to precombination and postcombination services in more complex fact patterns. Complex fact patterns may include situations where tranches are only partially exercised, awards do not vest rateably, 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 (as required under IFRS and as permitted under US GAAP), the allocation would be calculated differently. Under a graded-vesting allocation approach CU392 of the CU600 fair value of the replacement awards would be attributable to precombination services 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 services**
Tranche 3	CU200	83.3%[1]	CU167
Tranche 4	200	62.5%[2]	125
Tranche 5	200	50.0%[3]	100
Total	CU600		CU392

[1] Calculated as 30 months out of 36 months total service period.

[2] Calculated as 30 out of 48 months total service period.

[3] Calculated as 30 out of 60 months total service period.

The remaining value of the 60 replacement awards is attributable to postcombination services. That is, CU600 fair value of the 60 replacement awards less the CU392 attributable to precombination services results in CU208 attributable to postcombination services.

3.4.2 *Service required after the acquisition date is equal to or greater than the original service requirement*

An employee may hold an award that is fully vested under its original terms, but the terms of the replacement award require additional service from the employee. 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 [vesting] period to the replacement awards. Therefore, a portion of the fair value of the replacement award will be attributable to postcombination services.

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 [vesting] period of five years. The acquirer will use the ratio of the four years of service completed compared to the total service [vesting] period of five years, resulting in 80% of the fair value of the acquiree award being attributed to precombination services 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 [vesting] period of one year in the postcombination financial statements.

3.4.3 *Service required after the acquisition date is less than the original service requirement*

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 service requirement. See BCG 3.4.3.1 for information on awards with an automatic change in control clause. The amount of fair value attributable to the 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 service. The ratio of the precombination service period [portion of the vesting period completed] to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award should be used when calculating the amount of the replacement award attributable to precombination services.

Example 3-5 further illustrates this guidance.

EXAMPLE 3-5

Attribution of fair value when service required after the acquisition date is less than the original service requirement

Company X (the acquirer) exchanges replacement awards with a fair value of CU100 for Company Y's (the acquiree) awards with a fair value of CU100. When originally granted, Company Y's awards provided for cliff vesting after a service [vesting] 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 services?

Analysis

Company X accelerated the vesting of the awards by eliminating the one year of postcombination service that would have been required under the awards' original terms. The amount of Company X's replacement awards' value attributable to precombination services is equal to the fair value of Company Y's awards at the acquisition date, multiplied by the ratio of precombination service period (portion of the vesting period completed) to the greater of the total service [vesting] period or the original service [vesting] period of Company Y's awards.

- The total service [vesting] period is three years (i.e., the years of service rendered as of the acquisition date).
- The original service [vesting] period of Company Y's awards was four years.
- The original service [vesting] period of four years is greater than the total service [vesting] period of three years; therefore, the original service period of four years should be used to determine the amount attributable to precombination services; the amount attributable to precombination services is CU75 (the value of Company Y's awards of CU100 × 3 years precombination service / 4 years original service).
- The fair value of Company Y's replacement awards of CU100, less the amount attributed to precombination services of CU75, or CU25 (the portion for which vesting was accelerated), should be recognized in the postcombination financial statements. Because the replacement awards are vested, the entire CU25 should be recognized immediately in the postcombination financial statements.

3.4.3.1 *Acquiree awards with an automatic change in control provision*

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 in the postcombination period in accordance with ASC 805-30-55-23 through 55-24 and IFRS 3.B56–B59, IE70. However, a preexisting change in control clause should be assessed carefully to determine if the change in control clause is a transaction separate from the business combination (e.g., considering when the change in control clause was added to the terms of the agreement).

Example 3-6 illustrates the accounting for an award with an automatic change in control provision.

EXAMPLE 3-6

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 CU100 for Company Y's (the acquiree) awards with a fair value of CU100. 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 [vesting] 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 replacements awards be attributed to the precombination services?

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 [vesting] period to the original service [vesting] period. Therefore, the amount attributable to precombination services is the entire CU100 fair value of the replacement awards. If the replacement awards issued by Company X had a fair value greater than CU100, any excess would have been recognized in the postcombination financial statements of the combined company.

3.4.3.2 Acquiree awards with a discretionary change in control provision

Acquiree awards for which vesting is accelerated based on a discretionary change in control clause need to be analysed 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 (as illustrated in Example 3-5). 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. Refer to BCG 3.2 for the factors to consider in this analysis.

3.4.4 Excess fair value of the acquirer's replacement award

Any excess fair value of the replacement awards over the fair value of the acquiree awards at the acquisition date is considered an expense incurred by the acquirer (i.e., additional compensation) 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 employee's 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 employees), it is likely that there will be excess fair value. The acquirer should recognize the excess fair value over the remaining service [vesting] period in the postcombination financial statements in accordance with ASC 805-30-55-10 and IFRS 3.B59. Refer to ASC 805-30-55-18 through 55-19 and IFRS 3.IE63-IE64 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 employee awards are not exchanged and do not expire but continue after the business combination. This may occur when the acquirer purchases a target company and the target company continues as a separate subsidiary of the acquirer. When the employee awards of the target are not exchanged but continue under the original terms after the business combination, 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 and IFRS 3.B56.

Alternatively, under US GAAP, 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.

3.4.6 Awards with performance or market conditions

For awards with performance conditions (as defined by ASC 718 and IFRS 2), the acquirer should follow the same principle outlined in the Standards for awards with service conditions. Consistent with the guidance in the Standards, 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 and IFRS 3.B59.

The determination of the fair value attributable to precombination and postcombination services would also be consistent with the analysis performed for awards with service conditions. The amount attributable to precombination services is determined by multiplying the fair value of the acquiree award by the ratio of the precombination service [vesting] period completed prior to the exchange to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award. The amount attributable to postcombination services would then be calculated by subtracting the portion attributable to precombination services from the total fair value of the acquirer's replacement award. The determination of the postcombination service [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. The acquirer will need to make a probability assessment at the acquisition date.

Example 3-7 illustrates this guidance.

EXAMPLE 3-7

Allocation of fair value for awards with a performance condition

Company Z (the acquirer) exchanges replacement awards with a fair value of CU300 for Company A's (the acquiree) awards with a fair value of CU300. 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 A had to assess the probability of whether the performance condition would be achieved. Prior to the acquisition, it was considered 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 service [vesting] condition. 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 services?

Analysis

The amount of Company Z's replacement awards attributable to precombination services is equal to the fair value of Company A's awards at the acquisition date, multiplied by the ratio of the precombination service period (portion of the vesting period completed) to the greater of the total service [vesting] period or the original service [vesting] period of Company A's awards. The original service [vesting] period of Company A's awards was three years. Company Z, at the acquisition date, 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 service [vesting] period of three years. That is, the original service [vesting] period and the total service [vesting] period are both three years. The amount attributable to precombination services is CU100 (CU300 × 1 year precombination service / 3 years original service). The remaining fair value of the awards of CU200 should be recognized in the postcombination financial statements over the remaining service [vesting] period of two years because the awards have not yet vested.

Had the acquirer determined on the acquisition date that it was probable that the product would be completed one year from the acquisition date, then the amount attributable to precombination services (CU100) would remain the same. This would be the case since the original service [vesting] period of three years is greater than the total service [vesting] period of two years. The remaining fair value of CU200, however, would be recognized over the remaining service [vesting] period of one year.

Question 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 and IFRS 2), assuming it is not probable both before and after the exchange that the condition will be achieved?

PwC response

Under ASC 718 and IFRS 2, the probability that an award with a service or performance condition will vest is not incorporated into the fair value of the award; instead, 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 and IFRS 2.20.

The Standards provide that replacement share-based payment awards should be measured using the fair-value-based measurement method of ASC 718 or IFRS 2 in accordance with ASC 805-30-30-11 and ASC 805-30-55-7 and IFRS 3.B57. Under ASC 718-10-35-3 and IFRS 2.20, no compensation cost is recognized for an award with a performance condition that is not expected to vest. Accordingly, if it is not probable both before and after 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. The acquirer should not record any compensation cost in the postcombination financial statements unless and 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 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 55-12 and IFRS 3.B60. The approach in the consolidated financial statements of the combined entity would be the same under US GAAP and IFRS.

For awards with a market condition, the acquirer should follow the same principle outlined in the Standards for awards with service conditions. Because a market condition is reflected in the fair value of an award, the market condition should be taken into consideration when calculating the fair value of the acquirer's replacement awards. Consistent with the guidance in the Standards, any excess fair value should be recognized as compensation cost in the postcombination financial statements.

The determination of the fair value attributable to precombination and postcombination services is consistent with the analysis performed for awards with service conditions. The determination of the precombination and postcombination service [vesting] periods for the replacement 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 *Illustrative summary of attributing fair value to precombination and postcombination services*

The examples presented in Figure 3-3 are based on the following assumptions:
(1) the original terms of the acquiree's awards cliff vest following four years of service, (2) the acquirer is obligated to issue replacement awards under the terms of the acquisition agreement (except as specified in Example 6), and (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 Example 3). See BCG 3.4.1.1 for information on awards with graded-vesting features.

Figure 3-3
Attribution of fair value to precombination and postcombination services

Acquiree's awards	Acquirer's replacement awards	Greater of total service [vesting] period or original service [vesting] period	Fair value attributable to precombination services	Fair value attributable to postcombination services
Example 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 [vesting] period and the total service [vesting] period are the same.	100% (4 years precombination service/4 years total service).	0%
Example 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 [vesting] period and the total service [vesting] 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 services). This amount is recognized in the postcombination financial statements over the remaining service [vesting] period of 1 year.
Example 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 employee 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 [vesting] period of 5 years is greater than the original service [vesting] 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 services). This amount is recognized in the postcombination financial statements over the remaining service [vesting] period of 1 year.

Acquiree's awards	Acquirer's replacement awards	Greater of total service [vesting] period or original service [vesting] period	Fair value attributable to precombination services	Fair value attributable to postcombination services
Example 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 [vesting] period for the replacement awards is 3 years, which is less than the original service [vesting] period of 4 years). Therefore, the original service [vesting] period is greater than the total service [vesting] period.	25% (1 year precombination service/4 years original service [vesting] period).	75% (total fair value of the replacement award less the 25% for precombination services). This amount is recognized in the postcombination financial statements over the remaining service [vesting] period of 2 years.
Example 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 [vesting] period for the replacement awards is 3 years, which is less than the original service [vesting] period of 4 years). Therefore, the original service [vesting] period is greater than the total service [vesting] period.	75% (3 years precombination service / 4 years original service [vesting] period).	25% (total fair value of the replacement award less the 75% for precombination services). This amount is recognized in the postcombination financial statements immediately because no future service is required.
Example 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 services.	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 services.	0%. For acquiree awards with a pre-existing change in control clause, no amount is attributable to postcombination services because there is no future service required.

3.5 Cash settlement of employee share-based payment awards

An acquirer may elect to pay cash to settle outstanding awards held by employees 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 and IFRS 2.28. The accounting for the cash settlement of share-based payment awards within a business combination is not explicitly addressed by the Standards. 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, determine the portion of the cash settlement to be attributed to precombination services or postcombination services using the guidance for the exchange of share-based payment awards and the allocation formula described in Figure 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 3.3.

3.5.1 Initiated by the acquirer

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 and IFRS 3.B59.

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 service requirement and settled the awards for cash. The portion attributable to precombination service 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 employees, attributable to the postcombination service, should be immediately recognized as compensation cost in the postcombination financial statements. This analysis is similar to the illustration in Example 3-5, 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 55-24 and IFRS 3.IE70–IE71.

An acquirer may pay cash in exchange for unvested awards of the acquiree and additional postcombination service, with the cash payment made at the completion of the additional service [vesting] period. In this case, the acquirer will need to determine the portion of the payment attributable to precombination services and postcombination services. The amount attributable to precombination services is determined by multiplying the fair value of the acquiree award by the ratio of the precombination service [vesting] period completed prior to the payment, to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award. The amount attributable to postcombination services would be recognized in the postcombination financial statements over the remaining service [vesting] period.

3.5.2 *Initiated by the acquiree*

The acquiree (as opposed to the acquirer) may cash-settle outstanding awards prior to the acquisition. However, these transactions, including their timing, should be carefully 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 and IFRS 2.28. 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. Example 3-8 illustrates this guidance.

EXAMPLE 3-8

Example of cash settlement of awards by the acquiree

Company D (the acquiree) cash-settles the outstanding unvested awards held by its employees immediately prior to being acquired by Company C (the acquirer). The amount of cash paid by Company D is CU100 million, which is equal to the current fair value of the awards. At the time of settlement, the employees had completed 75% of the service required to vest in the awards (and 25% of the service period remained).

How should Companies C and Company D account for the cash settlement of the outstanding unvested awards by Company D?

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 employees. The settlement of the portion of the unvested awards not attributable to precombination services 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 and IFRS 3.B50) 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. 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 services, or CU25 million (the fair value of the awards of CU100 million remaining service [vesting] 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 CU25 million should be recognized immediately because no postcombination service is required.

3.6 Other arrangements

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

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 [vesting] period are often described as 'last-man-standing' arrangements. The accounting for these arrangements, if cash-settled, is the same under US GAAP and IFRS. However, if the arrangement involves equity-settled share-based payment awards, there is a difference in the accounting model under US GAAP and IFRS. Under US GAAP, a reallocation of awards in a "last-man-standing" arrangement is accounted for as a forfeiture of the original awards and a grant of new awards. Under IFRS, the estimated number of awards that are expected to vest does not change; therefore, a reallocation of awards would generally not have an accounting impact.

Example 3-9 illustrates "last-man-standing" arrangements that are provided as share-based payment awards; Example 3-10 illustrates those that are payable in cash.

EXAMPLE 3-9

"Last-man-standing" arrangement involving share-based payment awards

On 1 January 2X10, 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 CU300 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 1 January 2X12, 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 1 January 2X12. On 1 January 2X11, one of the five executives terminates employment with the combined company. The 100 unvested awards (100 awards × 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 CU360.

How should Company M account for the "last-man-standing" arrangement?

Analysis

Under US GAAP, the fair value of all awards granted to the executives on the acquisition date is CU1,500 (CU300 × 5 sets of awards), which should be recognized over the two-year service [vesting] 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 employee(s). In this example, 100 unvested awards (100 awards × 1 executive) were forfeited and regranted to the remaining four employees (25 awards each). Company M would reverse CU150 (CU300 × 1 terminated executive × 1/2 of the service [vesting] period completed) of previously recognized compensation for the terminated employee's forfeited awards. Company M would then recognize an additional CU90 (CU360 / 4 executives) for each of the four remaining executives over the new service [vesting] period of one year.

Under IFRS, the estimated number of total awards that will ultimately vest is not expected to change; therefore, there is no accounting consequence arising from the reallocation.

EXAMPLE 3-10

"Last-man-standing" arrangement involving cash consideration

Company B (the acquirer) acquires Company A (the acquiree) for cash consideration of CU250. 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.

Analysis

The contingent payments 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 incentivises 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. The entire additional payment, given this combination of factors, would be accounted for as compensation expense in the postcombination period.

3.6.2 "Dual trigger" arrangements

Preexisting employment agreements often include clauses that accelerate vesting 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. Employment agreements of the acquiree should be carefully 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 [ASC 805-10-55-18; IFRS 3.B50]

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 25-22 and IFRS 3.51–52, B50.

The dual trigger clause effectively places the decision to retain the acquiree's employees in the control of the acquirer, and thus the decision 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 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 30-13 and ASC 805-30-55-10; IFRS 3.B58–B59).

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 post-acquisition financial statements and the acquiree's pre-acquisition financial statements. These scenarios typically arise when the acquiree legally incurred the related obligation, and other accounting standards require the acquiree to recognize the related cost even though the cost was incurred for the benefit of the acquirer.

Example 3-11 illustrates the accounting for a dual trigger arrangement.

EXAMPLE 3-11

Accelerated vesting conditioned upon a dual trigger consisting of 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 [ASC 805-30-30-9; IFRS 3R.B56].

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 awards vest only if the employee is subsequently terminated without cause or leaves for good reason as defined in the employment contract. 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

Company A should immediately recognize compensation cost related to the accelerated vesting of the awards (measured as of the closing of the acquisition using the methodology described in ASC 805-30-30-12 through 30-13 and ASC 805-30-55-10; IFRS 3.B58–B59) in its postcombination period. 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 separately from the business combination [ASC 805-10-25-20 through 25-22; IFRS 3.51–52].

3.7 Postcombination accounting for share-based payment 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 718-20-35-3 through 35-4 or IFRS 2.26-29. 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 or IFRS 2.

Modifications of awards after the acquisition date should be accounted for based on the modification guidance in ASC 718 or IFRS 2. No adjustments are made to the accounting for the business combination as a result of changes in forfeiture estimates (refer to Questions 3-2 and 3-3) or modifications of replacement awards after the acquisition date in accordance with ASC 805-30-55-11 through 55-12 and IFRS 3.B60. 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 and IFRS 3.B61.

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 or IFRS 2, and will not affect the accounting for the business combination.

Question 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 25-22 and IFRS 3.51–52. The aquirer's decision not to issue replacement awards is in the control of the acquirer. Therefore, the acquirer should immediately recognize compensation cost in the postcombination period for the acceleration of the unvested portion of the awards. The accounting would be the same if the acquirer issued fully vested replacement awards.

Question 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 or IFRS 3.B55 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 3-12 illustrates an arrangement that includes contingent payments that is modified during the measurement period.

EXAMPLE 3-12

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 (3 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 or IFRS 3.B55, Company A appropriately determined that it should account for the contingent payment as compensation cost and not as an element of consideration transferred. The contingent payment to the former shareholders was linked to their 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 or IFRS 3.B55. This would also 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 US GAAP and IFRS differences—income tax effects of share-based payment awards

The accounting for the income tax effects of share-based payment awards differs under ASC 718 and IFRS 2. Therefore, the accounting for the income tax effects of replacement awards in a business combination will also differ between US GAAP and IFRS. 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.

The accounting for the tax effects under IFRS is described below. For additional guidance on the accounting under US GAAP, refer to TX 17.

3.8.1 Accounting for the income tax effects of replacement awards—IFRS

IAS 12 provides guidance for instances in which an item has a tax base (the amount the tax authorities will permit as a deduction in future periods with respect to goods or services consumed to date), but is not recognized as an asset or liability in the entity's balance sheet. For equity-settled awards under IFRS 2, employee services are expensed and their carrying amount is zero. Assuming the employer will be entitled to a tax deduction equal to the options' intrinsic value on the exercise date, an estimate of the value of the tax base at the end of each reporting period is determined by multiplying the options' current intrinsic value by the proportion of the total vesting period that has elapsed. The difference between the tax base of the employee services received to date and the carrying amount of zero is a temporary difference that results in a deferred tax asset, provided the company has sufficient future taxable profit against which the deferred tax asset can be utilized [IAS 12.9–11,68A–68C].

When an award is exchanged in a business combination, the income tax accounting will differ between (1) the portion included in the consideration transferred for the acquiree and (2) the portion of the award for which expense will be recognized in the postcombination financial statements.

For the portion of the replacement award included in consideration transferred for the acquiree, a deferred tax asset is recorded based on the intrinsic value at the acquisition date, subject to the deferred tax asset recognition criteria of IAS 12 noted above. The recognition of this deferred tax asset will reduce net assets acquired (e.g., goodwill). Any change in the intrinsic value of the award and, therefore, the deferred tax asset, and any change in the recoverability of the deferred tax asset will be reflected through an adjustment to the deferred tax asset in the period in which the change arises, and will be reflected in the postcombination financial statements. There is diversity in practice as to where the movement in the deferred tax asset is recognized. One view asserts that the deferred tax movement should be reflected directly in equity similar to the method used for deferred tax movements relating to share-based payments that exceed the total share-based payment expense. This view is based on the rationale that since no expense was reflected in the income statement when the replacement award was originally recorded through acquisition accounting, no expense should be recorded when the movement in the deferred tax asset is recognized. Another view asserts that some or all of the movement can be presented in the income statement because the amounts treated as purchase consideration represent benefits earned pre-acquisition that are analogous to book expenses. The guidance is not specific, and given the diversity in practice, management should make a policy choice and apply it consistently.

For the portion of the replacement award accounted for in the postcombination financial statements, a deferred tax asset should be recorded equal to the tax benefit related to the estimated future tax deduction, multiplied by the proportion of the postcombination vesting period that has elapsed. No deferred tax asset would be recorded at the acquisition date because none of the vesting period for this portion of the award has elapsed as of the acquisition date. However, as the award vests, the deferred tax asset balance should be based on the tax benefit related to the estimated tax deduction at the end of each period (measured using the current share price) in accordance with IFRS 2 and IAS 12 [IAS 12.9–11,68A–68C].

Any limitations on the deductibility of compensation imposed by the local taxing authority should be considered when determining the deferred tax asset that should be recognized.

Example 3-13 illustrates the deferred tax guidance.

EXAMPLE 3-13

Income tax accounting for a vested equity-classified option under IFRS

Company K (the acquirer) exchanges replacement awards with a fair value of CU50 at the acquisition date for Company L's (the acquiree) awards with a fair value of CU50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L's awards had a service [vesting] period of four years. The replacement awards have the same terms as the original awards. As of the acquisition date, all four years of service required by the original terms of Company L's awards have been rendered; therefore, the replacement awards are vested and require no further service. A tax deduction for the replacement awards will not arise until the options are exercised. The tax deduction will be based on the stock options' intrinsic value at the exercise date. The exercise price of the awards is CU40. At the acquisition date, the market price of Company K's shares is CU60. The intrinsic value at the acquisition date is CU20 (market price of Company K's shares of CU60 less the exercise price of CU40). Company K's applicable tax rate is 40%.

What are the income tax accounting impacts to Company K?

Analysis

Because the replacement awards do not have any excess fair value over the acquiree awards at the acquisition date and 100% (4 years precombination service / 4 years total service) of the fair value of the replacement awards is attributable to precombination services, the entire CU50 should be included in the consideration transferred for the acquiree.

Company K should record a deferred tax asset equal to CU8 (CU20 intrinsic value × 40% tax rate) because at the time of the acquisition, the awards are expected to result in a tax deduction based on intrinsic value. The deferred tax asset will be recorded as follows:

Deferred tax asset	CU8[1]	
Goodwill (as residual)		CU8

[1] All computations have been provided on an individual award basis.

3.9 US GAAP and IFRS difference—recognition of social charges

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. 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(s), in accordance with ASC 718-10-25-22. Therefore, practice has been not to record a liability for social 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).

Under IFRS, social charges, such as payroll taxes levied on the employer in connection with share-based payment awards, are usually recognized as an expense in the same period as the related share-based payment compensation cost. Therefore, a liability should be recorded in the business combination for social charges related to outstanding awards. When share-based payment awards are deemed to be part of the consideration transferred in a business combination, the related social charges on such awards is also deemed to be part of the consideration for the acquiree.

Chapter 4:
Intangible assets acquired in a business combination

4.1 Chapter overview

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 key criteria for recognizing intangible assets separately in a business combination and covers some of the challenges that companies face in recognizing and measuring intangible assets. These challenges include those related to customer-related intangible assets, intangible assets used in research and development activities, contracts and lease agreements, and grouping of complementary intangible assets. FV 7 discusses the valuation of acquired assets and assumed liabilities in a business combination in more detail, including intangible assets. BCG 7 discusses the accounting for intangible assets in connection with asset acquisitions.

For the most part, the initial recognition and measurement of intangible assets acquired in a business combination are the same for companies that report under US GAAP or IFRS. However, there are differences in the subsequent accounting for intangible assets. These differences primarily relate to the recognition and measurement of impairment losses and the accounting for subsequent research and development costs. The various approaches to impairment under US GAAP are discussed in BCG 8, and the approach under IFRS is discussed in BCG 10. The accounting for subsequent research and development costs for both US GAAP and IFRS is discussed in BCG 4.3.4.1.

4.2 Intangible assets and the identifiable criteria

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; IFRS 3.B32.

- 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. However, there cannot be restrictions on the transfer, sale, or exchange of the asset in accordance with ASC 805-20-55-3 through 55-4; IFRS 3.B33.

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, would not be recognized as separate intangible assets. Examples include:

- Customer base or unidentifiable “walk-up” customers

- Noncontractual customer relationships that are not separable

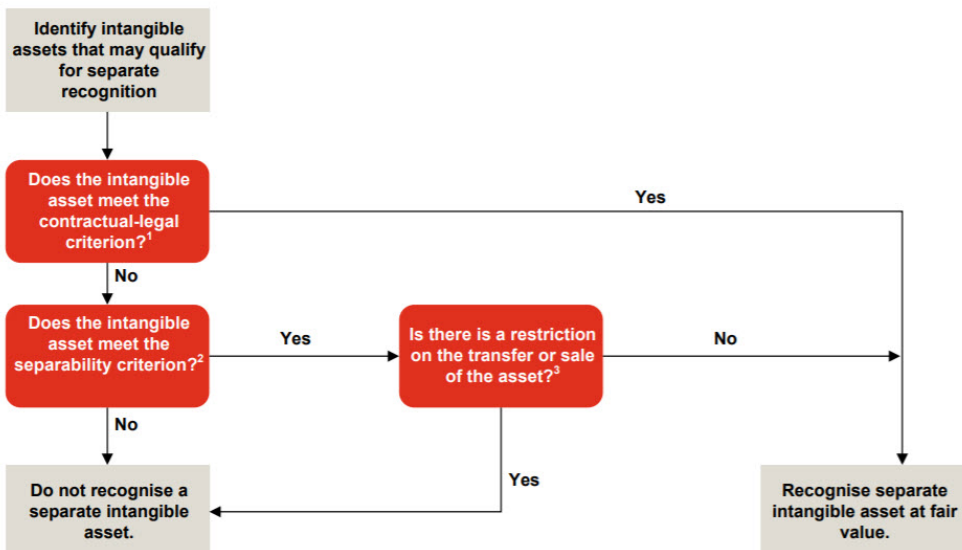
- Customer service capability
- Presence in geographic locations or markets
- Specially trained employees

The Standards do not permit an assembled workforce to be recognized as a separate intangible asset in accordance with ASC 805-20-55-6; IFRS 3.B37. See BCG 4.3.3.2 for further information on assembled workforce.

The flowchart in Figure 4-1 outlines a process that may be used to determine whether an intangible asset meets the identifiable criteria for separate recognition.

Figure 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; IFRS 3.B32.

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 55-4; IFRS 3.B33.

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 805-20-55-3 through 55-4; IFRS 3.B33.

4.2.1 Contractual-legal criterion

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.

The Standards do not define the term “contractual or other legal rights,” but the list of contractual-legal intangible assets included in the Standards 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 and IFRS 3.IE28, 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 the Standards may be broader than that used in other accounting literature in US GAAP and IFRS. 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 and IFRS, 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.

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.

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.

4.2.2 Separability criterion

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. 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 and IFRS 3.B33. Accordingly, the customer list subject to such restrictions would not meet the separability criterion.

4.2.3 *Examples of applying the identifiable criteria*

Examples 4-1 to 4-3 demonstrate the application of the identifiable criteria.

EXAMPLE 4-1

Sales to customers through contracts

Company X acquires Company Y in a business combination on 31 December 20X0. Company Y does business with its customers solely through purchase orders. At the acquisition date, Company Y has customer purchase orders in place from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of Company Y's customers are also recurring customers. However, as of 31 December 20X0, 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 percent 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 percent 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 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 4-3

Unpatented technical expertise closely related to a trademark

An acquiree, a restaurant chain, sells prepared chicken using a secret recipe. The acquiree owns a registered trademark, a secret recipe formula, and unpatented technical expertise used to prepare and sell its famous chicken. If the trademark is sold, the seller would also transfer all knowledge and expertise associated with the trademark, which would include the secret recipe formula and the unpatented technical expertise used to prepare and sell chicken.

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 technical expertise based on the separability criterion. The separability criterion is met because the secret recipe formula and unpatented technical expertise 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 technical expertise) as a single intangible asset if their useful lives are similar.

4.3 *Types of identifiable intangible assets*

Figure 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 55-45 and IFRS 3.IE16-IE44. 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 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	✓	

Intangible asset	Contractual-legal criterion	Separability criterion
Internet domain names	✓	
Noncompetition agreements	✓	
Customer-related:		
Customer lists		✓
Order or production backlog	✓	
Customer contracts and related customer relationships	✓	
Noncontractual customer relationships		✓
Artistic-related:		
Plays, operas, ballets	✓	
Books, magazines, newspapers, other literary works	✓	
Musical works, such as compositions, song lyrics, advertising jingles	✓	
Pictures, photographs	✓	
Video and audiovisual material, including motion pictures, music videos, television programs	✓	
Contract-based:		
Licensing, royalty, standstill agreements	✓	
Advertising, construction, management, service, or supply contracts[1]	✓	
Lease agreements[1]	✓	
Construction permits	✓	
Franchise agreements	✓	
Operating and broadcast rights	✓	

Intangible asset	Contractual-legal criterion	Separability criterion
Use rights,[2] such as drilling, water, air, mineral, timber cutting, and route authorities	✓	
Servicing contracts (e.g., mortgage servicing contracts)	✓	
Employment contracts[3]	✓	
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	✓	

[1] In most cases, such intangibles would be favorable or unfavorable contracts. See BCG 4.3.3.5 for further information.

[2] Only in certain circumstances, see BCG 4.3.3.3 for further information.

[3] 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.

The following sections discuss common marketing-related intangible assets recognized and measured in a business combination.

4.3.1.1 *Trademarks, trade names, and other types of marks*

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 domain names

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 and IFRS 3.IE22.

4.3.1.3 Noncompetition agreements

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 employee 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 CU20 million to acquire a target, including a noncompete agreement with a fair value of CU2 million, the noncompete agreement should be recognized separately at a fair value of CU2 million. The remaining purchase price (CU18 million) will be allocated to the net assets acquired, excluding the noncompete agreement, but including goodwill.

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. See BCG 8 for further information on postacquisition accounting for noncompete agreements under US GAAP, and see BCG 10 for further information on accounting under IFRS.

4.3.1.4 *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 and IFRS 3.IE27.

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 term “contractual” in ASC 805 and IFRS 3 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. Given the range of terms and conditions associated with these programs, careful consideration should be given in assessing the recognition and measurement of any related intangible assets.

The following sections discuss the common customer-related intangible assets recognized and measured in a business combination.

4.3.1.5 *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; IFRS 3.IE28.

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. For example, if market-participants may not receive much value from the relationship, the resulting intangible asset may have a nominal value. However, if market-participants would expect to receive significant value from the relationship with the acquired customer, the resulting intangible asset may have significant value. See FV 7 for further information on valuation of intangible assets.

Examples 4-4 and 4-5 demonstrate the assessment of the contractual-legal criterion for various contract-related customer relationships.

EXAMPLE 4-4

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

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 4-5

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

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 is 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. However, the acquirer should assess the facts and circumstances surrounding the events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date in accordance with ASC 805-20-55-7; IFRS 3.B38.

Question 4-1

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 of the Standards 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 805-10-55-21; IFRS 3.IE28. See BCG 2.7.3 for further information on the settlement of preexisting relationships between the acquirer and the acquiree.

4.3.1.6 Noncontractual customer relationships

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 in which 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; IFRS 3.IE31.

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.

4.3.1.7 Customer lists

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 acquiree 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.

4.3.1.8 Customer base

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.

4.3.1.9 Order or production backlog

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.

Example 4-6 demonstrates the recognition of customer-related intangible assets due to purchase orders.

EXAMPLE 4-6

Identification of customer-related intangible assets due to purchase orders

Company M is acquired in a business combination by Company Y and has the following two customers:

- Customer A is a recurring customer that transacts with Company M through purchase orders and certain purchase orders are outstanding at the acquisition date.

- Customer B is a recurring customer that transacts with Company M through purchase orders; however, there are no purchase orders outstanding at the acquisition date.

Should Company Y recognize the customer-related intangible assets due to purchase orders?

Analysis

Company Y assesses the various components of the overall customer relationship that may exist for the acquired customers. As a result of this assessment, Company Y would recognize an intangible asset(s) for Customers A and B based on the contractual-legal criterion. The customer relationship with Customer A meets the contractual-legal criterion as there is a contract or agreement in place at the acquisition date. Customer B's customer relationship also meets the contractual-legal criterion as there is a history of Company M using purchase orders with this customer, even though there are no purchase orders outstanding on the acquisition date. Company Y should considered whether a production backlog exists related to acquired sales orders. This may meet the contractual-legal criterion for separate recognition.

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 and IFRS 3.IE33 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 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.

The following sections discuss the common contract-based intangible assets recognized and measured in a business combination.

4.3.3.1 *Contracts to service financial 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. For US GAAP companies, 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*

Employment contracts may result in contract-based intangible assets or liabilities according to ASC 805-20-55-36 and IFRS 3.IE37. An employment contract may be above or below market in the same way as a lease or a servicing contract. See BCG 4.3.3.6 for further information on at-the-money contracts. 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 when such contracts are part of a business combination. 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 and IFRS 3.B37 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 in above, the entire assembled workforce does not have such a contract. Therefore, an assembled workforce does not meet the contractual-legal criterion. Furthermore, the Boards concluded that 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 under US GAAP. However, an assembled workforce may be indicative that a business was acquired as discussed in BCG 1. IFRS does not permit an assembled workforce to be recognized in asset acquisitions. See BCG 7 for information on the accounting for asset acquisitions.

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

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; IFRS 3.IE38.

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 BCG 11.2 for further information on the accounting for insurance and reinsurance contract intangible assets.

4.3.3.5 Favorable and unfavorable contracts

Intangible assets or liabilities may be recognized for certain off balance sheet contracts, such as operating lease arrangements (prior to adopting ASC 842 or IFRS 16), 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 Boards have 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 under the US GAAP and IFRS accounting frameworks. Within this guide, these adjustments are referred to as assets and liabilities for consistency with the treatment by the Boards.

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 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. For example, if the acquiree is the lessee in a favorable operating lease, the renewals would likely be considered, because the acquirer would likely plan to exercise the renewal right and realize the acquiree's benefit of the favorable terms. If the acquiree is the lessor in a favorable operating lease, the acquirer would usually not presume that the lessee (third party) would renew its unfavorable lease.

- 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.

Examples 4-7 and 4-8 demonstrate the recognition and measurement of favorable and unfavorable contracts.

EXAMPLE 4-7

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 CU80 per year, and the annual cost for the five-year extension period is CU110 per year. The current annual market price for electricity at the acquisition date is CU200; 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 CU200. 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 4-8

Unfavorable purchase contract

Assume the same facts above, except that the current annual market price for electricity at the acquisition date is CU50 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 CU50. 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*

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 *Lease agreements (accounted for under ASC 840 or IAS 17)*

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 versus capital [finance]) 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. See

BCG 2.5.17 for further information on the classification of assumed leases in a business combination. Differences in the recognition and measurement of these assets and liabilities between US GAAP and IFRS should be considered. For example, one difference is in the area of recognition of assets subject to operating leases if the acquiree is the lessor.

Acquiree is a lessee

An acquiree may be the lessee in an operating lease agreement containing rental rates that are favorable or unfavorable compared to the market terms of leases for similar items at the acquisition date. As the lease arrangement is not recorded on the lessee's balance sheet, an intangible asset or liability should be recognized for such a favorable or unfavorable arrangement. There may also be value associated with an at-the-money lease contract depending on the nature of the leased asset. See BCG 4.3.3.6 for further information on at-the-money contracts. In addition, other assets may be identifiable if the terms of the lease contain purchase or renewal options. Lastly, leasehold improvements of the acquired entity would be recognized as tangible assets on the acquisition date at their fair value.

No separate intangible asset or liability would typically be recognized for the lease contract terms if the acquiree is a lessee in a capital [finance] lease, since the leased asset and lease liability are already recognized on the lessee's balance sheet. Any value inherent in the lease (i.e., fair value associated with favorable or unfavorable rental rates, renewal or purchase options, or "in-place" leases), is typically reflected in the amount assigned to the asset under capital lease and the capital lease obligation. However, when there has been a significant passage of time between the lease signing date and the lease inception date (such as in a build-to-suit lease), market rents may fluctuate resulting in a favorable or unfavorable contract.

In measuring the amount to record for the property under capital lease, the acquirer should determine whether it is expected that the acquirer will obtain ownership of the leased property by the end of the lease term. Factors to consider when making this determination include contractual requirements or a bargain purchase option. If it is expected that the acquirer will obtain ownership of the leased property, then the acquirer should record the property under capital lease at the fair value of the underlying property. If it is not expected that the acquirer will obtain ownership of the leased property, then the acquirer should record the property under capital lease at an amount equal to the fair value of the leasehold interest (i.e., the fair value of the right to use the property until the end of the lease). In addition, any related leasehold improvements would be recognized and measured at fair value.

A liability for the remaining rent payments due under a capital [finance] lease would also be recognized and measured at fair value. The assumptions used in measuring the liability, such as the lease term, should be consistent with the assumptions used in measuring the asset.

Acquiree is a lessor

Under US GAAP, the asset subject to the lease would be recognized and measured at fair value unencumbered by the related lease(s) if the acquiree is a lessor in an operating lease. In other words, the leased property (including any acquired tenant improvements) is measured at the same amount, regardless of whether an operating lease(s) is in place. 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(s) (referred to as an "in-place" lease(s), as further discussed in the chapter) 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.

Under IFRS, the asset subject to the lease would be recognized at its fair value as encumbered by the existing lease, if the acquiree is a lessor in an operating lease. Therefore, a separate intangible asset or liability associated with the favorable or unfavorable terms, and any value associated with "in-place" leases would not be separately recognized but instead is included in the value of the leased asset in accordance with IFRS 3.B42. However, under IAS 16.44, it may be appropriate to amortize separately amounts related to favorable or unfavorable lease terms. Additionally, an intangible asset may be recognized for any value associated with the relationship the lessor has with the lessee.

Under both US GAAP and IFRS, the acquired entity may also be a lessor in a lease other than an operating lease, such as a direct finance or sales-type lease. In those situations, the acquirer recognizes and measures a financial asset that represents its remaining investment in the lease. Such investment would be recognized in accordance with ASC 840 or IAS 17, based on the nature of the lease arrangement, and would typically include any value associated with the existing "in-place" lease. Further, the acquirer lessor would recognize and measure the residual value, if any, of the leased asset. Additionally, an intangible asset may be recognized for any value associated with the relationship the lessor has with the lessee.

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 expense or revenue on a straight-line basis. Such asset or liability would not be carried forward by the acquirer. Rather, the acquirer would recognize rent expense or revenue prospectively on a straight-line basis. See BCG 2.5.17 for further information on deferred charges arising from leases. 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.

Figure 4-3 summarizes the typical items to consider in the recognition of assets and liabilities associated with lease arrangements in a business combination.

Figure 4-3

This table lists items to consider when recognizing lease-related assets and liabilities (for leases recorded under ASC 840 or IAS 17)[1].

Lease classification	US GAAP	IFRS
Acquired entity is a lessee in an operating lease.	□ Favorable or unfavorable rental rates (BCG 4.3.3.5) □ Premium paid for certain at-the-money contracts (BCG 4.3.3.6) □ Purchase or renewal options □ Leasehold improvements	□ Favorable or unfavorable rental rates (BCG 4.3.3.5) □ Premium paid for certain at-the-money contracts (BCG 4.3.3.6) □ Purchase or renewal options □ Leasehold improvements

Lease classification	US GAAP	IFRS
Acquired entity is a lessee of a capital [finance] lease.	□ Property under capital lease (recognized at an amount equal to the fair value of the underlying property if ownership is reasonably certain to transfer to the lessee) □ Property under capital lease (recognized at an amount equal to the fair value of the leasehold interest if ownership is not reasonably certain to transfer to the lessee) □ Leasehold improvements owned □ Lease obligation, including lease payments for the remaining noncancellable term and possibly payments required under renewal and purchase options □ Favorable or unfavorable rental rates, for capital leases that have not commenced	□ Property under finance lease (recognized at an amount equal to the fair value of the underlying property if ownership is reasonably certain to transfer to the lessee) □ Property under finance lease (recognized at an amount equal to the fair value of the leasehold interest if ownership is not reasonably certain to transfer to the lessee) □ Leasehold improvements owned □ Lease obligation recognized for remaining lease payments □ Favorable or unfavorable rental rates, for finance leases that have not commenced
Acquired entity is lessor in an operating lease.	□ Leased asset (including tenant improvements) recognized without regard to the lease contract □ Favorable or unfavorable rental rates □ "In-place" leases □ Unfavorable renewal or written purchase options □ Customer (or tenant) relationships	□ Leased asset (including tenant improvements) recognized, taking lease terms into account □ Customer (or tenant) relationships

Lease classification	US GAAP	IFRS
Acquired entity is lessor in a finance lease (IFRS) or a sales-type, direct financing, or leveraged lease (US GAAP).	□ Financial asset for remaining lease payments (including any guaranteed residual value and the payments that would be received upon the exercise of any renewal or purchase options that are considered reasonably certain of exercise) and any unguaranteed residual value is recognized □ Customer (or tenant) relationships □ Residual value of leased asset, if any	□ Financial asset that represents its remaining investment in the lease, measured in accordance with IAS 17, is recognized □ Customer (or tenant) relationships □ Residual value of leased asset, if any

[1] The table reflects guidance under ASC 840. Refer below (within this section) for additional considerations results from the adoption of ASC 842.

Intangible assets related to "in-place" leases—US GAAP

There may be value associated with leases that exist at the acquisition date (referred to as "in-place" leases) when the acquiree leases assets to others 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.

Measurement attribute of leased assets and liabilities

Under the Standards, assets and liabilities that arise on the acquisition date from leases assumed in a business combination are not exempt from the general fair value measurement principle. Accordingly, these assets and liabilities should be measured at their fair value on the acquisition date.

For US GAAP companies, ASC 805 reflects the guidance in ASC 840 for the classification of leases (e.g., capital or operating) assumed in a business combination. That guidance states that the classification of a lease determined at lease inception in accordance with ASC 840-10-35-5 should not be changed as a result of a business combination unless the provisions of the lease are modified. IFRS 3.17 incorporates similar guidance. See BCG 2.5.18 for further information on the lease classification exception under the Standards.

Two approaches have developed to measure the fair value of the assets and liabilities on the acquisition date arising from a lease assumed in a business combination. Under the first approach, the acquirer follows ASC 840 for lease classification and assumes the same lease term that was used by the acquiree in establishing the original lease classification when determining the fair value of the lease assets and liabilities at the acquisition date. For example, if, at the inception of the lease contract, the acquiree determined that a renewal option was reasonably assured to be exercised at the end of the noncancellable term, the acquiree would have included the period covered by the renewal option in the lease term in classifying and accounting for the lease. In this case, the acquirer would assume the same lease term, including the period covered by the renewal option, for purposes of measuring the lease assets and liabilities. This would be true even if the rental payments that would be due during the period covered by the renewal option were unfavorable to market terms at the acquisition date and the acquirer had no intention of exercising the renewal option. Under the second approach, the acquirer applies ASC 840 only to the classification of the lease. Following this approach, the assumptions used by the acquirer in measuring the lease assets and liabilities at fair value on the acquisition date are not required to be consistent with the assumptions used by the acquiree at the inception of the lease. However, the assumptions used by the acquirer to classify the lease and measure the related assets and liabilities on the acquisition date should be consistent.

Summary example of lease assets and liabilities recognized

Example 4-9 illustrates the recognizable intangible and tangible assets related to leases acquired in a business combination.

EXAMPLE 4-9

Lease-related assets and liabilities

Company A, the lessor of a commercial office building subject to various operating leases, was acquired by Company G in 20X0. 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 inception.

US GAAP 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. (See BCG 4.3.3.5 for further information on favorable and unfavorable contracts.)

- **"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.

IFRS Analysis

Using the acquisition method, Company G would consider the following in recognizing and measuring the building and the assets and liabilities, if applicable, associated with the lease arrangements:

- **Building:** A tangible asset would be recognized and measured at fair value, taking into account the terms of the leases in place at the acquisition date. Therefore, the acquirer would not recognize separate intangible assets or liabilities related to the favorable/unfavorable leases or for the value of "in-place" leases. However, it may be appropriate to depreciate separately amounts related to favorable or unfavorable lease terms relative to market terms in accordance with IAS 16.

- **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.

Lease agreements

The boards issued new lease accounting standards in 2016. The US standard, ASC 842, *Leases*, is effective for years beginning after December 15, 2018 for public business entities. Certain not-for-profit entities and employee benefit plans that file financial statements with the SEC, are also subject to the transition date applicable to public business entities. All other entities are required to apply ASC 842 for annual periods beginning after December 15, 2019. The standard may be adopted early. IFRS 16, *Leases* is effective on or after January 1, 2019, and may also be adopted early, but no earlier than the adoption of IFRS 15, *Revenue from Contracts with Customers*. See LG 1.5 for further information on transition to ASC 842.

Under the new guidance, a lessee will record right-of-use assets and lease liabilities on their balance sheet for most leases. Only short-term leases, and, for an IFRS reporting lessee, low-value leases, as defined by those standards, are not recognized on a lessee's balance sheet. See LG 2.2.1 for further information about leases that are exempt from the recognition provisions of the new guidance under US GAAP. Lessor accounting will not substantially change under the new standards, as lessors will retain the various lease classifications they use under existing standards.

Under US GAAP, a lessee will still classify certain leases as operating leases, but unlike the accounting guidance under ASC 840, operating leases will be reported on a lessee's balance sheet. (See LG 3.5 for further information on the distinction between operating and finance leases for lessees.) Since right-of-use assets and lease liabilities will be reported on the balance sheet, similar to capital [finance] leases under existing lease guidance, after a lessee adopts the new leases guidance, identifying intangible assets related to leases in an acquisition will be similar to the guidance described above in Example 4-3 related to capital leases. In other words, ASC 842 did not change the requirement to identify intangible assets in an acquisition; it changed whether a lessee must report lease assets and liabilities.

For example, as described above in 4.3.3.7, under existing accounting guidance, a lessee should identify favorable or unfavorable intangible assets related to operating leases, but not for capital [finance] leases, because for capital leases, the favorable or unfavorable aspects of the arrangement would be incorporated into the valuation of the assets under capital lease and the lease liability. Under the new guidance, a lessee with an operating lease, therefore, would follow the guidance described for capital leases above, since operating leases will no longer be off balance sheet.

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 2.7.3 for further information on the accounting for the settlement of preexisting relationships.

Question 4-2

How should the acquirer account for the acquisition of an existing capital [finance] lease arrangement with the acquiree (e.g., acquirer leased assets under a capital [finance] lease from acquiree) in its acquisition accounting?

PwC response

Before the acquisition, the acquirer would have recognized a leased asset and a capital [finance] lease liability while the acquiree may have recognized a finance lease receivable. 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 capital [finance] lease liability of the acquirer shall be derecognized on the settlement of the preexisting relationship in accordance with ASC 470 and IAS 39. As a result, the acquirer should recognize a gain or loss for the effective settlement of a preexisting relationship. See BCG 2.7.3.1 for further information on calculating the settlement of preexisting relationships.

The acquirer does not adjust the carrying amount of the existing leased asset for the settlement of the liability. Rather, the acquired asset would be recognized and measured at fair value. Finally, the acquirer should also reconsider the useful life of the formerly leased assets.

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.

The following sections discuss the common technology-based intangible assets recognized and measured in a business combination.

4.3.4.1 Intangible assets used in research and development activities

Intangible assets used in research and development activities acquired in a business combination are initially recognized at fair value and classified as indefinite-lived [not available for use] 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 amortization or subsequent impairment testing. Determining useful lives and potential impairment issues related to intangible assets used in research and development activities under US GAAP and IFRS is discussed in Chapters 8 and 10, respectively.

In December 2013, the American Institute of Certified Public Accountants (AICPA) issued the *AICPA Accounting and Valuation Guide Assets Acquired to Be Used in Research and Development Activities* (the IPR&D Guide). It replaces the AICPA's 2001 practice aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices & Pharmaceutical Industries*. The Guide does not contemplate accounting or reporting under IFRS. While the IPR&D Guide is non-authoritative, it reflects the input of financial statement preparers, auditors, and regulators and serves as a US GAAP accounting and reporting resource for entities that acquire IPR&D.

The accounting for subsequent research and development expenditures differs under US GAAP and IFRS. Under US GAAP, subsequent costs for both research and development are generally not eligible for capitalization in accordance with ASC 730. Under IFRS 3, subsequent costs incurred for acquired projects that are in the development stage are capitalized, subject to impairment testing, if they meet the recognition criteria. If they do not, then subsequent costs are expensed.

4.3.4.2 Patented technology, unpatented technology, and trade secrets

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

Unpatented technology is typically not protected by legal or contractual means and, therefore, does not meet the contractual-legal criterion. Unpatented technology, however, is often sold in conjunction with other intangible assets, such as trade names or secret formulas. 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, mask works, databases, and title plants

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.

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.

In the United States, 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.

4.4 Complementary intangible assets and grouping of other intangible assets

Separate intangible assets often work together or complement each other. In some cases, an acquirer may wish to group these 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. Only limited grouping is permitted under IFRS.

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 Standards' identifiable 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; IFRS 3.IE21.

An acquirer may also recognize other groups of complementary intangible assets as a single asset. The conclusion in the Standards, with respect to a brand, may also be applied to other assets for which 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.

4.4.1 *Assessment of other factors in determining grouping of complementary assets—US GAAP*

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 *Intangible assets that the acquirer does not intend to use or intends to use differently than other market-participants*

The Standards clarify that 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 under both US GAAP and IFRS 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.

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." 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.

Examples 4-10 and 4-11 demonstrate how to distinguish defensive intangible assets from other intangible assets.

EXAMPLE 4-10

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

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 55-28I.

EXAMPLE 4-11

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. 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.

ASC 350-30-55 contains the US GAAP accounting guidance related to certain aspects of accounting for defensive intangible assets. IFRS companies may also apply these principles in accounting for defensive assets as ASC 350-30-55 does not conflict with IFRS. ASC 350-30-55 contains the following guidance:

- A defensive asset should be considered a separate unit of accounting. This means that a defensive asset should be accounted for as an individual asset and should not be grouped with the acquirer's existing asset(s) whose value it may enhance.

- The useful life of a defensive asset should reflect the acquiring entity's consumption of the defensive asset's expected benefits. The consumption period should reflect the period over which the defensive asset is expected to contribute directly and/or indirectly to the acquiring entity's future cash flows.

- Classification of a defensive intangible asset as an indefinite-lived intangible asset would be rare.

- A defensive intangible asset cannot be considered immediately abandoned following its acquisition.

- Acquired research and development intangible assets are excluded from the scope of ASC 350-30-25-5 and should continue to be accounted for in accordance with ASC 350-30-35-17A.

See FV 7.3.1 for further information on the valuation of intangible assets based on their highest and best use/market-participant assumptions. See BCG 8 and BCG 10 for further information on the postacquisition accounting for intangible assets under US GAAP and IFRS, respectively.

4.6 Summary of intangible assets and typical useful life characteristics found in major industries

Figure 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 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	□ Trade and brand names □ Franchise rights □ Customer and supplier contracts □ Favorable/unfavorable contract or lease terms □ Process technology and know-how □ Liquor licenses □ Customer relationships (e.g., pharmacy script files) □ Customer lists □ Internet domain names	Trade, 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	□ Trade names □ Customer and supplier contracts □ Favorable/unfavorable contract or lease terms □ 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 range from short- to long-term. Customer relationships are often short to

Industry	Typical significant intangible assets	Typical life characteristics
	◻ Customer relationships	moderate but may be longer depending on rate of customer churn.
Real estate	◻ Tenant relationships ◻ Favorable/unfavorable lease terms ◻ "In-place" leases	Determined by lease life and expectation of tenant renewals.
Banking	◻ Core deposit intangibles (CDI) ◻ Distribution channels (e.g., agents) ◻ Brands and trade names ◻ Customer relationships (including purchased credit card relationships) ◻ Customer lists	CDI is short to moderate, based on customer churn, although may be longer for companies based outside the United States. 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.
Insurance	◻ 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	◻ 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 manager

Industry	Typical significant intangible assets	Typical life characteristics
		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.
Technology	□ 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	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. IPR&D would be an indefinite-lived [not available for use] 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.
Life sciences and pharmaceuticals	□ Brands and trade names □ Patents, product rights, and know-how □ Partnering and alliance arrangements □ IPR&D □ Customer relationships and customer base □ Supplier contracts	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. IPR&D would be an indefinite-lived [not available for use] 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.

Industry	Typical significant intangible assets	Typical life characteristics
Entertainment and media	□ Trade names/trademarks □ Artistic properties (e.g., cartoon characters, copyrights) □ Licenses (e.g., broadcast licenses, program material licenses) □ Favorable/unfavorable contract terms	Trade names/trademarks and certain licenses and artistic properties likely to be longer term or possibly indefinite-lived if sustainable.
Telecommunications	□ Trade names □ Licenses and rights of use □ Installed base □ Technology □ Customer relationships	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.
Energy & resources (including oil & gas)	□ Trade and brand names where downstream operations are present (e.g., retail front) □ Contractual relationships □ Favorable/unfavorable contract terms (e.g., drilling contract) □ Agreements (franchise service, interconnection, operations and maintenance, railroad crossing) □ Contracts (purchased power, fuel, and other supply contracts) □ Easements, rights of way, and rights of use □ Siting, environmental, and other licenses □ Customer relationships[1]	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.

[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 Private company accounting alternative for intangible assets acquired in a business combination under US GAAP

On December 23, 2014, the FASB issued a private company alternative that simplifies the accounting for intangible assets acquired in a business combination. Under the alternative, an acquirer other than a public business entity or not-for-profit entity (private company) 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.

Private companies that elect the alternative should continue to separately recognize and measure customer-related intangibles that are capable of being sold or licensed independently, as well as all other identifiable intangibles (for example, trade names). A private company that elects the accounting alternative on intangibles must also adopt the accounting alternative related to amortizing goodwill. See BCG 9.12 for further information.

Before electing any of the private company alternatives, companies should consider the possibility of a future initial public offering 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.

4.7.1 Customer-related intangible assets

Private companies electing the intangible 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 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 4-12

Acquisition of an equipment manufacturer and servicer 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 alternative is likely to have less of an impact in industries where 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 4-13

Acquisition of an online apparel business with custom 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 on 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 intangibles; a single intangible asset is often recognized for both. Private companies electing the 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 private company 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 electing the intangible alternative would recognize neither a customer contract intangible asset nor an unfavorable contract liability.

The private company 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 private company alternative does not apply to leases. Thus, favorable and unfavorable lease terms should continue to be recognized and measured separate from goodwill.

4.7.2 Noncompetition agreements

Private companies electing the alternative should not recognize noncompetition agreements acquired in a business combination separate from goodwill. 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. Because these agreements arise from contractual rights, US GAAP considers them to be identifiable intangible assets that should be recognized separate from goodwill. The private company alternative provides a specific exception allowing private companies to subsume noncompetition agreements into goodwill, thereby eliminating the need to estimate their fair value.

The private company 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 alternative also applies to new noncompetition agreements when a reporting entity determines that such agreements were entered into concurrent with the business combination.

4.7.3 Disclosures

The private company alternative does not introduce any incremental disclosure requirements. Existing disclosure requirements in ASC 805 continue to apply to private companies electing the intangible alternative. Those disclosures include a qualitative description of intangible assets that do not qualify for separate recognition. Accordingly, while the fair value of certain intangibles would not need to be determined by private companies, the nature of all acquired intangibles should be described in the financial statement footnotes.

4.7.4 Transition and related considerations

The private company alternative is available to all entities except for public business entities and not-for-profit 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:

a. Business combinations under Topic 805

b. Investments in an equity method investee under Topic 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 Topic 852 for reorganizations

The guidance is required to be applied prospectively. That is, customer-related intangibles and noncompetition agreement intangibles that have been recognized in previously issued financial statements prior to the period of adoption are not affected by the private company alternative and should not be subsumed into goodwill.

A private company that elects the alternative on intangibles must also adopt the goodwill accounting alternative (ASU 2014-02), which requires goodwill to be amortized over a period of up to 10 years and introduces a simplified impairment approach. See BCG 9.12 for further information. However, the opposite is not the case. That is, a private company that elects the goodwill accounting alternative can choose to, but does not have to adopt the intangible accounting alternative.

Chapter 5: Partial acquisitions, step acquisitions, and accounting for changes in the noncontrolling interest

5.1 Chapter overview

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 associated with partial acquisitions, step acquisitions, and changes in a company's NCI in a business pursuant to ASC 810-10 and IFRS 10. NCI valuation considerations are discussed in FV 7.

For changes in ownership interest in an asset or group of assets that do not constitute a business, the appropriate consolidation or derecognition model should be identified, which may be different from the guidance for a business. Refer to PPE 5 for additional guidance under US GAAP and BCG 5.6.2 for guidance under IFRS.

The accounting for partial acquisitions and step acquisitions of a business is generally the same under US GAAP and IFRS, although there are some differences. The primary difference relates to the initial measurement of NCI. Companies that follow IFRS can choose to measure NCI at fair value (the fair value method) or at the proportionate share of the acquiree's identifiable net assets at the acquisition date (the proportionate share method). US GAAP companies are required to recognize any new NCI at fair value at the acquisition date. Thus, the initial measurement for the noncontrolling interest will differ between IFRS companies that choose the proportionate share method and US GAAP companies.

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 Definition and classification of the noncontrolling interest

In accordance with ASC 810-10-20 and IFRS 10, noncontrolling interest is the equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. The noncontrolling interest is (1) reported as part of equity of the consolidated group, (2) recorded separately from the parent's interests, and (3) clearly identified and labelled (e.g., noncontrolling interest in subsidiaries) to distinguish it from other components of the parent's equity. A company with a noncontrolling interest in more than one subsidiary may aggregate its various noncontrolling interests in the consolidated financial statements under ASC 810-10-45-16 or; IFRS 10.22.

Financial instruments, which may be either freestanding or embedded, can be treated as a noncontrolling interest in the consolidated financial statements if issued by a subsidiary and classified as equity for financial reporting purposes in both the parent's consolidated financial statements and subsidiary's financial statements. The parent may, in some circumstances, issue financial instruments on behalf of a subsidiary. If such financial instruments qualify for equity classification in both the parent's consolidated financial statements and subsidiary's financial statements they should, similar to an equity-classified financial instrument issued by a subsidiary, be treated as noncontrolling interest in the consolidated financial statements. Guidance under US GAAP (ASC 815-40-15-5C) also clarifies that a financial instrument issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the shares of a consolidated subsidiary that is considered indexed to the entity's own shares in the consolidated financial statements of the parent, is also treated as a noncontrolling interest.

A financial instrument that a subsidiary classifies as a liability is not a noncontrolling interest in the consolidated financial statements. For example, a subsidiary's mandatorily redeemable financial instruments that are classified as liabilities under ASC 480 or IAS 32 are not considered a noncontrolling interest because they are not ownership interests under ASC 810-10-45-17. Also, financial instruments classified as liabilities in the parent's consolidated financial statements under IAS 32 are not considered a noncontrolling interest, even if classified as equity in the subsidiary's financial statements. The guidance in ASC 480 or IAS 32 is used to determine the classification of a financial instrument as a liability or equity.

Further, US GAAP companies with redeemable securities that are subject to the guidance in ASC 480 must apply that guidance in determining the classification and measurement of those securities (see BCG 2.6.6.1). This includes presenting redeemable securities outside of shareholders' equity and accreting the reported amount of those securities to their redemption value. Financial instruments issued by a subsidiary and classified as mezzanine equity in the subsidiary's financial statements are classified as mezzanine equity in the consolidated financial statements and are generally considered a noncontrolling interest.

See BCG 5.11 for further information on the classification of a financial instrument as a noncontrolling interest.

5.2.1 Measurement of the noncontrolling interest—fair value method

NCI is recognized and measured at fair value on the acquisition date by the acquirer for all US GAAP companies, and IFRS companies that choose the fair value method of measuring the NCI in accordance with ASC 805-20-30-1 and IFRS 3.19. NCI is not remeasured in subsequent periods. However, NCI will 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 and IFRS 10.B94.

5.2.2 Measurement of the noncontrolling interest—proportionate share method—IFRS

IFRS companies have the option of measuring NCI at fair value or at its proportionate share of the recognized amount of the acquiree's identifiable net assets at the acquisition date, as measured in accordance with IFRS 3.19. This accounting can be elected on a transaction-by-transaction basis and does not require an IFRS company to make an accounting policy election. The NCI is not remeasured in subsequent periods. In accordance with IFRS 10.B94, NCI will be allocated its share of profit or loss and its share of each component of other comprehensive income in subsequent periods.

The option of measuring noncontrolling interest under the proportionate share method applies only to components of noncontrolling interests that are present ownership instruments and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. Other noncontrolling interests should be measured at fair value unless another measurement basis is required by IFRS. Preference shares, employee share options, and the equity element of convertible debt are examples of instruments measured at other than fair value under IFRS.

Example 5-1 demonstrates the application of the proportionate share method and measurement of other noncontrolling interest.

EXAMPLE 5-1

Measurement of noncontrolling interest in a business including preference shares-IFRS

Company B has issued 1,000 common shares and 100 preference shares (nominal value of CU1 per preference share). The preference shares are appropriately classified within equity. The preference shares give their holders a right to a preferential dividend in priority to the payment of any dividend to the holders of common shares. Upon liquidation of Company B, the holders of the preference shares are entitled to receive CU1 per share in priority to the holders of the common shares. The holders of the preference shares do not have any further rights on liquidation.

Company A acquires 800 common shares of Company B, resulting in Company A controlling Company B. The acquisition date fair value of a preference share is CU1.2 per share.

How should Company A measure the noncontrolling interest, including preference shares?

Analysis

Company A can choose to measure the noncontrolling interest that relates to the 200 common shares either at fair value or at the proportionate share of Company B's identifiable net assets.

The noncontrolling interest, including preference shares, that relates to Company B's preference shares should be measured at fair value. The preference shares do not entitle their holders to a proportionate share of Company B's net assets in the event of liquidation. Company A must measure the preference shares at their acquisition date fair value of CU120 (100 preference shares × CU1.2 per share).

IFRS companies that choose the proportionate share method typically record the NCI at an initial value that is lower than the value that would be used under the fair value method. Therefore, subsequent purchases of NCI for these companies may result in a larger percentage reduction of the controlling interest's equity on the subsequent acquisition date. This is demonstrated in Examples 5-9 through 5-16 in BCG 5.5.

5.3 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 blocks of 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, the accounting result, and the impact on the financial statements is included in Figure 5-1. Each is described in more detail in BCG 5.4–5.6.

For guidance on the accounting for an asset acquisition or group of assets that does not constitute a business, refer to BCG 7. Note that the table below discusses the remeasurement of previously held interests in a business. Similar guidance does not exist for asset acquisitions.

Figure 5-1

Summary of accounting for changes in ownership interests in businesses

<table>
<tr><th>Change in ownership interest</th><th>Result</th><th>Impact</th></tr>
<tr><td>Partial acquisition: control is obtained, but less than 100% of business is acquired</td><td>Consolidate as of date control is obtained
Recognize the NCI in equity</td><td>Recognize 100% of identifiable assets and liabilities
Fair value method (all US GAAP companies and IFRS companies, if chosen):
□ Recognize the NCI at fair value
□ Recognize 100% of the goodwill
Proportionate share method (only IFRS companies, if chosen):
□ Recognize the NCI at its proportionate share of the recognized amount of the identifiable net assets, excluding goodwill
□ Recognize the goodwill attributable to controlling interest</td></tr>
<tr><td>Step acquisition: control is obtained where there is a previously held equity interest</td><td>Change classification and measurement of previously held equity interest
Consolidate as of date control is obtained
Recognize a gain or loss on any previously held equity interest in the income statement
If less than 100% acquired, recognize the NCI in equity</td><td>Recognize 100% of the identifiable assets and liabilities
Remeasure the previously held equity interest to fair value and recognize any difference between the fair value and carrying value as a gain or loss in the income statement
Recognize 100% of the goodwill if all equity interests are acquired
If less than 100% interest is acquired:
□ Fair value method (all US GAAP companies and IFRS companies, if chosen):
○ Recognize the NCI at fair value
○ Recognize 100% of the goodwill
□ Proportionate share method (only IFRS companies, if chosen):
○ Recognize the NCI at its proportionate share of the recognized amount of</td></tr>
</table>

Change in ownership interest	Result	Impact
		identifiable net assets, excluding goodwill ○ Recognize the goodwill attributable to controlling interest
Additional interest obtained: 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 and the related carrying value of the NCI acquired in the controlling entity's equity/APIC Reclassify the carrying value of the NCI obtained from the NCI to the controlling entity's equity
Reduction in parent's ownership interest: control is maintained[1]	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 received and the related carrying value of the controlling interest sold in the controlling entity's equity/APIC 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]	Change classification and measurement of investment Cease consolidation accounting and begin accounting for investment under other applicable guidance Recognize the gain or loss on disposal and gain or loss on the retained noncontrolling investment in the income statement	Deconsolidate investment Remeasure any retained noncontrolling investment at fair value Recognize the gain or loss on interest sold and the gain or loss on the retained noncontrolling investment in the income statement

[1] Reduction in a parent's ownership interest may occur by different methods, including (1) a parent sells part of its interest in its subsidiary or (2) the subsidiary issues shares, thereby reducing the parent's ownership in the subsidiary [ASC 810-10-45-22].

[2] Loss of control by a parent may occur in different ways, including (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 [ASC 810-10-40-4, ASC 810-10-55-4A; IFRS 10.B37].

5.4 Accounting for partial and step acquisitions

Each acquisition of equity interests is accounted for as an additional investment under the applicable literature for step acquisitions until control is achieved. 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.

5.4.1 Fair value method

If a partial acquisition or a step acquisition in which control is obtained is considered a business combination, then all US GAAP companies and IFRS companies choosing the fair value method will recognize the following at the acquisition date:

- 100% of the identifiable net assets, as measured in accordance with the Standards
- NCI at fair value
- Goodwill as the excess of (a) over (b) below in accordance with ASC 805-30-30-1 and IFRS 3.32:

  a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, 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; less

  b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed

As discussed in BCG 2, the identifiable assets acquired and liabilities assumed are generally measured at fair value. ASC 805-20-25-16 and IFRS 3.21–31 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 and IFRS 3.33. See FV 4.4 for further information on valuation techniques.

Under the fair value method, 100% of the goodwill of the acquiree is recognized, not just the portion attributable to the controlling interest acquired. For IFRS companies, if the company chooses to use the proportionate share method instead of the fair value method, only the controlling interest's portion of goodwill is recognized.

Example 5-2 in BCG 5.4.3 illustrates the full amount of goodwill that would be recognized in a partial acquisition by all US GAAP companies and IFRS companies electing the fair value method.

5.4.2 Remeasurement of previously held equity interest in a business or VIE and recognition of gains and losses

A step acquisition occurs when a shareholder obtains control over an entity by acquiring an additional interest in that entity. Under US GAAP, if that entity is a business or a VIE, the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired. Under

US GAAP, any difference between the carrying value and the fair value of the previously held equity interest is recognized as a gain or loss in the income statement in accordance with ASC 805-10-25-10. This remeasurement is likely to result in the recognition of gains, since companies are required to periodically evaluate their investments for impairment.

Under IFRS, these same principles apply, except for the option to designate equity securities not for trading on initial recognition. This option allows an entity to make an initial irrevocable election to present subsequent changes in the fair value of the equity interest in other comprehensive income in accordance with IFRS 9.5.7.5.

When calculating the gain or loss to be recognized in the income statement, the acquirer should reclassify and include any gains or losses associated with the previously held equity interest it had recognized in other comprehensive income in prior reporting periods in accordance with ASC 805-10-25-10 or IFRS 3.42. See BCG 5.4.4 for further information on the considerations in valuing the previously held equity interest.

In a step acquisition in which control is obtained, but the acquirer does not purchase all of the remaining ownership interests, an NCI is created at the acquisition date. The NCI is recorded in equity at fair value for US GAAP companies. For IFRS companies, the NCI is recorded in equity at fair value under the fair value method or its proportionate share of the recognized amount of the acquiree's identifiable net assets under the proportionate share method.

5.4.3 *Examples of the fair value method*

Examples 5-2 through 5-4 demonstrate the acquisition date calculations for a partial acquisition and a step acquisition in which control is obtained and the fair value method is used to value the NCI.

EXAMPLE 5-2

Accounting for a partial acquisition of a business or VIE when control is obtained: fair value method

Company A acquires Company B (a business) by purchasing 60% of its equity for CU150 million in cash. The fair value of the noncontrolling interest is determined to be CU100 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU50 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, calculated as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, 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 measured in accordance with

The journal entry recorded on the acquisition date for the 60% interest acquired would be as follows (in millions):

Identifiable net assets	CU 50[2]	
Goodwill	CU200[3]	
Cash		CU150[4]
NCI[1]		CU100[5]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded

[3] The full amount of goodwill is recorded (in millions):

Fair value of consideration transferred	CU150
Fair value of the NCI	100
Fair value of previously held equity interest	n/a
Subtotal	250
Recognized value of 100% of the identifiable net assets, measured in accordance with the Standards	(50)
Goodwill recognized	CU200

[4] Cash paid for the 60% interest acquired in Company B

[5] Fair value of the 40% NCI is recognized in equity

EXAMPLE 5-3

Accounting for a step acquisition of a business or VIE when control is obtained: fair value method

Company A has a 40% previously held equity interest in Company B (a business). The carrying value of the previously held equity interest is CU20 million. Company A purchases the remaining 60% interest in Company B for CU300 million in cash. The fair value of the 40% previously held equity interest is CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. (For illustrative purposes, the tax consequences on the gain 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, and (3) goodwill, calculated as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, 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 measured in accordance with

Any gain or loss on the previously held equity interest is recognized in the income statement.

The journal entry recorded on the acquisition date is as follows (in millions):

Identifiable net assets	CU440[2]	
Goodwill	CU60[3]	
Cash		CU300[4]
Equity investment		CU20[5]
Gain on equity interest[1]		CU180[6]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the previously held equity interest may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded (in millions):

Fair value of consideration transferred	CU300
Fair value of the NCI	n/a
Fair value of previously held equity interest	200
Subtotal	500
Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(440)
Goodwill recognized	CU60

[4] Cash paid for the remaining 60% interest acquired in Company B

[5] Elimination of the carrying value of the 40% previously held equity interest

[6] The gain on the 40% previously held equity interest is recognized in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest (CU200 – CU20)

EXAMPLE 5-4

Accounting for a partial acquisition when control is obtained, but less than 100% is acquired: fair value method

Company A has a 40% previously held equity interest in Company B, with a carrying value of CU20 million. Company A purchases an additional 50% interest in Company B for CU250 million in cash. The fair value of Company A's 40% previously held equity interest is determined to be CU200 million.[1] The fair value of the NCI is determined to be CU50 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. (For illustrative purposes, the tax consequences on the gain 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, calculated as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, 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 measured in accordance with the Standards

Any gain or loss on the previously held equity interest 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):

Identifiable net assets	CU440[2]	
Goodwill	CU 60[3]	
Cash		CU250[4]
Equity investment		CU20[5]
Gain on equity interest[1]		CU180[6]
NCI[1]		CU 50[7]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the NCI and the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI and the previously held equity interest may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded:

Fair value of consideration transferred	CU250
Fair value of the NCI	50
Fair value of previously held equity interest	200
Subtotal	500
Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(440)
Goodwill recognized	CU60

[4] Cash paid for the 50% interest acquired in Company B

[5] Elimination of the carrying value of the 40% previously held equity interest

[6] The gain on the 40% previously held equity interest is recognized in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest (CU200 – CU20)

[7] Fair value of the 10% NCI is recognized in equity.

5.4.4 *Fair value considerations*

The fair value of a noncontrolling interest can be measured on the basis of market prices for the equity shares not held by the acquirer if the noncontrolling interest consists of publicly traded securities. The acquirer must measure the fair value of the noncontrolling interest using other valuation techniques if the securities are not publicly traded. The fair value of the previously held equity interest may also need to be similarly measured.

On a per-share basis, the fair value of the acquirer's interest in the acquiree and the noncontrolling interest may differ. This difference may be due to 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 in the per-share fair value of the noncontrolling interest.

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 and minority interest discounts should not be applied without considering whether the noncontrolling interest will benefit in ways similar to the acquirer. For example, certain operational synergies will often impact the cash flows of the acquiree as a whole, including the noncontrolling interest in the acquiree. In such a case, deducting those operational synergies (control premium) to value the noncontrolling interest may not be appropriate. FV 7.3.5.2 contains further discussion on valuation techniques and methods.

5.4.5 *Consideration of goodwill when noncontrolling interest exists—US GAAP*

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 for US GAAP companies.

5.4.6 *Consideration of goodwill when noncontrolling interest exists—IFRS*

The impairment model for goodwill is different under IFRS than for US GAAP. Under IAS 36, any impairment charge is allocated between the controlling and noncontrolling interests on the basis of their relative profit shares if the fair value method was used to measure the noncontrolling interest on the acquisition date. The impairment charge is allocated to the controlling interest if the proportionate share method was used to measure the noncontrolling interest on the acquisition date. See BCG 10 for further information on impairment testing of goodwill for IFRS companies.

5.4.7 *Bargain purchase in a partial or step acquisition—US GAAP companies and IFRS companies choosing the fair value method*

Occasionally, an acquirer will make a bargain purchase, a business combination in which (a) the acquisition-date amounts of the identifiable net assets acquired and the liabilities assumed, as measured in accordance with the Standards, exceeds (b) the aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally require 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, the acquirer shall reassess whether it has identified all of the assets acquired and liabilities assumed. The acquirer shall 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, ASC 805-30-25-4 and IFRS 3.34 through 3.36.

In a bargain purchase, the bargain element realized by the controlling interests in the transaction is not allocated to the NCI. Therefore, the NCI is recognized at its fair value.

Example 5-5 demonstrates the accounting for a bargain purchase in a partial acquisition.

EXAMPLE 5-5

Accounting for a bargain purchase in a partial acquisition of a business

Company A acquires Company B by purchasing 70% of its equity for CU150 million in cash. The fair value of the NCI is determined to be CU69 million.1 The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU220 million. (For illustrative purposes, the tax consequences on the 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, as measured in accordance with the Standards 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.

Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards (a)	CU 220
Fair value of consideration transferred	(150)
Fair value of the NCI	(69)
Fair value of previously held equity interest	n/a
Less: subtotal (b)	(219)
Bargain purchase gain (a – b)	CU 1

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 CU1 million would be recognized in the income statement.

The journal entry recorded on the acquisition would be as follow:

Identifiable net assets	CU220[2]	
Cash		CU150[3]
Gain on bargain purchase		CU1[4]
NCI[1]		CU69[5]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] Cash paid for the 70% interest acquired in Company B

[4] Gain recognized on bargain purchase: recognized amount of the identifiable net assets less fair value of consideration transferred plus the fair value of the NCI and the fair value of previously held equity interest (CU220 – (CU150 + CU69)

[5] Fair value of the 30% NCI is recognized in equity.

Because the NCI is required to be recorded at fair value, a bargain purchase gain is recognized only for CU1 million. The NCI is recognized at fair value, which includes embedded goodwill of CU3 million: Fair value of NCI – NCI's share of identifiable assets (CU69 – (CU220 × 30%) = CU3). Although the NCI value includes embedded CU3 million of goodwill, the consolidated financial statements do not contain a separate goodwill line item.

5.4.8 Partial acquisition and step acquisition—proportionate share method—IFRS

Application of the proportionate share method under IFRS is the same as the fair value method, except that NCI is recognized at its proportionate share of the recognized amount of the identifiable net assets. The acquirer measures 100% of the identifiable assets and liabilities, but recognizes only the goodwill associated with the controlling interest. When the proportionate share method is used, goodwill is recognized, in accordance with IFRS 3.32, at the acquisition date as the difference between (a) and (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with IFRS 3, which generally requires acquisition-date fair value; (2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); 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; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with IFRS 3.

If no consideration is transferred, goodwill is measured by reference to the fair value of the acquirer's interest in the acquiree, as determined using an appropriate valuation technique. See FV 7 for further information on valuation techniques.

Examples 5-6 and 5-7 demonstrate the calculation on the acquisition date for cases in which the proportionate share method is used to value the NCI in a partial acquisition or a step acquisition where control is obtained.

EXAMPLE 5-6

Accounting for a partial acquisition of a business—IFRS company electing proportionate share method

Company A acquires Company B by purchasing 60% of its equity for CU150 million in cash. The net aggregate value of the identifiable assets and liabilities measured in accordance with the Standards is determined to be CU50 million. Company A chooses to measure the NCI using the proportionate share method for this business combination.

How should Company A recognize the partial acquisition under the proportionate share method?

Analysis

The acquirer would recognize 100% of the identifiable net assets on the acquisition date. NCI would be recorded at its proportionate share of the recognized amount of the identifiable net assets in accordance with IFRS 3.19. Goodwill would be recognized at the acquisition date as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value;
(2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); 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 measured in accordance with the Standards

The journal entry recorded on the acquisition date for the 60% interest acquired would be as follows (in millions):

Identifiable net assets	CU 50[1]	
Goodwill	CU120[2]	
Cash		CU150[3]
NCI		CU 20[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[2] Since NCI is recorded at its proportionate share of Company B's identifiable net assets, goodwill is recognized only for the controlling interest's portion. (That is, goodwill is not recognized for the NCI.) Goodwill is calculated as follows:

Fair value of consideration transferred	CU150
Proportionate share of the NCI (CU50 × 40%)	20
Fair value of previously held equity interest	n/a
Subtotal	170
Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(50)
Goodwill recognized	CU120

3 Cash paid for the 60% interest acquired in Company B

4 Recognition of the 40% NCI at its proportionate share of the identifiable net assets (CU50 × 40%)

EXAMPLE 5-7

Accounting for a partial acquisition of a business when control is obtained but less than 100% is acquired—IFRS company choosing proportionate share method

Company A has a 40% previously held equity interest in Company B, with a carrying value of CU20 million. Company A purchases an additional 50% interest in Company B for CU250 million in cash. The fair value of the 40% previously held equity interest is determined to be CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. Company A chooses to measure NCI using the proportionate share method for this business combination. (For illustrative purposes, the tax consequences on the gain have been ignored.)

How should Company A recognize the partial acquisition when control is obtained using the proportionate share method?

Analysis

The acquirer would recognize 100% of the identifiable net assets on the acquisition date. In accordance with IFRS 3.19, NCI would be recorded at its proportionate share of the recognized amount of the identifiable net assets. Goodwill would be recognized at the acquisition date as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value;
(2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); 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 measured in accordance with the Standards

In accordance with IFRS 3.42, any gain or loss on the previously held equity interest would be recognized in the income statement.

The journal entry recorded on the acquisition date would be as follows (in millions):

Identifiable net assets	CU440[2]	
Goodwill	CU 54[3]	
Cash		CU250[4]
Equity investment		CU 20[5]
Gain on investment[1]		CU180[6]
NCI		CU 44[7]

1 As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the previously held equity interest may have to be independently derived.

2 The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards

3 Since NCI is recorded at its proportionate share of Company B's identifiable net assets, goodwill is recognized only for the controlling interest's portion. (That is, goodwill is not recognized for the NCI.) Goodwill is calculated as follows:

Fair value of consideration transferred	CU250
Proportionate share of the NCI (CU440 × 10%)	44
Fair value of previously held equity interest	200
Subtotal	494
Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(440)
Goodwill recognized	CU54

4 Cash paid for the 50% interest acquired in Company B

5 Elimination of the carrying value of the 40% previously held equity interest

6 The gain on the 40% previously held equity interest is recognized in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest (CU200 – CU20)

7 Recognition of the 10% NCI at its proportionate share of the identifiable net assets (CU440 × 10%)

5.4.9 *Bargain purchase in a partial or step acquisition—proportionate share method—IFRS*

The process to determine a bargain purchase under the proportionate share method is the same as the fair value method. The acquirer compares (a) 100% of the identifiable net assets, as measured in accordance with IFRS 3, and (b) the fair value of the consideration transferred, plus the recognized amount of the NCI (at its proportionate share) and, in a step acquisition, the fair value of the previously held equity interest. A bargain purchase gain is recognized for the excess of (a) over (b) in accordance with IFRS 3.34.

Prior to recognizing a bargain purchase gain, the acquirer should reassess whether it has identified all of the assets acquired and liabilities assumed. The acquirer shall also review its valuation procedures used to measure the amounts recognized for the identifiable net assets, previously held equity interest, and 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 IFRS 3.36.

Example 5-8 demonstrates the calculation on the acquisition date when the proportionate share method is used to value the NCI in a bargain purchase.

EXAMPLE 5-8

Accounting for a bargain purchase in an acquisition of a business—an IFRS company chooses the proportionate share method for valuing the NCI

Company A acquires Company B by purchasing 70% of its equity for CU150 million in cash. The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU220 million. Company A chooses to measure NCI using the proportionate share method for this business combination. (For illustrative purposes, the tax consequences on the gain have been ignored.)

How should Company A determine the bargain purchase to be recognized when under the proportionate share method?

Analysis

This method calculates the bargain purchase the same as under the fair value method, except that the NCI is measured as the proportionate share of the identifiable net assets. The gain is the excess of (a) the recognized amount of the identifiable net assets acquired, as measured in accordance with IFRS 3, over (b) the fair value of the consideration transferred, plus the recognized amount of the NCI (proportionate share of the identifiable net assets) and the fair value of the previously held equity interest.

Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards (a)	CU220
Fair value of consideration transferred	(150)
Amount of the NCI recognized (at proportionate share) (CU220 × 30%)	(66)
Fair value of previously held equity interest	n/a
Less: subtotal (b)	(216)
Bargain purchase gain (a – b)	CU 4

Because the recognized amount of the identifiable net assets is greater than the fair value of the consideration transferred, plus the recognized amount of the NCI (at proportionate share), and there was no previously held equity interest in Company B to fair value, a bargain purchase gain of CU4 million would be recognized in the income statement.

The journal entry recorded on the acquisition date for the 70% interest acquired would be as follows (in millions):

Identifiable net assets	CU220[1]	
Cash		CU150[2]
Gain on bargain purchase		CU 4[3]
NCI		CU 66[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards

[2] Cash paid for the 70% interest acquired in Company B

[3] Gain recognized on bargain purchase: recognized amount of the identifiable net assets, less the fair value of the consideration transferred, plus the recognized amount of the NCI (at proportionate share) and the fair value of the previously held equity interest (CU220 – (CU150 + (CU220 × 30%)))

[4] Recognition of the 30% NCI at its proportionate share of the recognized amount of the identifiable net assets (CU220 × 30%)

Under the proportionate share method, NCI is recorded at its proportionate share of the identifiable net assets, and not at fair value. Therefore, the bargain purchase gain recognized under the proportionate share method may be higher than the gain recognized under the fair value method.

5.5 Accounting for changes in ownership interest that do not result in 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. Thus, if the parent maintains control, it will recognize no gain or loss in earnings [profit or loss] upon selling shares of a subsidiary. Similarly, the parent will not record any additional acquisition adjustments to reflect its subsequent purchases of additional shares in a subsidiary if there is no change in control. Instead, 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 and IFRS 10.B96.

NCI is recorded at fair value [or proportionate share for IFRS companies, if chosen] only at the date of the business combination. Subsequent purchases or sales of ownership interests when control is maintained are recorded at the NCI's proportionate share of the net assets, including goodwill.

A subsidiary may issue shares to a third party, thereby diluting the controlling interest's ownership percentage. 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.

Examples 5-9 through 5-16 demonstrate changes in ownership interest where control of a business does not change.

IFRS companies that elect the proportionate share method will record the NCI initially at a lower value than if they had elected the fair value method. Therefore, subsequent purchases of the NCI for these companies may result in a larger percentage reduction of the controlling interest's equity on the transaction date. This is illustrated in Examples 5-12 and 5-13.

EXAMPLE 5-9

Change in controlling ownership interest of a business—initial acquisition of controlling interest—fair value method used to measure the NCI in a business combination

Company A acquires Company B by purchasing 60% of its equity for CU300 million in cash. The fair value of NCI is determined to be CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU370 million.

How should Company A recognize the acquisition of a controlling interest using the fair value method?

Analysis

The acquirer would recognize at the acquisition date (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill, calculated as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred as measured in accordance with the Standards, which generally require 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 measured in accordance with the Standards

The journal entry recorded on the acquisition date for the 60% interest acquired would be as follows (in millions):

Identifiable net assets	CU370[2]	
Goodwill	CU130[3]	
Cash		CU300[4]
NCI[1]		CU200[5]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded:

Fair value of consideration transferred	CU300
Fair value of the NCI	200
Fair value of previously held equity interest	n/a
Subtotal	500

Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(370)
Goodwill recognized	CU130

[4] Cash paid for the 60% interest acquired in Company B

[5] Fair value of the 40% NCI is recognized in equity

EXAMPLE 5-10

Change in controlling ownership interest of a business that does not result in loss of control—acquisition of additional shares

Two years after the transaction in Example 5-9, Company A purchases the outstanding 40% interest from the subsidiary's noncontrolling shareholders for CU300 million in cash. The goodwill of CU130 million from the acquisition of the subsidiary is assumed to not have been impaired. The carrying value of the 40% NCI is CU260 million (original value of CU200 million, plus CU60 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 (additional paid-in capital) and attributed to the controlling interest in accordance with ASC 810-10-45-23 and IFRS 10.B96.

The journal entry recorded for the 40% interest acquired would be as follows (in millions):

NCI	CU260[1]	
Equity/APIC	CU40[2]	
Cash		CU300[3]

[1] Elimination of the carrying value of the 40% NCI on Company A's books.

[2] Difference in NCI: consideration paid less the carrying value of NCI (CU300 – CU260)

[3] Cash paid for the 40% interest acquired in the subsidiary

EXAMPLE 5-11

Change in controlling ownership interest of a business that does not result in loss of control—sale of shares, control is maintained

Three years after the transaction in Example 5-10, Company A sells a 20% interest in the subsidiary to outside investors for CU200 million in cash. Company A still maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is CU600 million, including goodwill of CU130 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 and IFRS 10.B96. 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):

Cash	CU200[1]	
NCI		CU120[2]
Equity/APIC		CU 80[3]

[1] Cash received for the 20% interest sold.

[2] Recognition of the 20% NCI at its proportionate interest in the carrying value of the subsidiary (CU600 × 20%)

[3] Fair value of the consideration received less the recorded amount of the NCI (CU200 – (CU600 × 20%))

EXAMPLE 5-12

Change in controlling ownership interest of a business—initial acquisition of controlling interest—proportionate share method—IFRS

Company A acquires Company B by purchasing 60% of its equity for CU300 million in cash. The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU370 million. Company A chooses to measure NCI using the proportionate share method for this business combination.

How should Company A recognize the acquisition of a controlling interest using the proportionate share method?

Analysis

The acquirer would recognize 100% of the identifiable net assets on the acquisition date. The NCI would be recorded at its proportionate share of the recognized amount of the identifiable net assets in accordance with IFRS 3.19. Goodwill would be recognized at the acquisition date as the excess of (a) over (b):

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); 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 measured in accordance with the Standards

The journal entry recorded on the acquisition date for the 60% interest acquired would be as follows (in millions):

Identifiable net assets	CU370[1]	
Goodwill	CU78[2]	
Cash		CU300[3]
NCI		CU148[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[2] Since NCI is recorded at its proportionate share of Company B's identifiable net assets, only the controlling interest's portion of goodwill is recognized, and there is no goodwill recognized for the NCI. Goodwill is calculated as follows:

Fair value of consideration transferred	CU300
Proportionate share of NCI (CU370 × 40%)	148
Fair value of previously held equity interest	n/a
Subtotal	448
Recognized value of 100% of the identifiable net assets, as measured in accordance with the Standards	(370)
Goodwill recognized	CU78

[3] Cash paid for the 60% interest acquired in Company B

[4] Recognition of the 40% NCI at its proportionate share of the identifiable net assets (CU370 × 40%)

EXAMPLE 5-13

Change in controlling ownership interest of a business that does not result in loss of control—acquisition of additional shares—proportionate share method used to measure the NCI in a business combination—IFRS

Two years after the transaction in Example 5-12, Company A purchases the outstanding 40% interest from the subsidiary's noncontrolling shareholders for CU300 million in cash. The goodwill of CU78 million from the acquisition of the subsidiary is assumed to not have been impaired. The carrying value of the 40% NCI is CU208 million (original value of CU148 million plus CU60 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 and attributed to the controlling interest in accordance with IFRS 10.B96.

The journal entry recorded for the 40% interest acquired would be as follows (in millions):

NCI	CU208[1]	
Equity/APIC	CU 92[2]	
Cash		CU300[3]

[1] Elimination of the carrying value of the 40% NCI on Company A's books

[2] Difference in NCI: fair value of the consideration paid less the carrying value of NCI (CU300 – CU208)

[3] Cash paid for the 40% interest acquired in the subsidiary

Because Company A chose the proportionate share method over the fair value method, it would recorded a lower value for the NCI on the acquisition date. This resulted in Company A recording a larger reduction to the controlling interest's equity than under the fair value method when it acquired additional interests. However, the change in total equity (CU300 million) is the same for both methods.

EXAMPLE 5-14

Change in controlling ownership interest of a business that does not result in loss of control—sale of shares, control is maintained—proportionate share method used to measure the NCI in a business combination IFRS

Three years after the transaction in Example 5-13, Company A sells a 20% interest in Company B to outside investors for CU200 million in cash. Company A still maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is CU548 million. This includes the goodwill of CU78 million from the initial acquisition of the subsidiary (refer to Example 6-12).

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 IFRS 10.B96.

The journal entry recorded on the disposition date for the 20% interest sold would be as follows (in millions):

Cash	CU200[1]	
NCI		CU110[2]
Equity/APIC		CU 90[3]

[1] Cash received for the 20% interest sold

[2] Recognition of the 20% NCI at its proportionate interest in the carrying value of the subsidiary (CU548 × 20%)

[3] Fair value of the consideration received less the value of the NCI (CU200 – (CU548 × 20%))

The accounting result is different than in Example 5-13 because NCI was originally recorded using the proportionate share method; therefore, no goodwill was recognized for the NCI (i.e., the carrying value of the subsidiary is lower in Example 5-11).

EXAMPLE 5-15

Change in controlling ownership interest of a business that does not result in loss of control—sale of additional shares by subsidiary, dilution of controlling interest's ownership percentage, 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 CU200 million in cash.

Assume the following facts on December 31 and January 1 (CU's 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	CU370[3]	CU458[4]
Subsidiary Z's net equity	CU411	CU611

[1] 90 shares divided by 100 shares outstanding

[2] 90 shares divided by 120 shares outstanding

[3] Subsidiary Z's net equity × 90%

[4] Subsidiary Z's net equity × 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 recognized directly in equity and attributed to the controlling interest in accordance with ASC 810-10-45-23 and IFRS 10.B96.

In its consolidated accounts, Company A would records the following journal entry (in millions):

Cash	CU200[1]	
Equity/APIC		CU88[2]
NCI		CU112[3]

1 Cash received for the 20 shares sold by Subsidiary Z to Company C

2 Company A's share of the fair value of the consideration received (CU200 × 75%) less the change in Company A's basis in Subsidiary Z (CU411 × (90% – 75%))

3 The change in the recorded amount of NCI represents:

NCI's share of the fair value of the consideration received (CU200 × 25%)	CU50
Change in NCI's basis in Subsidiary Z (CU411 × 15%)	62
	CU112

Alternatively, the journal entries can be recorded in the separate accounts of Subsidiary Z and Company A as follows (in millions):

Recorded by Subsidiary Z:

Cash	CU200[4]	
Equity		CU200

4 Cash received for the 20 shares sold to Company C

Recorded by Company A:

Investment in Subsidiary Z	CU88[5]	
Equity/APIC		CU88[5]

5 Company A's share of the fair value of the consideration received (CU200 × 75%) less the change in Company A's basis in Subsidiary Z (CU411 × (90% – 75%))

In consolidation, Company A will eliminate its investment in Subsidiary Z of CU458 million, Subsidiary Z's equity of CU611 million, and recognize the NCI of CU153 million in Subsidiary Z (CU112 + CU41 (10% of the original investment)).

This example assumes that the cash will stay in Subsidiary Z. In other cases, if the cash is transferred to the parent, the accounting for this transaction may be different.

EXAMPLE 5-16

Change in controlling ownership interest of a business that does not result in loss of control—accounting for the indirect decrease in an interest in an investee through the sale of shares of an intermediate subsidiary—proportionate share method used to measure the NCI in a Business Combination—IFRS

Company A owns 100% of Company B, a substantive operating company, which owns 30% of an equity-method investee, Company Z. The carrying amount of Company A's investment in Company B is CU160, which includes the carrying amount of Company B's investment in Company Z of CU60. Company A sells a 40% interest in Company B for CU100 to an unrelated third party, out of which CU40 is allocated to the indirect disposal of an interest in Company Z.

How should Company A account for the change in ownership interest?

Analysis

A change in ownership interests that does not result in a change in 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 and IFRS 10.23.

The journal entry recorded on the disposition date for the 40% interest sold is as follows (in millions):

Cash	CU100[1]	
NCI		CU64[2]
Equity/APIC		CU36[3]

1 Cash received for the 40% interest in Company B sold by Company A to an unrelated third party

2 Recognition of the 40% NCI at its proportionate interest in the carrying value of Company B (CU160 × 40%)

3 Fair value of the consideration received less the recorded amount of NCI (CU100 – (CU160 × 40%))

Alternatively, if Company B was a shell company with no other investments, Company A would effectively own only an equity investment in Company Z. Therefore, if Company A sold a partial interest in Company B it would, in substance, be akin to Company A disposing of a portion of its equity investment in Company Z. In this case, gain recognition in earnings for the difference between the portion of the consideration received attributable to the investment in Company Z and the carrying amount of the disposed interest in Company Z generally would be appropriate in accordance with ASC 323-10-40-1 and IAS 28.

5.5.1 Parent company accounting for an equity-classified freestanding written call option on subsidiary's shares

Equity-classified freestanding written call option on subsidiary's shares issued by parent

A freestanding written call option (including an employee stock 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.

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 and IFRS 10.23. 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 and IAS 32 when no other noncontrolling interest is outstanding.

Example 5-17 illustrates this guidance.

EXAMPLE 5-17

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 CU150 to Investor B for CU60. Before and after Investor B's exercise of the warrant, Company A's carrying amount in Subsidiary, including goodwill, is CU1,000. 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		
Cash	CU60	
Noncontrolling interest		CU60
To record the exercise of the warrant		
Cash	CU150	
Noncontrolling interest		CU40[1]
Additional paid in capital		CU110

[1] Company A's basis in Subsidiary's equity after exercise of warrant	CU1,000
Investor B's ownership percentage	x 10%
Noncontrolling interest after exercise	100
Less: Noncontrolling interest prior to exercise	(60)
Increase in noncontrolling interest	CU40
[2] Warrant consideration received by Company A	CU60
Plus: Exercise price	150
Total consideration received by Company A	210
Less: 10% of Company A's basis in Subsidiary's equity	(100)
Change in Company A's additional paid in capital	CU110

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; IAS 32:

To account for the expiration of the warrant

Noncontrolling interest	CU60	
Additional paid in capital		CU60

Equity-classified freestanding written call option on subsidiary's shares issued by subsidiary

A freestanding written call option (including an employee stock 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 810-10-45-23 and IFRS 10.23.

Example 5-18 illustrates this guidance.

EXAMPLE 5-18

Accounting for a freestanding written call option (including an employee stock option) on a subsidiary's shares (that is a business) issued by the 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 CU150 to Investor B for CU60. After Investor B's exercise of the warrant, Subsidiary's equity, including goodwill, is CU1,210 (CU1,000 of net assets plus CU60 of cash received for issuance of the warrant and CU150 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:

Cash	CU60	
Noncontrolling interest		CU60

To record the issuance of the warrant

Cash	CU150	
Noncontrolling interest		CU61[1]
Additional paid in capital		CU89[2]

To record the exercise of the warrant

[1] Company A's basis in Subsidiary's equity after exercise of warrant	CU1,210
Investor B's ownership percentage	x 10%
Noncontrolling interest after exercise	121
Less: Noncontrolling interest prior to exercise	(60)
Increase in noncontrolling interest	CU 61

[2] Subsidiary's carrying amount of net assets after exercise	CU1,210
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	CU 89

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 and IAS 32.

Noncontrolling interest	CU60	
Additional paid in capital		CU60

To account for the expiration of the warrant

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.

5.5.2 Parent company accounting for employee stock option issued by a subsidiary

An employee stock option issued by the subsidiary that is a business that qualifies for equity classification should be accounted for by the parent as noncontrolling interest (recorded as the option vests) totaling the grant date fair value based measure of the employee stock option. However, during the period the option is outstanding, the noncontrolling interest related to the option holder should not be attributed any profit or loss of the subsidiary. Even though a portion of the profit or loss is compensation expense related to the NCI, until the option is exercised, the noncontrolling interest related to the option is not an actual equity interest in the entity. Therefore, there is no attribution of profit or loss to the NCI.

If the option is exercised and the parent maintains control of the subsidiary that is a business, 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 basis in the subsidiary's equity. Subsequent to exercise, the NCI would be attributed profit or loss of the business. Conversely, if the option expires, the parent should record a reduction in the noncontrolling interest and an increase to controlling equity/APIC for the parent's proportionate share of the carrying amount of the employee stock option in accordance with ASC 810-10-45-23 and IFRS 10.23.

5.5.3 Accounting for a transaction in which a noncontrolling interest in a wholly owned subsidiary is exchanged for a controlling interest in another entity

If an entity exchanges a noncontrolling interest in its wholly owned subsidiary that is a business 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 acquiring entity would record 100% of the assets acquired and liabilities assumed of the acquired entity in accordance with ASC 805-20-25-1 and IFRS 3.10. As part of the business combination, the acquiring entity would also measure the noncontrolling interest held by the acquiree at its fair value [or at its proportionate share for IFRS companies who choose this option].

As discussed in BCG 5.5, 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 acquiring entity's controlling interest in its existing subsidiary may need to be adjusted to reflect the change in ownership interest in the subsidiary.

The noncontrolling interest in the acquiring entity's consolidated financial statements would comprise the sum of the noncontrolling interest's share of the fair value [or proportionate share for IFRS companies who choose this option] 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 5-19 illustrates this guidance.

EXAMPLE 5-19

Accounting for a transaction in which NCI in a subsidiary that is a business is exchanged for a controlling interest in another entity—fair value method

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	CU690
Subsidiary A net equity	CU300
Subsidiary A fair value	CU810

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) the fair value of 54% 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 the Standards. 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 CU690 (100% of Target's fair value) and noncontrolling interest of CU455 (46% of Target's fair value of CU690 plus 46% of the net equity of Subsidiary A of CU300).

Company A would record the following journal entry to account for the acquisition:

Target net assets acquired	CU690	
Noncontrolling interest		CU455
APIC—controlling interest		CU235[2]

[2] The change in ownership interest is calculated in accordance with ASC 810-10-45-23 as follows:

NewCo equity before acquisition of Target	CU300
NewCo equity issued to acquire Target	690
Total NewCo equity after acquisition of Target	CU990
Company A's ownership interest in NewCo after acquisition of Target	× 54%
Company A's investment in NewCo after acquisition of Target	CU535
Company A's investment in NewCo before acquisition of Target	(300)
Change in Company A's ownership interest in NewCo	CU235

5.5.4 *Accumulated other comprehensive income considerations*

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, 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 attributable to the parent in accordance with ASC 810-10-45-24 and IFRS 10.B98. AOCI is reallocated proportionately between the controlling interest and the NCI. For financial statement purposes, the line item titled "Accumulated Other Comprehensive Income" is generally attributed entirely to the controlling interests. AOCI related to the NCI is typically included in the NCI balance.

Changes in ownership interest that do not result in a change of control should be accounted for as equity transactions. Example 5-20 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 5-20

Reallocation of accumulated other comprehensive income

Company A owns 80% of a subsidiary that is a business. Company A acquires an additional 10% of the subsidiary (i.e., 50% of the NCI) for CU35 million in cash. The carrying value of the 20% NCI is CU50 million, which includes CU4 million of accumulated other comprehensive income.

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 and the fair value of the consideration paid is recognized directly in equity and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.B96].

The journal entry to record the acquisition of the 10% interest would be as follows (in millions):

NCI	CU25[1]	
Equity/APIC	CU10[2]	
Cash		CU35[3]

1 Elimination of the carrying value of the 10% NCI (CU50 × 50%). This adjustment effectively includes CU2 of accumulated other comprehensive income (CU4 × 50%).

2 Consideration paid less the change in the carrying value of NCI (CU35 – CU25)

3 Cash paid for the 10% interest acquired in the subsidiary

Company A would adjust the carrying value of the accumulated other comprehensive income to reflect the change in ownership through an adjustment to equity (e.g., additional-paid-in capital) attributable to Company A.

Equity/APIC	CU2[4]	
Accumulated other comprehensive income		CU2[4]

4 Reallocation of accumulated other comprehensive income to the controlling interest (CU4 × 50%)

5.5.5 Accumulated other comprehensive income considerations when the parent disposes of a group of assets in a 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. ASU 2013-05 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. However, transactions impacting the investment in the foreign entity may result in full or partial release of CTA even though complete or substantially complete liquidation of the foreign entity has not occurred. Under IFRS, a parent must reclassify to profit and loss the proportionate share of the cumulative amount of exchange differences recognized in other comprehensive income upon loss of control of a foreign operation through an entire or partial disposal of an interest in a subsidiary in accordance with IAS 21.48. The loss of control provisions of IFRS 10 apply to a group of assets that constitute a business if it is considered to be a foreign operation, as well as to the loss of control of a subsidiary. See BCG 5.6.2 for further information.

Example 5-21 demonstrates the accounting for CTA in a foreign entity under IFRS as well as ASC 830-30 and ASU 2013-05 when a group of assets which qualifies as a business is disposed.

EXAMPLE 5-21

Disposal of a portion 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 Y are individual businesses with different functional currencies and are reported to Company A separately and translated directly into Company A's group consolidation.

Company A's carrying amount of branch X is CU20 exclusive of a credit balance of CU 2 for CTA related to branch X. Company A disposes of branch X for CU24 in cash, which is remitted to Company A.

How should Company A account for the disposal of a portion of a foreign entity?

Analysis

Under both ASC 360-10-40-5 and IAS 16.71, and IFRS, a gain is recognized on the disposal of the business for the amount received that is greater than the carrying amount of the business. Under ASC 830-30 and ASU 2013-05, as the disposal of the business represents a complete liquidation of the foreign entity, CTA should be released into earnings. Under IAS 21.48, the CTA related to Branch X should be released into profit and loss as the branch is a separate foreign operation.

Company A's journal entry to record the disposal of the Branch X would be as follows (in millions):

Cash	CU24[1]	
Accumulated other comprehensive income	CU 2[2]	
Disposal group of assets		CU20[3]
Gain on disposal of net assets		CU 6[4]

1 Cash received for the group of assets disposed of
2 CTA attributable to Branch X
3 Carrying amount of disposal group of assets that constitutes a business, exclusive of CTA
4 Sum of the gain on disposal of the group assets (CU24 – CU20 = CU4) and the portion of CTA released into earnings (CU2).

Under US GAAP, if Branch X and Y had the same functional currency and therefore 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.

5.5.6 *Acquisition of a noncontrolling interest 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 and IAS27.30. 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 5-22 demonstrates the accounting for the acquisition of a controlling interest in an entity and indirectly obtaining an additional interest in a controlled entity.

EXAMPLE 5-22

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 CU70 million in Company A's consolidated financial statements and a fair value of CU100 million. Company A acquires Company C in a business combination for CU1,000 million, which includes the indirect acquisition of the noncontrolling interest in Subsidiary B for CU100 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 CU900 million and the fair value of the noncontrolling interest in Subsidiary B of CU100 million in accordance with ASC 805-50-30-3 and IAS 16.24.

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 CU30 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 and IFRS 10.23.

Company A would also recognizes and measures the other identifiable assets acquired and liabilities assumed of Company C at the acquisition date in accordance with the Standards, 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):

Identifiable net assets of Company C	CU900[1]	
Noncontrolling interest of Subsidiary B	CU70[2]	
Equity/APIC	CU30[3]	
Cash		CU1,000[4]

[1] The value of 100% of the identifiable net assets of Company C is recorded, as measured in accordance with the Standards

[2] Elimination of the carrying value of the 10% NCI on Company A's books

[3] Difference in NCI: consideration paid less the carrying value of NCI (CU100 – CU70)

[4] Cash paid for the 100% interest in Company C

5.5.7 *Acquisition of additional ownership interests in a variable interest entity—US GAAP*

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).

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.

5.6 *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.

In accordance with ASC 810-10-55-4A and IFRS 10.B37, 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

Question 5-1

When should a parent company, which is not in bankruptcy, deconsolidate a subsidiary that is a business that has filed for bankruptcy?

PwC response

A parent should deconsolidate a subsidiary that is a business as of the date the parent no longer has control of the subsidiary in accordance with ASC 810-10-40-4 and IFRS 10.B37. Examples of events that result in deconsolidation of a subsidiary include when a subsidiary becomes subject to the control of a government, court, administrator, or regulator. Normally, 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), and the subsidiary should be deconsolidated on that date.

5.6.1 Loss of control—US GAAP

The guidance in ASC 810-10 generally applies both to the loss of control of a subsidiary that is a business, and also to the loss of control of a group of assets that constitute a business (i.e. an unincorporated division which meets the definition of a business). This includes transfers of a business to an equity-method investee or joint venture. Conveyances of oil and gas mineral rights that are subject to specific industry guidance are outside the scope of ASC 810-10. Prior to the adoption of the new revenue standard (ASC 606) and the derecognition of nonfinancial asset standard (ASC 610-20), sales of in substance real estate (e.g., subsidiaries that are comprised of all or substantially all of real estate) are outside the scope of ASC 810-10.

ASC 810-10 and ASC 360-20 clarify that a parent should follow specific industry guidance when it ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of a default on the subsidiary's nonrecourse debt. Generally, a parent would continue to consolidate the subsidiary until legal title to the real estate is transferred, to legally satisfy the debt even if the parent ceases to have a controlling financial interest under ASC 810-10 at an earlier date.

New Guidance

In February 2017, the FASB issued ASU 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*. ASU 2017-05 provides specific guidance for the derecognition of nonfinancial assets that do not constitute a business. In addition, ASU 2017-05 supersedes the industry-specific real estate guidance noted above. Subsequent to adoption of ASU 2017-05, a real estate entity will be derecognized according to its character (i.e., business, financial assets, nonfinancial assets, etc.). Refer to PPE 5 for more information.

5.6.2 Loss of control—IFRS

The definition of a subsidiary under IFRS includes legal entities and those that are unincorporated (i.e., unincorporated division). Therefore, the loss of control provisions of IFRS 10 apply to a group of assets that constitute a business, as well as to the loss of control of a subsidiary. IFRS 10 is silent as to whether a subsidiary must also be a business. We believe that the loss of control of a legal entity that is not a business may apply IFRS 10, if no other IFRS would be applicable to the underlying assets and liabilities. For example, financial assets and liabilities should follow the derecognition flowchart in IAS 39.AG36 and IFRS 9.B3.2.1 rather than IFRS 10.

Further, there are no exclusions from the scope of IFRS 10 related to sales of in substance real estate or conveyances of oil and gas mineral rights.

5.6.3 *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 [profit or loss], or transfers directly to retained earnings if required, in accordance with other US GAAP [IFRS], the amounts recognized in other comprehensive income in relation to that subsidiary
- Recognize any resulting difference as a gain or loss in income [profit or loss] attributable to the parent

The gain or loss is calculated as the difference between:

- The aggregate of:
  - The fair value of the consideration transferred
  - The fair value of any retained noncontrolling investment in the former subsidiary on the date the subsidiary is deconsolidated
  - 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
- The carrying amount of the former subsidiary's net assets

The calculation outlined above results in an amount that includes the gain or loss for both the interest sold and the noncontrolling investment retained. However, the NCI Standards require a parent 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 and IFRS 12.19. 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.

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 FAS 160.B53. This includes the parent's and the NCI's share of gains or losses previously recognized in other comprehensive income on foreign exchange differences, cash flow hedges, and other individual assets and liabilities (e.g., available-for-sale financial assets).

Amounts recognized in equity (outside of 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. Additionally, under IFRS, amounts recognized in equity for revaluation of assets should not be included in determining the gain or loss on the interest sold and the retained noncontrolling investment. For example, IFRS companies may have recognized gains or losses on the revaluation of fixed and intangible assets. These amounts are reclassified from reserves directly to retained earnings and do not form part of the gain or loss recognized.

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.

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 (cash generating unit) is impaired, the impairment loss should be recognized in earnings [profit or loss] in accordance with ASC 350-20 [IAS 36.60].

Examples 5-23 and 5-24 demonstrate the accounting for a change in interest when control is lost, assuming the transactions do not involve nonreciprocal transfers to owners or sales of in substance real estate.

EXAMPLE 5-23

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 CU360 million, and loses control of the subsidiary. At the disposal date, the fair value of the retained noncontrolling investment is determined to be CU240 million. The carrying value of the identifiable net assets is CU440 million, excluding goodwill. There is CU60 million of goodwill recorded related to the previously acquired interests in the subsidiary. Company A tested the goodwill and long-lived assets of the subsidiary prior to disposal and there was no impairment. (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):

Cash	CU360[1]	
Equity-method investment	CU240[2]	
Net assets		CU500[3]
Gain on investment		CU100[4]

[1] Cash received for the 60% interest sold

[2] Fair value of the 40% retained noncontrolling investment is recognized

[3] 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

[4] Gain or loss on the interest sold and the retained noncontrolling investment is recognized in earnings [profit or loss], calculated as follows:

Fair value of consideration	CU360
Fair value of retained noncontrolling investment	240
Carrying value of NCI	n/a
Subtotal	600
Less: carrying value of former subsidiary's net assets (CU440 net assets excluding goodwill + CU60 goodwill)	(500)
Gain on interest sold and retained noncontrolling investment	CU100

The CU100 million gain on the interest sold and the retained noncontrolling investment would be recognized in earnings [profit or loss] 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	CU240
Percentage retained of carrying value of subsidiary ((CU440 + CU60) × 40%)	(200)
Gain on retained noncontrolling investment	CU40

EXAMPLE 5-24

Accounting for changes in interest in a business if control is lost—accounting for changes in interest of a partially owned subsidiary if control is lost

Company B owns 80% of a subsidiary that is a business. Company B disposes of 50% of the subsidiary for CU300 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 CU180 million. The carrying value of the identifiable net assets is CU440 million and there is no goodwill. The carrying value of the

20% noncontrolling interests held by third parties prior to the transaction is CU88 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 are as follows (in millions):

Cash	CU300[1]	
Equity-method investment	CU180[2]	
NCI	CU 88[3]	
Net assets		CU440[4]
Gain on investment		CU128[5]

[1] Cash received for the 50% interest sold

[2] Fair value of the 30% retained noncontrolling investment is recognized

[3] Derecognition of the carrying value of the NCI

[4] Deconsolidation of the subsidiary and removal of the carrying value of the subsidiary's net assets

[5] 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	CU300
Fair value of retained noncontrolling investment	180
Carrying value of NCI	88
Subtotal	568
Less: carrying value of former subsidiary's net assets	(440)
Gain on interest sold and retained noncontrolling investment	CU128

The CU128 million gain on the interest sold and the retained noncontrolling investment would be recognized in earnings [profit or loss] 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	CU180
Percentage retained of carrying value of subsidiary (CU440 × 30%)	(132)
Gain on retained noncontrolling investment	CU48

Question 5-2

Should a parent company, which is not in bankruptcy and has a negative investment in a subsidiary, recognize a gain upon deconsolidating a subsidiary that files for bankruptcy if that subsidiary is a business?

PwC response

Following the guidance in ASC 810-10 and IFRS 10, a parent would derecognize the negative investment and determine the amount of gain or loss to recognize on the date of the bankruptcy filing. The parent should consider the fair value of its retained investment when making this determination. This includes consideration of whether it needs to separately recognize any obligations related to its ownership of the subsidiary, which would reduce the gain or increase the loss on deconsolidation (e.g., the parent has guaranteed, or the court will hold the parent liable for, certain obligations of the subsidiary).

Question 5-3

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/IFRS 10. Assuming similar facts and circumstances in the scenarios, an equal gain would result.

5.6.4 Retained noncontrolling investment

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 lease 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 5-25 illustrates this guidance.

EXAMPLE 5-25

Determining the amount of gain or loss to be recognized upon the sale of a controlling interest in a subsidiary

Company A owns 100% of Subsidiary B. Subsidiary B rents an office building from Company A at a nominal cost (i.e., below market rental rate). Company A sells 60% of its ownership in Subsidiary B to an unrelated third party. The lease 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 rent to its former Subsidiary B under its unfavorable lease contract, versus consideration for the sale of the 60% ownership in Subsidiary B. The amount ascribed to the off-market lease 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.

5.6.5 *Nonreciprocal transfer to owners*

If a US GAAP company loses control of a subsidiary that is a business through a nonreciprocal transfer to owners (i.e., distribution of a business to owners in a spin-off), ASC 810-10's guidance for measuring the gain or loss will not apply to the transferred portion. Rather, the transferred portion will be accounted for under ASC 845, *Nonmonetary Transactions*, specifically ASC 845-10-30-10. Under this guidance, the nonmonetary assets, which meet the definition of a business as discussed in ASC 805-10-20, distributed in the nonreciprocal transfer will be recorded at their carrying value, adjusted for any impairment. If the portion is transferred (1) through a spin-off or other form of reorganization or liquidation, or (2) under a plan that is, in substance, the rescission of a prior business combination, the distribution should be recorded based on the carrying amount of the nonmonetary assets. This guidance is also applicable to distributions to shareholders of an investee being accounted for under the equity method. Depending upon facts and circumstances, other nonreciprocal transfers of nonmonetary assets to owners may be accounted for at fair value.

A nonreciprocal transfer to owners under IFRS is recorded at the fair value of the net assets to be distributed. The difference between the fair value of the net assets distributed and the carrying amount of the net assets is recorded in profit or loss in accordance with IFRIC 17, Distributions of Non-cash Assets to Owners (IFRIC 17). The scope of IFRIC 17 is narrow and applies only to distributions where all owners in the same class of equity are treated equally and to distributions that result in a change in control over the assets distributed. There is no specific guidance under IFRS for transactions outside of the scope of IFRIC 17. Current practice is to use predecessor basis.

5.6.6 *Multiple transactions or agreements 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 and IFRS 10.B97 require 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 [profit or loss].

The existence of one or more of the following indicators in ASC 810-10-40-6 and IFRS 10.B97 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.

5.6.7 Multiple transactions or agreements that result in gaining control

Sometimes a company may gain 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 5.6.6 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 5.6.6 to assess whether a series of transactions that results in gaining control should be considered as a single transaction.

5.7 Attribution of net income and comprehensive income to controlling and noncontrolling interests

Net income or loss and comprehensive income or loss are attributed to the controlling and noncontrolling interests in accordance with ASC 810-10-45-20 and IFRS 10.B94. The standards do not specify any particular method for attributing earnings between the controlling interest and the noncontrolling interest.

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 determined to be substantive. If there are no such contractual arrangements, the relative ownership interests in the entity should be used if the parent's ownership and the NCI's ownership in the assets and liabilities are proportional. For example, if the controlling interest owns 60% of Company A and the NCI owns 40%, then 60% of the earnings should be allocated to the controlling interest and 40% to the NCI. If, however, the parties have a contractual arrangement specifying a 50/50 split of the earnings, 50% of the earnings should be allocated to the controlling interest and 50% to the NCI, provided the contractual arrangement is substantive.

In some instances, agreements may designate different splits among the parties of profit and loss for financial reporting, taxable profit and loss, distributions of cash from operations, and distributions of cash proceeds on liquidation. And one or more of the splits may change with the lapse of time or the occurrence of specified events. In such circumstances, the accounting for a party's equity in earnings must be considered with care, including the possibility that the split of profit and loss specified in the agreement may be solely for tax purposes or that it may not be substantive.

Furthermore, for US GAAP companies, the parent's and the NCI's relative carrying values in particular assets and liabilities may not be proportional to their relative ownership interests. For example, if an entity acquired 80% of the ownership interests in a subsidiary in a single transaction before the effective date of ASC 805, the intangible assets that it recognized in the acquisition would likely have been recorded at 80% of their fair value (80% fair value for the ownership interest acquired plus 20% carryover value for the interest not acquired, which for previously unrecognized intangible assets would have been zero). In this case all of the amortization expense for previously unrecognized intangible assets would be allocated to the parent's interest in accordance with FAS 160.B38.

5.7.1 Attribution of losses to noncontrolling interests in excess of carrying amount of noncontrolling interests

All earnings and losses of a subsidiary should be attributed to the parent and the NCI based on their relative ownership interests in the absence of explicit agreements that designate different splits among the parties. Losses should continue to be attributed to the NCI even if that results in a debit balance in shareholders' equity in accordance with ASC 810-10-45-21 and IFRS 10.B94.

If prior to adoption of the NCI Standards, a company had stopped attributing losses to the NCI because the losses exceeded the carrying amount of the NCI, upon adoption of the NCI Standards, the company will prospectively attribute losses to the NCI. However, the company should not revise its prior consolidated net income to deduct losses that were attributed to it because the losses exceed the NCI's carrying amount. Rather, on the date of adoption, the NCI should reflect the previous carrying amount for minority interest (i.e., zero). Earnings or losses after that date should be attributed to the NCI. See BCG 2.13 for further information on transition issues.

5.7.2 Attribution of other items to noncontrolling interests in excess of carrying amount of noncontrolling interests–US GAAP

The NCI is considered part of the equity of the consolidated group under US GAAP. It participates in both the risk and rewards of ownership in a subsidiary. Therefore, other items, such as an excess distribution, can also result in a debit balance of the NCI.

For example, appreciated property in a real estate subsidiary may be refinanced, and the proceeds from the refinancing are distributed to the owners of the subsidiary. Under US GAAP, attributing distributions to the NCI in excess of the carrying amount is consistent with the view that the NCI represents an equity interest in the consolidated group.

5.8 Recognition of gain or loss by investor in a joint venture—IFRS

The new and revised standards on consolidation and joint arrangements (IFRS 10, 11, IAS 27 (2011), IAS 28 (2011)) do not change the fundamental accounting for joint ventures. There is, however, an apparent conflict between IFRS 10 and IAS 28 (2011). Under IAS 28 (2011), gains or losses on the contribution to a joint venture are recognized in income by the investor only to the extent of the equity interest of other investors at the time of the contribution to the joint venture. However, following the guidance in IFRS 10, gains or losses would be recognized in income by the investor for the full amount of the business contributed. IFRS 11 did not resolve this apparent conflict. We believe that presently both approaches are acceptable to account for the contribution of a business to a joint venture.

In September 2014, the IASB published amendments to IFRS 10 and IAS 28 to resolve the inconsistency between the two standards. The amendments clarify that a full gain or loss will be recognized by the investor when the non-monetary assets sold or contributed constitute a business; but, when the assets do not meet the definition of a business, the gain or loss is recognized by the investor to the extent of the other investors' interests. The amendments were intended to be effective for periods commencing on or after January 1, 2016 and would require prospective application. However, the effective date was postponed indefinitely, to be addressed as part of a broader project on equity accounting. Until a new effective date has been determined, investors have an accounting policy choice and should apply it consistently.

5.9 Accounting for transaction costs associated with sale or purchase of noncontrolling interest

Transaction costs associated with the purchase or sale of a noncontrolling interest in a subsidiary when control is maintained is similar to a treasury stock or capital raising transaction, and is accounted for as an equity transaction in accordance with ASC 810-10-45-23 and IFRS 10.23. 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 and IAS 32.33,35. Additionally, incremental and directly attributable costs to issue equity instruments are accounted for as a deduction from equity under ASC 340-10-S99-1 and IAS 32.37.

The transaction costs that should be recognized as a deduction from equity are only incremental costs directly attributable to the equity transaction. The remaining transaction costs (e.g., general administrative costs) should be expensed as incurred.

Under US GAAP, 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.

5.10 Required disclosures and supplemental schedule

Companies must disclose a reconciliation of the carrying amount of equity at the beginning of the period and the end of the period for each of total equity, equity attributable to the parent, and equity attributable to the NCI. The reconciliation discloses separately the changes resulting from (1) net income or loss [profit or loss], (2) transactions with equity holders acting in their capacity as owners, showing separately contributions from and distributions to equity holders, and (3) each component of other comprehensive income. This disclosure must appear either on the face of the statement of changes in equity or in the notes to the consolidated financial statements in accordance with ASC 810-10-50-1A and IAS 1.106.

Additionally, companies are required to provide a supplemental schedule in the notes to the consolidated financial statements. The schedule must show the effects of any transactions with the NCI on the equity attributable to the parent for each period that any income statement is presented in accordance with ASC 810-10-50-1A and IFRS 12.18. See FSP 5 or an example of the supplemental schedule.

5.11 Classification of financial instruments as noncontrolling interest

Figures 5-2 and 5-3 summarize the accounting and reporting for financial instruments issued to third parties by a subsidiary. They do not reflect all possible scenarios or contain all possible financial instruments that may be issued. Additionally, the classification of the financial instruments may change if they are issued by the parent rather than the subsidiary.

Figure 5-2

Accounting and reporting for financial instruments issued to third parties by a subsidiary—US GAAP

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under ASC 810-10
Common shares issued by the subsidiary	Equity	Noncontrolling interest
Perpetual preferred shares issued by the subsidiary	Equity	Noncontrolling interest
Redeemable preferred shares and redeemable common shares issued by the subsidiary which are redeemable at maturity date or are puttable for cash or other assets at a fixed or determinable date or upon an event that is outside the control of the issuer (The redemption feature is embedded.)	Liability, mezzanine, or equity [ASC 480, ASC 480-10-S99]	Public company: Liability: If it is classified as a liability by the subsidiary, then it would continue to be a liability. Mezzanine (under ASC 480-10-S99 in US GAAP): If it is classified as mezzanine by the subsidiary, it would be a noncontrolling interest, classified as mezzanine. Non-public company: Liability: If it is classified as a liability by the subsidiary, then it would continue to be a liability.

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	**Accounting classification at the subsidiary level**	**Parent classification in consolidation under ASC 810-10**
		Equity: If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest. Some non-public companies may also have accounting policies that are consistent with mezzanine classification under ASC 480-10-S99.
Conversion option (on a convertible bond) that is required to be separately accounted for by ASC 815 or ASC 470-20, issued by the subsidiary	Liability or equity[ASC 815, ASC 480, ASC 470-20, ASC 815-40-15-5C]	Liability: If it is classified as a liability by the subsidiary, then it would continue to be a liability. Mezzanine (under ASC 480-10-S99 in US GAAP): If it is classified as mezzanine by the subsidiary, it would be a noncontrolling interest, classified as mezzanine. Equity: If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest, classified as equity.
(1) Freestanding written call option on subsidiary's own common shares, (2) warrants or options issued by the subsidiary for goods and services (to non-employees) on the subsidiary's own common shares, (3) detachable warrants on the subsidiary's own common shares issued with debt and (4) employee stock options.	(1) Liability or equity [ASC 815, ASC 480, ASC 815-40-15-5C] (2) Liability or equity [ASC 815, ASC 505-50] (3) Liability or equity [ASC 815, ASC 480] (4) Liability or equity [ASC 718, ASC 505-50]	Applicable to all four scenarios Liability: If it is classified as a liability by the subsidiary, then it would continue to be a liability. Equity: If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest. ASC 810-10 addresses the prior mixed practice in US GAAP by clarifying that all equity instruments of the subsidiary (not held by the parent) are noncontrolling interests.
Freestanding written put option on the subsidiary's own common shares	Liability [ASC 480]	The instrument would be classified as a liability.
Freestanding purchased call option on the subsidiary's own common shares	Asset or equity [ASC 815, ASC 480, ASC 815-40-15-5C]	Asset: If it is classified as an asset by the subsidiary, then it would continue to be an asset.

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under ASC 810-10
		Equity: If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest.
(1) Embedded written put and purchased call options (issued contemporaneously) on the subsidiary's own common shares with the same fixed strike price and exercise date (synthetic forward contract), and (2) forward contract at a fixed price.	(1) Liability [ASC 480] (2) Liability [ASC 480]	Applicable to both scenarios Treated as 100% acquisition with a financing. No noncontrolling interest.

Figure 5-3

Accounting and reporting for financial instruments issued to third parties by a subsidiary—IFRS

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under IAS 27 (2008)
Common shares issued by the subsidiary	Equity (IAS 32)	Noncontrolling interest
Preferred shares issued by subsidiary that meet the requirements to be classified as equity	Equity (IAS 32.16)	Noncontrolling interest
Convertible bond issued by subsidiary and the conversion option meets the requirements to be classified as equity component	Compound financial instrument with an equity and a liability component (IAS 32.28)	It would be a liability for the liability component and a noncontrolling interest for the equity component.
Preferred or common shares issued by subsidiary redeemable at the option of the holder (i.e., puttable to the subsidiary)	Equity, if specified conditions are met (IAS 32.16A-D); otherwise, a liability	Liability (IAS 32.BC68)
Written call option on the subsidiary's own common shares that will be physically settled (not part of a share-based payment arrangement)	Equity, if it entitles the holder to acquire a fixed number of shares for a fixed amount of cash (IAS 32.22); otherwise, a derivative liability	If it is classified as equity by the subsidiary, it would be a noncontrolling interest. If it is classified as a derivative liability by the subsidiary, then

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under IAS 27 (2008)
		it would continue to be a liability.
Purchased call option on the subsidiary's own common shares that will be physically settled	A reduction of equity, if it entitles the holder to acquire a fixed number of shares for a fixed amount of cash (IAS 32.22); otherwise, a derivative asset	If recorded in equity by the subsidiary, it would result in proportionate decreases in the net assets attributable to the parent and in the noncontrolling interest. If it is classified as an asset by the subsidiary, then it would continue to be an asset.
Written put option on the subsidiary's own common shares	Liability for the present value of the redemption amount (IAS 32.23)	It would be a liability for the present value of the redemption amount (IAS 32.23). A noncontrolling interest may or may not (continue to) be recognized in addition to the liability, based on the assessment of risks and rewards.
Options on the subsidiary's own common shares issued by the subsidiary for goods and services to non-employees and employees (i.e., share based payments)	Liability, if cash settled at the subsidiary level (IFRS 2) Equity, if equity settled at the subsidiary level	It would be a liability if cash is settled from the consolidated perspective. A noncontrolling interest may or may not be recognized in addition to the liability, based on the assessment of risks and rewards. It would be a noncontrolling interest if equity settled using subsidiary common shares.
(1) Embedded written put and purchased call options (issued contemporaneously) on the subsidiary's own common shares with the same fixed strike price and exercise date (synthetic forward contract) and (2) forward contract at a fixed price.	(1) Liability for the present value of the redemption amount (IAS 32.23) (2) Liability for the present value of the redemption amount (IAS 32.23)	Applicable to both scenarios Treated as 100% acquisition with financing. No noncontrolling interest.

Chapter 6: Common control transactions

6.1 Chapter overview

Common control transactions occur frequently, particularly in the context of reorganisations, spin-offs, 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 or IFRS 3. Common control transactions are defined differently under US GAAP and IFRS. ASC 805-50-15-6 states that they are transfers and exchanges between entities that are under the control of the same parent. IFRS 3.B1 states that they 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.

The accounting and reporting for common control transactions can differ between US GAAP and IFRS. Under US GAAP, 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 historical carrying values. Transactions involving the transfer of a business ordinarily will result in a change in reporting entity for the receiving entity and require the application of the relevant guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. 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 assets or a business.

There is no specific US GAAP guidance on how the contributing entity should account for the transfer of a business or an asset in a common control transaction. The contributing 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 6.2.4.1 for further information.

IFRS does not provide guidance on the accounting for common control transactions, but IAS 8.10 requires that entities develop an accounting policy for transactions not specifically addressed by IFRS. The two methods most commonly chosen for accounting for business combinations between entities under common control are (1) the acquisition method and (2) the predecessor values method. Once a method has been adopted it should be applied consistently as a matter of accounting policy. Neither IFRS 3 nor any other IFRS require or prohibit the application of either method to business combinations involving entities under common control.

IFRS companies can elect (but are not required) to apply acquisition accounting to a business combination involving entities under common control. When there is no specific IFRS governing a transaction, IAS 8.11(a) requires reference to IFRSs dealing with similar and related issues. An entity may choose to apply the acquisition method may be used because the transaction is a business combination and IFRS 3 provides guidance for business combinations. IAS 8.12 also allows reference to guidance issues by certain other standard-setting bodies. IFRS companies could, therefore, elect to apply the predecessor values method, by reference to other GAAP that permits or requires it for similar transactions.

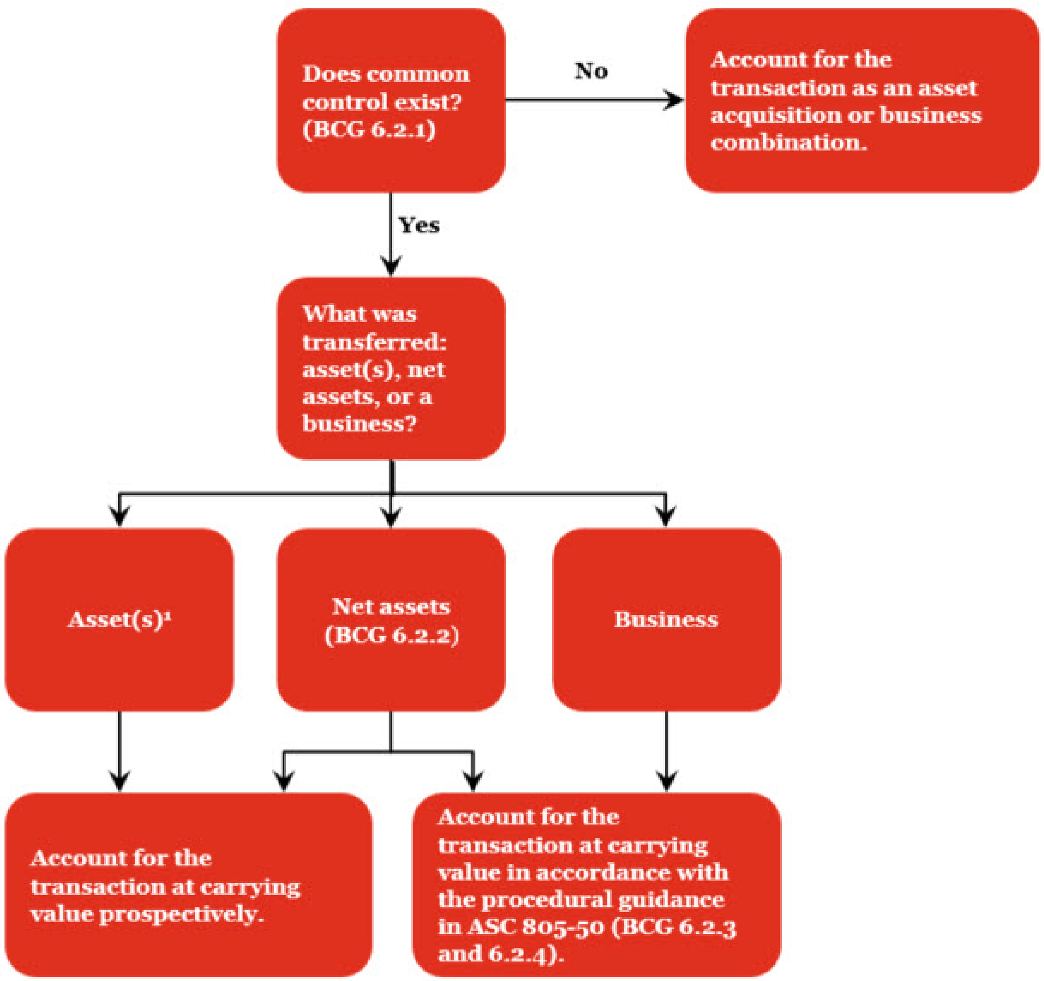
Under both US GAAP and IFRS, companies will need to use judgment to determine the nature of the transaction and the appropriate method of accounting.

6.2 Common control transactions under US GAAP

Figure 6-1 provides a decision tree which may help determine how the transaction should be measured and presented for financial reporting purposes under US GAAP.

Figure 6-1

Accounting for common control transactions under US GAAP by the receiving entity



[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 basis 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 6.2.2.1 for more information on transfers of financial assets involving entities under common control.

Transfers among entities with a high degree of common ownership are not common control transactions, and are separately discussed in BCG 6.2.1.3. The following sections provide guidance on identifying common control transactions and accounting for such transactions.

6.2.1 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). US GAAP does not define the term "common control." However, ASC 805-50-15-6 provides the following examples of the types of transactions that qualify as common control transactions:

ASC 805-50-15-6

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.

Several factors must be considered to determine if common control exists. 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, contractual or other legal arrangements, or the rights of a sole general partner in a partnership (see ASC 810-20-25). An assessment of whether common control exists is based on all of the facts and circumstances surrounding the relationship(s) between the parties (both direct and indirect). Generally, entities that are consolidated by the same parent, or that would be consolidated if consolidated financial statements were required to be prepared by the parent or controlling party, are considered to be under common control. If common control exists, the guidance discussed in this chapter should be applied in the same manner, regardless of the means through which common control was attained.

In addition, sometimes a new parent company may be added to an existing company (or consolidated group of companies) by setting up a new holding company. 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) should reflect the capital of the new parent company.

6.2.1.1 Common control and control groups

There is no definition of common control in the Accounting Standards Codification. However, 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. 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.

6.2.1.2 Entities consolidated under the variable interest approach (the variable interest entities subsections of ASC 810-10)

In addition to voting ownership interests, control may be established through various other means, including the ownership of variable interests that result in consolidation by a primary beneficiary under the Variable Interest Entities subsections of ASC 810-10. Generally, entities that are consolidated by the same parent company are considered to be under common control. However, to determine if common control exists, consideration should be given to all of the facts and circumstances surrounding the relationship(s) between the parties (both direct and indirect).

The Variable Interest Entities subsections of ASC 810-10 incorporates the general principles governing common control transactions in ASC 805 and other guidance contained in US GAAP. ASC 810-10-30-1 states:

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).

This paragraph requires that there be no remeasurement of a VIE's assets and liabilities 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. The agreement 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 amounts at which they are carried 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 6.2.3.2.

6.2.1.3 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. Transfers among entities that have a high degree of common ownership, but in which no one shareholder controls the entities, are not common control transactions. However, such transfers may be accounted for in a manner similar to a common control transaction if it is determined that the transfers lack economic substance. For example, a transaction in which shareholders have identical ownership interests before and after the transaction generally has been determined to lack economic substance and has been accounted for in a manner similar to a common control transaction.

The SEC staff has historically looked to the guidance provided in FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations, Including Costs of Closing Duplicate Facilities of an Acquirer*, *Stock Transactions between Companies under Common Control*, *Downstream Mergers*, *Identical Common Shares for a Pooling of Interests*, *Pooling of Interests by Mutual and Cooperative Enterprise* (FTB 85-5), paragraph 6, to evaluate whether a transaction lacked economic substance. In response to the question of how a parent company should account for minority interest in an exchange of stock between two of its subsidiaries if one or both of the subsidiaries are partially owned, that guidance stated:

Excerpt from FTB 85-5

...if the exchange lacks substance, it is not a purchase event and should be accounted for based on existing carrying amounts. That is, if the minority interest does not change and if in substance the only assets of the combined entity after the exchange are those of the partially owned subsidiary prior to the exchange, a change in ownership has not taken place, and the exchange should be accounted for based on the carrying amounts of the partially owned subsidiary's assets and liabilities.

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 historical cost accounting. Transfers of businesses that have been determined to have economic substance should be accounted for using the acquisition method.

FTB 85-5 was nullified 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.

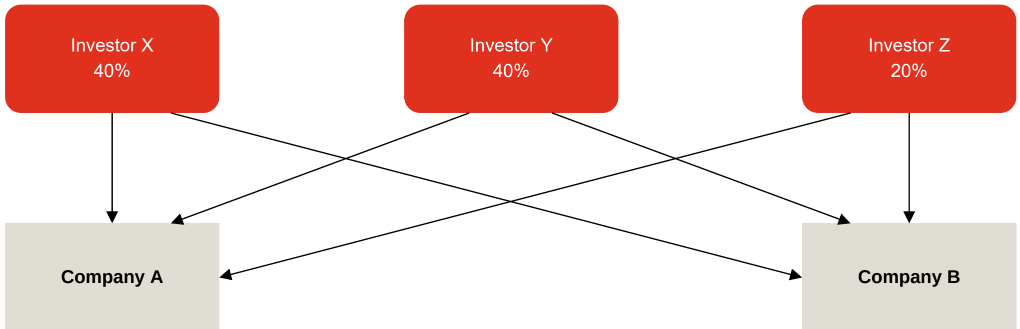
Example 6-1 illustrates an exchange (transaction) that lacks economic substance between entities with a high degree of common ownership.

EXAMPLE 6-1

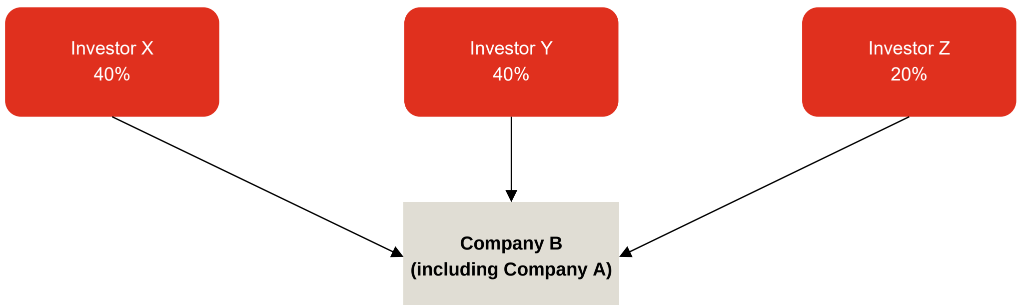
Transfer between entities with a high degree of common ownership that lacks economic substance

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 each constitute a business under ASC 805. On December 31, 20X7, 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 comprising 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. The transaction would be presented in Company B's financial statements in accordance with the guidance contained in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. See BCG 6.2.3.2 for further information. For the investors' financial reporting purposes, consideration should be given to any difference between the investors' bases in Company A and their proportionate interests in the equity of Company A in Company B's financial statements.

In assessing transactions among entities with a high degree of common ownership, questions arise as to whether a small change in ownership percentages can preclude historical cost accounting. Although there is no bright line in making such a determination, the SEC staff has evaluated situations where the minority-ownership percentage changed by a relatively small amount and concluded that there was a substantive economic change in ownership interests, precluding historical cost accounting. In assessing changes in ownership, consideration should be given to all interests outstanding on a fully diluted basis. Consideration should also be given to other economic factors (beyond ownership percentages) which may indicate a transaction has economic substance.

6.2.2 Nature of the transfer

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. The ASC Glossary defines a change in reporting entity as a change that results in financial statements that, in effect, are those of a different reporting entity. A change in reporting entity is limited mainly to (1) presenting consolidated or combined financial statements in place of financial statements of individual entities, (2) changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and (3) changing the entities included in the combined financial statements. Neither a business combination accounted for by the acquisition method nor the consolidation of a VIE under the Variable Interest Entities Subsections of ASC 810-10 is a change in reporting entity [ASC Glossary].

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 BCG 11.2.1 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.

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 6.2.3.2 for further information. Transfers of assets are accounted for prospectively.

6.2.2.1 Specialized accounting considerations

Other sections of the ASC prescribe the accounting treatment for related party transactions in certain specific situations where common control may exist, as described below.

Prior to the adoption of the revenue standard, ASC 606, *Revenue from Contracts with Customers*, and the guidance on the derecognition of nonfinancial assets (ASC 610-20), ASC 360-20-40-47 specifies that if the seller of real estate controls the buyer, no profit on the sale should be recognized until it is realized from transactions with outside parties through sale or operation of the property. ASC 610-20 removes this requirement and eliminates rules specifically addressing sales of real estate. In order to derecognize the asset and recognize a gain or loss under ASC 610-20, the seller of real estate needs to assess whether control is lost and satisfy the criteria for transfer of control to another party under ASC 606. Refer to PPE 5 for more information.

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 separate-entity financial statements if all the conditions of ASC 860-10-40-5 are met and the transferee subsidiary is not consolidated into the separate-entity financial statements of the transferring subsidiary. This guidance may not apply to transfers of financial assets between a parent company and its subsidiaries as ASC 860-10-55-78 only applies to transfers of financial assets between subsidiaries of a common parent that are accounted for in the subsidiaries' stand-alone financial statements. 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 under the Transactions Between Entities Under Common Control Subsections of ASC 805-50.

Examples 6-2 through 6-5 provide additional guidance related to real estate transactions where common control or common management may exist (Examples 6-2 to 6-4) and transactions involving the transfer of financial assets between subsidiaries of a common parent (Example 6-5).

EXAMPLE 6-2

Real estate contributed by 100% owner

An individual contributes real estate to a wholly-owned real estate development company. The real estate has appreciated in value since the individual acquired it.

How should the real estate development company record the contributed property?

Analysis

The real estate development company should record the contributed property at its carryover basis since the transaction is with its controlling shareholder.

EXAMPLE 6-3

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 management agreements do not result in control by the common manager of Company A or Company B.

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 preclude recognition of a real estate sales transaction or gain on the sale by Company A.

Prior to the adoption of ASC 606 and the guidance on the derecognition of nonfinancial assets (ASC 610-20), the transaction is subject to the general requirements of ASC 360-20, which may limit or preclude recognition of a real estate sales transaction or gain on the sale for other reasons.

EXAMPLE 6-4

Property sold to subsidiary, and then sold to a third party

Company A agrees to sell a building with a book value of CU20 million and a fair value of CU35 million to a third party. Prior to consummation of the sale, Company A sells the building to its subsidiary, Subsidiary B, for CU20 million and the subsidiary sells the building to the third party for CU35 million.

How should Company B record the additional sale proceeds?

Analysis

Subsidiary B should record the additional CU15 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 CU20 million from Subsidiary B to Company A with a concurrent capital contribution of CU35 million from Company A to Subsidiary B. However, the gain on sale of CU15 million would be credited to income in Company A's consolidated financial statements.

EXAMPLE 6-5

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 marketable securities accounted for as available-for-sale under ASC 320-10. The fair value of the marketable securities is CU1,000,000 with a cost basis of CU800,000 at 31 December 20X9. Company A recorded the CU200,000 unrealized gain in these marketable securities in other comprehensive income (this example ignores tax effects). On 31 December 20X9, 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

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 separate-company financial statements if all the conditions of ASC 860-10-40-5, addressing the accounting for transfers of financial assets, are met and the transferee subsidiary is not consolidated into the separate-company financial statements of the transferring subsidiary. Since marketable securities are financial assets and Company A does not consolidate Company B into its separate-entity financial statements, 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 marketable securities at their fair value and record a gain of CU200,000 in its separate-entity financial statements upon the transfer of the marketable securities to Company B. Parent, however, would not recognize a gain.

6.2.3 *Accounting and reporting by the receiving entity*

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.

6.2.3.1 *Basis of transfer*

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests should initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of the transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control in accordance with ASC 805-50-30-5.

Examples 6-6 through 6-9 provide additional guidance for use in determining the proper basis at which to record transfers.

EXAMPLE 6-6

Accounting by the receiving subsidiary

The parent of both Company A and Company B will contribute its ownership interest in Company B to Company A. Company B meets the definition of a business. The assets and liabilities transferred to Company A will be accounted for at historical cost in accordance with the Transactions Between Entities Under Common Control Subsections of ASC 805-50. The parent's basis in Company B exceeded the underlying equity recorded in Company B's stand-alone financial statements at the transfer date. This is because the parent did not pushdown its basis to Company B's separate financial statements at the acquisition date.

How should the transfer be recorded in Company A's consolidated financial statements?

Analysis

The transaction represents a transfer of net assets between entities under common control. Pursuant to ASC 805-50-30-5, the historical cost of the parent's basis in Company B should be reflected in Company A's consolidated financial statements upon the transfer. For the accounting and reporting by the contributing entity (Company B), see BCG 6.2.4 for further information.

EXAMPLE 6-7

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 CU150 million and an estimated fair value of CU250 million for CU250 million in cash.

How should Company B record the transaction?

Analysis

The transaction represents a transfer of net assets 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 CU150 million, and the excess paid over the parent's basis of the transferred division of CU100 million should be charged to equity as a deemed dividend.

EXAMPLE 6-8

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 CU115 million in cash. The fair value of Company C, as determined by an independent third party, is CU115 million and its book value is CU100 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 record the sale of Company C?

Analysis

The transaction represents a transfer of business 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 CU100 million, and the excess paid over the parent's basis in Company C of CU15 million should be charged to equity as a deemed dividend. In addition, the excess of the cash proceeds of CU115 million over Company C's book value of CU100 million should be recorded as additional paid-in capital in Company A's separate financial statements. If the fair value of Company C had been determined to be lower than the carrying value of its assets and liabilities, Company A should consider following the guidance for long-lived assets to be disposed of other than by sale in ASC 360-10-40-4 in preparing its separate financial statements. See BCG 6.2.4.1 for further information.

EXAMPLE 6-9

Parent transfers acquired entity to newly formed subsidiary

Parent acquired Company A for CU7 million. Company A was then transferred to a newly formed subsidiary of Parent, Company B, for consideration of CU1 million in cash and a CU8 million note. The initial capitalization of Company B was CU1 million.

How should Company B record the transaction?

Analysis

Company B should record the net assets of Company A at Parent's basis of CU7 million. Accordingly, the financial statements of Company B should reflect the net assets of Company A, a note payable to the parent of CU8 million, and a deemed dividend of CU2 million resulting in a net shareholder's deficit of CU1 million.

6.2.3.2 *Guidance for presenting a change in reporting entity*

If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are, in effect, considered to be those of a different reporting entity. The resulting 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 entity that receives the net assets:

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.

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 the next section.

6.2.3.3 Determining the on-going reporting entity in certain common control transactions

For accounting purposes, the ongoing reporting entity is the entity deemed to be the receiving entity in a common control transaction. However, the reporting entity for accounting purposes is not always the entity that legally receives the net assets or equity interests transferred. If both entities were under common control during the entire reporting period, it is not necessary to determine which entity is the reporting entity when the parent's basis is reflected in all of the combining entities for all periods presented, because doing so has no impact on the retrospectively adjusted historical financial statements. However, caution should be utilized when determining the appropriate historical entity in a common control transaction in which one of the combined entities was not under common control during the entire retrospectively adjusted reporting period or one or more of the combined entities does not reflect the parent's basis.

The historical entity in a common control transaction is normally the entity first controlled by the parent of the entities that are combined. In these situations, the historical entity for accounting purposes should be determined from the perspective of the parent company, as the parent controls the form of the transaction, and different accounting should not result solely based on the legal form of the transaction. Thus, from the parent's perspective, the entity that first came under control of the parent, is usually presented as the historical entity.

EXAMPLE 6-10

Determining the historical 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. There are no basis differences between Parent and Subsidiary A or Subsidiary B.

How should the financial statements of the combined entity for the three years ended 20X3 be presented?

Analysis

For accounting purposes, the merger should be viewed as a change in reporting entity and, as a result, requires retrospective adjustment of the historical financial statements pursuant to the Transactions Between Entities Under Common Control Subsections of ASC 805-50. Despite the legal form of the merger, Subsidiary A would be presented as the historical entity because Parent controlled Subsidiary A prior to acquiring Subsidiary B. The financial statements will present only Subsidiary A's results for year 20X1 and the combined results for Subsidiary A and Subsidiary B in years 20X2 and 20X3.

When one or more of the combining entities' separate financial statements do not reflect the parent's basis because push down accounting has not been elected, the receiving entity must record the received assets at the parent's basis.

EXAMPLE 6-11

Determining the historical entity in a common control transaction

Assume the same fact pattern as Example 6-10. However, 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 basis should be recorded in the financial statements of the entity?

Analysis

As discussed in Example 6-10, Subsidiary A is considered the historical entity. Therefore, Subsidiary A's assets would continue to be reflected at Subsidiary A's historical cost in the combined financial statements. Subsidiary A could also elect to pushdown Parent's basis. Subsidiary B's net assets, however, should be reflected at Parent's basis.

For purposes of SEC reporting, Regulation S-X requires financial statements for the registrant and its predecessor(s). In many cases, the historical entity for accounting purposes is also the predecessor for SEC reporting purposes. However, this is not always the case.

For SEC reporting purposes, 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. The determination should be made based on the specific facts and circumstances. No one factor is determinative.

EXAMPLE 6-12

Assume the same fact pattern as Example 6-10. 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?

Analysis

For SEC reporting purposes, it may be appropriate for Subsidiary B to be considered the predecessor entity after carefully 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.

In this example, Subsidiary B may determine that it is the predecessor entity despite Subsidiary A being the first entity controlled by Parent. If Subsidiary B is the predecessor, the predecessor period 20X1 would reflect the operations of Subsidiary B. A blackline would separate the periods 20X1 and 20X2 to reflect the new basis of accounting resulting from the transfer of Subsidiary A to Subsidiary B. The subsequent periods (20X2 and 20X3) would reflect the operations of the combined entity. In addition, financial statements of Subsidiary A may be required by Rule 3-05 of Regulation S-X.

6.2.3.4 *Noncontrolling interest in a common control transaction*

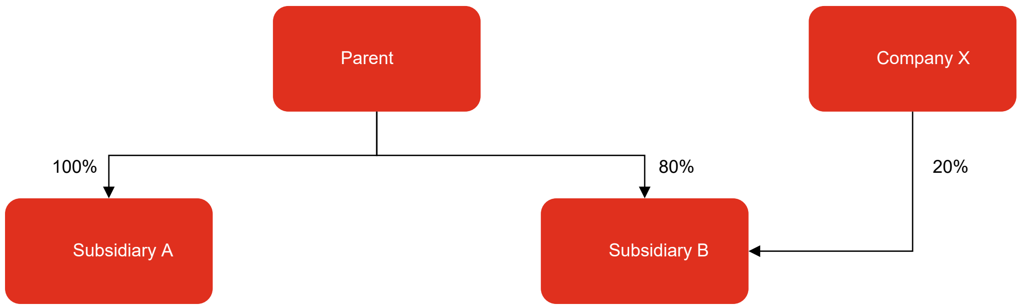
The accounting for any noncontrolling interest should follow the guidance in ASC 810-10 if one or more entities in a common control transaction are partially owned by the parent. Under ASC 810-10, changes in the parent's ownership interest while it retains a controlling financial interest in its subsidiary will be accounted for as equity transactions. The carrying amount of the noncontrolling interest should be adjusted to reflect the change in the ownership interest the noncontrolling shareholders have in the subsidiary. The noncontrolling interest is recorded at fair value only on the acquisition date in a business combination under ASC 805. The noncontrolling interest should not be recorded at fair value in a common control transaction, because common control transactions, by definition, do not result in a change in control.

Example 6-13 illustrates the accounting for the noncontrolling interest in a common control transaction.

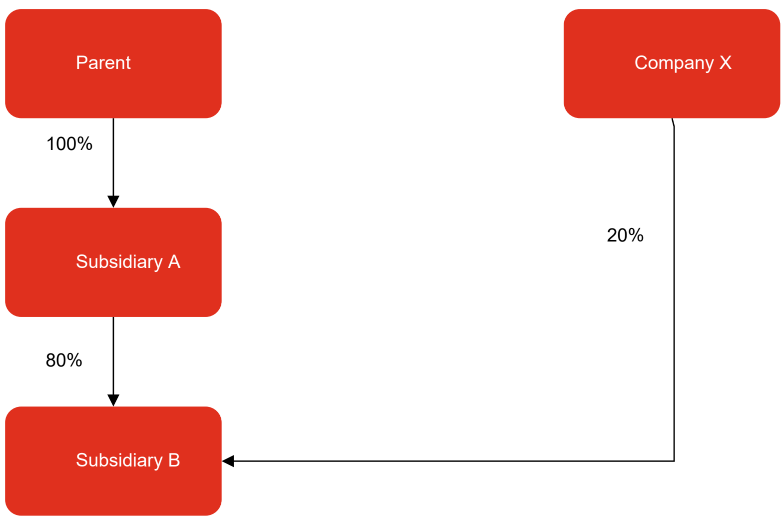
EXAMPLE 6-13

Acquisition of a noncontrolling interest in a common control transaction

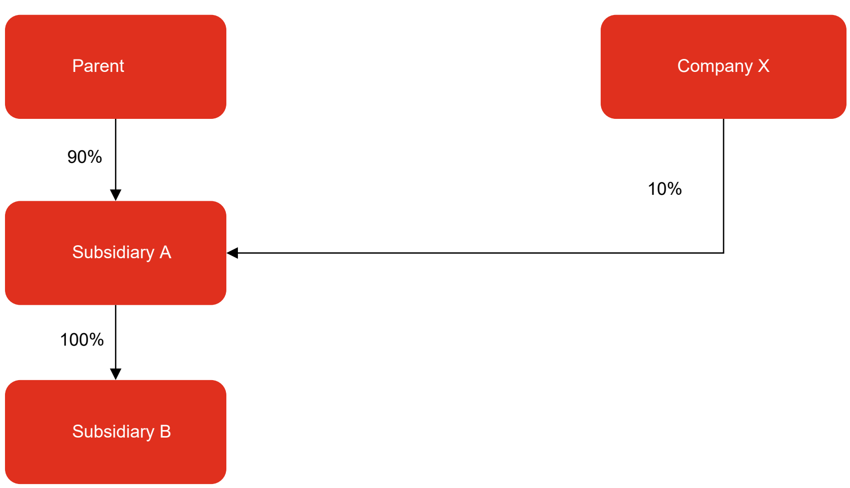
Parent owns 100% of Subsidiary A and 80% of Subsidiary B. Company X owns 20% of Subsidiary B.



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	CU500	CU200
Subsidiary B	CU500	CU300

- Parent's basis in 100% of Subsidiary A is CU200.
- Parent's basis in 80% of Subsidiary B is CU240.
- In Parent's financial statements, Company X's noncontrolling interest in Subsidiary B is CU60.
- Fair value of 10% of Subsidiary A and Subsidiary B combined is CU100.

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 CU240. The transaction would have no impact on Parent's consolidated financial statements.

Following the transaction, Subsidiary A would retrospectively adjust its financials to include Subsidiary B with a 20% NCI in Subsidiary B.

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	CU60[1]	
Equity/APIC—parent		CU10[2]
NCI—subsidiary A		CU50[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	CU200	—	CU20	CU20
Subsidiary B	CU300	CU(60)	30	(30)
Adjustment to parent's APIC		CU(60)	CU50	CU(10)

The effect of the CU60 reduction in the noncontrolling interest in Subsidiary B and CU50 increase in the noncontrolling interest in Subsidiary A results in a net CU10 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 (additional paid in capital). 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 CU500 × 10%).

Other Considerations – Parent's financial statements

In the example above, 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

In order to reflect the common control transfer of Subsidiary B to 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 for information and additional illustrative examples on how to account for transactions between a parent company and the noncontrolling interest.

Another type of transaction between entities under common control is one in which a partially owned subsidiary exchanges its common shares for the outstanding voting common shares of its parent (usually referred to as a "downstream merger"). Whether a parent acquires the noncontrolling interest of a subsidiary, or a subsidiary acquires 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. Accordingly, these transactions are also accounted for in accordance with ASC 810-10 as an acquisition of noncontrolling interest as if the parent had exchanged its common shares for the noncontrolling interest in its subsidiary. That is, the parent is the ongoing reporting entity regardless of the legal form of the transfer.

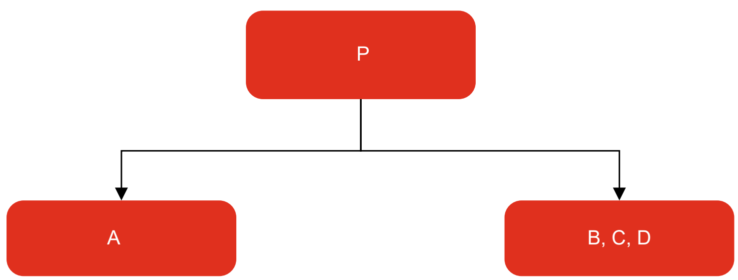
6.2.3.5 Goodwill impairment and reporting unit assessment

When an entity prepares combined financial statements following the guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50, it must consider how it should test goodwill for impairment in the combined financial statements. The question that often arises is whether the historical annual goodwill impairment tests should be performed assuming the transferred entity was its own separate reporting unit or whether the transferred entity should be assumed to have been integrated into the combined entity's reporting units as if it actually had been acquired at the earlier date. There is no specific guidance on this issue; and two alternative approaches have developed in practice.

The first alternative is based on an interpretation of the guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. That guidance indicates that the new reporting entity's financial statements should result in financial reporting similar to the pooling-of-interest method. Under that premise, the combined entity should reassess its historical reporting units for goodwill impairment testing as if the contributed 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 necessarily reflect how the entities were actually managed during those periods.

An 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 contributed entity, the receiving entity, or both did not have stand-alone reporting requirements, the entity (the contributing entity, the receiving entity, or both) would be treated as its own reporting unit for historical goodwill impairment testing purposes.

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, 20X7, 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 alternative discussed above, 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.

Regardless of the method used, the consolidated financial statement 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.

6.2.3.6 *Deferred taxes*

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 enterprises 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.

When preparing the retrospectively adjusted financial statements for the periods prior to the transaction date, a combining entity's deferred tax assets (e.g., operating loss carryforwards) cannot offset the other entity's taxable income unless allowed under certain jurisdictional tax laws. However, taxable income of the combined operations subsequent to the combination date should be considered in assessing the need for a valuation allowance in the retrospectively adjusted historical financial statements if the combined enterprise expects to file consolidated tax returns. Similarly, any tax law limitations on the use of entity-specific attributes subsequent to the transfer or exchange date should also be considered in evaluating the valuation of a deferred tax asset. Accordingly, in the retrospectively adjusted historical financial statements, a valuation allowance against deferred tax assets that is necessary for the combined entity may be different than the sum of the valuation allowances reflected in each of the combining entity's separate financial statements before the transfer or exchange. If the transfer or exchange causes any change in the combined entities' valuation allowance, the reduction or increase should be recognized as part of the adjustment to restate the entities' prior-period financial statements on a combined basis.

For purposes of restating periods prior to the transfer or exchange, a retrospective analysis is required to take into account (1) that the transfer or exchange has occurred and (2) any tax law limitations on the use of carry-over tax benefits after the transfer or exchange. However, a retrospective analysis or hindsight is precluded for purposes of assessing pre-transfer or exchange estimates of future taxable income. In other words, any increase or reduction in the valuation allowance for either entity's deferred tax assets would be reflected in the years the deductible differences or carryforwards arose, provided that one of the following conditions exists:

- Estimates that would have been made at the time of future combined taxable income (i.e., after the transfer or exchange, other than reversing differences and carryforwards of the other enterprise) would have been sufficient for realization of the deferred tax assets.

- The other entity's taxable differences existing at that time will generate sufficient future post-transfer or exchange taxable income to ensure realization of the deferred tax assets.

- A valid tax-planning strategy ensures realization of the deferred tax assets.

If none of these conditions were met in the year the deductible differences and carryforwards arose, the increase or reduction in the valuation allowance will be reflected in the first subsequent year in which one or more of these conditions are met.

In addition to adjustments that may be required to restate prior periods, in a taxable transfer or exchange, new tax bases may be established for assets and liabilities transferred. Because a new basis is not established for accounting purposes, taxable temporary differences may be reduced or eliminated, and deductible temporary differences may be increased or created. As of the transfer or exchange date, the tax effects attributable to any change in tax basis (net of valuation allowance, if necessary) should be charged or credited to contributed capital. If a valuation allowance is provided against the deferred tax assets at the combination date, any subsequent release of the valuation allowance should be reported as a reduction of income tax expense and reflected in continuing operations, unless the release is based on income recognized during the same year and classified in a category other than continuing operations. See TX 10.9 for further information.

6.2.3.7 Last-In, First-Out (LIFO) inventories

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.

6.2.3.8 Conforming accounting policies

In a common control transaction, the receiving entity and the transferring entity may have differing accounting policies. In this case, the receiving entity should consider conforming such policies in accordance with ASC 805.

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. ASC 250-10-45 provides guidance if retrospective application is impracticable.

6.2.4 Accounting and reporting by the contributing entity

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.

6.2.4.1 Accounting for the transfer

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 in a common control transaction. 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 contributing entity's wholly owned subsidiaries, the consolidated financial statements of the contributing entity will not be affected, except in certain cases for tax effects associated with an intra-entity sale or transfer of subsidiary stock. See TX 2.4.5.5 for further information. Otherwise, any differences between the proceeds received or transferred by the parent and the book value of the disposal or acquired group would be eliminated in consolidation, and no gain or loss would be recognized. In contrast, the financial statements of the contributing entity will be impacted by a contribution or sale to another party under common control that is not a subsidiary of the contributing 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 contributing 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 contributing entity have developed in practice. Regardless of the method used, the consolidated financial statements of the common parent will not be affected.

First, some infer from the receiving entity guidance that the same financial reporting should be applied to the contributing 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 contributing entity at their historical carrying values.

Alternatively, some believe the contributing entity should report 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 contributing 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 contributing 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.

For public companies in the United States, 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*, 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, preparers should carefully consider this guidance in determining the appropriate accounting by the contributing 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 have been met. Therefore, the more frequently applied accounting by the contributing entity has been to 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 6-14 provides additional guidance for use in determining the basis of transfer in the contributing entity's separate financial statements.

EXAMPLE 6-14

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 CU115 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 CU130 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 CU15 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.

6.2.4.2 Allocation of contributed entity goodwill

In certain circumstances, the contributed 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 connection with the preparation of the contributing entity's separate financial statements, the contributing entity needs to determine the appropriate method to allocate goodwill to the disposed business. There are two alternative methods to allocate goodwill to the contributed entity that are acceptable.

The contributing entity may apply the guidance prescribed in ASC 350-20-40-1 through 40-7. That guidance requires that goodwill of the reporting unit be allocated to the contributed entity based on the relative fair values of the retained portion of the reporting unit and the contributed entity on the date of the transfer.

Alternatively, by applying the historical cost approach, the contributing entity, in its separate financial statements, could utilize the guidance prescribed in ASC 805-50-30-5, and record the specifically identified original goodwill value of the contributed business from the original acquisition that generated such goodwill.

Subsequent to the allocation under either method, the contributing entity is required to test the remaining goodwill for impairment in accordance with ASC 350. Regardless of the method utilized to allocate goodwill to the transferred entity by the contributing entity, 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 contributing entity and the goodwill recorded by the receiving entity.

6.2.4.3 Transfers to owners

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 (whether or not in exchange for their ownership interests) 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 spin-off or a non-pro rata split-off.

A spinoff is defined in ASC 505-60-20.

Definition from ASC 505-60-20

Spinoff: The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor.

A transfer of assets that constitute a business to owners in a spinoff should be accounted for based on the recorded amount of those assets transferred (after reduction, if appropriate, for any impairment). In contrast, if the assets transferred do not constitute a business, the transaction is not a spinoff even though the distribution is pro rata. Rather, it would be considered a dividend-in-kind, which is generally accounted for based on the fair value of the assets transferred.

ASC 505-60 addresses whether or not to account for a spinoff as a reverse spinoff based on the substance instead of the legal form of the transaction. There is a presumption that the spinoff should be accounted for based on its legal form (i.e., the legal spinnor is also the accounting spinnor). When determining whether to account for a spinoff as a reverse spinoff, ASC 505-60-25-8 provides several indicators to consider when deciding if the presumption to account for the transaction based on legal form should be overcome. However, no one indicator should be considered presumptive or determinative. In a speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments, a member of the SEC staff noted that “when evaluating those criteria [in ASC 505], keep in mind that the guidance contains a rebuttable presumption that a spinoff should be accounted for based on its legal form.”

ASC 505-60-25-8 details the indicators that a spinoff should be accounted for as a reverse spinoff.

Excerpt from ASC 505-60-25-8

a. The size of the legal spinnor and the legal spinnee. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is larger than the accounting spinnee (legal spinnor). The determination of which entity is larger is based on a comparison of the assets, revenues, and earnings of the two entities. There are no established bright lines that shall be used to determine which entity is the larger of the two.

b. The fair value of the legal spinnor and the legal spinnee. All other factors being equal, in a reverse spinoff, the fair value of the accounting spinnor (legal spinnee) is greater than that of the accounting spinnee (legal spinnor).

c. Senior management. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) retains the senior management of the formerly combined entity. Senior management generally consists of the chairman of the board, chief executive officer, chief operating officer, chief financial officer, and those divisional heads reporting directly to them, or the executive committee if one exists.

d. Length of time to be held. All other factors being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is held for a longer period than the accounting spinnee (legal spinnor). A proposed or approved plan of sale for one of the separate entities concurrent with the spinoff may identify that entity as the accounting spinnee.

A split-off is defined in ASC 845-10-20.

Definition from ASC 845-10-20

Split-off: A transaction in which a parent entity exchanges its stock in a subsidiary for parent entity stock held by its shareholders.

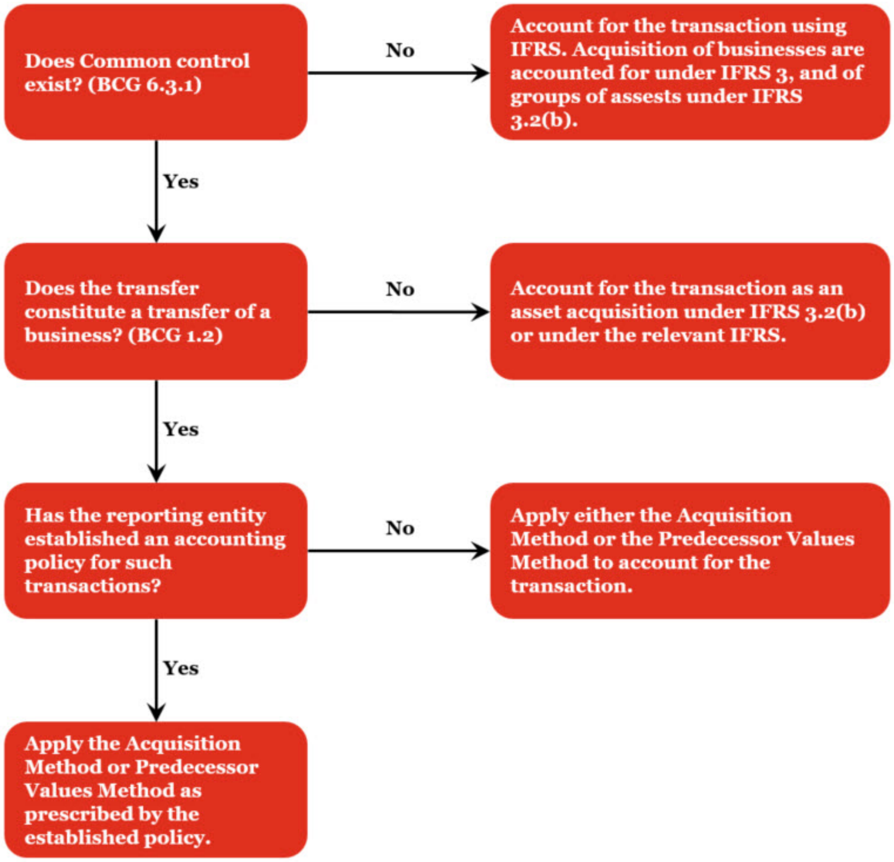
A split-off transaction is a non-pro rata distribution that may or may not involve all shareholders. If the shareholder receiving the split-off entity is not a controlling shareholder of the parent, a non-pro rata split-off is akin to a sale. The transaction is accounted for based on the fair value of the assets transferred, regardless of whether the subsidiary being split-off constitutes a business or an asset. See PPE 5.3.2 for further information regarding how spinoff and split-off transactions may impact long-lived asset impairment tests. A split-off to a controlling shareholder is a common control transaction and would be accounted for based on the recorded amount of those assets transferred.

6.3 Common control transactions under IFRS

Business combinations between entities under common control are not covered by IFRS 3. IFRS gives no guidance on the accounting for these types of transactions, but IAS 8.10 requires that entities develop an accounting policy for transactions not otherwise addressed in IFRS. The two methods most commonly chosen for accounting for business combinations between entities under common control are (1) the acquisition method and (2) the predecessor values method.

Figure 6-2 provides a decision tree that may assist in assessing these transactions under IFRS.

Figure 6-2
Accounting for common control transactions under IFRS



Common control issues not covered by the basic guidance contained in IFRS 3 often arise. Such issues include determining if common control exists, differentiating between business combinations and reorganizations, and applying the predecessor values method. This chapter addresses these and other common control issues and provides guidance for companies reporting under IFRS.

All other transactions under common control are accounted for under relevant IFRS.

6.3.1 Assessing whether common control exists

Control is defined in IFRS 10.7 as possessing power over the investee, having exposure, or rights, to variable returns from its involvement with the investee, and having the ability to use its power over the investee to affect the amount of the investor's returns. Under IFRS 3.B1, common control must exist both before and after the business combination so that control is not transitory. There cannot be a change in the ultimate control of the combining entities in a business combination involving entities under common control.

An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement. The individual or group of individuals may not be subject to the financial reporting requirements of IFRS. Therefore, in accordance with IFRS 3.B3, it is not necessary that combining entities be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control. Control can be exercised by an entity, such as a parent company or partnership, by an individual, or by a government. For example, entities would be under common control if they were wholly owned by an individual shareholder who was not required to prepare financial statements.

Example 6-15 illustrates how to assess common control in transactions involving government-controlled entities.

EXAMPLE 6-15

Assessing common control in transactions involving government-controlled entities

Company R operates city bus services. Company R was partially privatized four years ago when 49% of its equity was sold to the public. The government retained 51% of the voting rights and retained control. Company R has now acquired from the government for cash all of the voting shares of Company B, the regional bus operator. This is Company R's first acquisition since privatization. The government is not a "parent" as defined by IFRS 10 and so does not prepare consolidated financial statements.

How should Company R record the transaction?

Analysis

This is a business combination involving entities under common control. The combining entities are Company R and Company B. The government controls the combining entities before and after the transaction, so it is a transaction among entities under common control.

No accounting policy has previously been established and management has a choice of accounting treatment. Company R can account for its acquisition of Company B using the acquisition method or the predecessor values method.

If the predecessor values method is used, and the government did not prepare consolidated financial statements, the assets and liabilities of Company B are recognized in Company R's financial statements using the carrying values in Company B's financial statements. See BCG 6.3.5.1 for further guidance in these instances.

The extent of the noncontrolling interest in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. The fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements is also not relevant. What is relevant is that the combining entities remain under common control and control is not transitory. See BCG 6.3.2 for further information.

6.3.1.1 Common control and control groups

Control can be exercised by a group of individuals or a group of entities, rather than a single entity or a single individual. A group of individuals shall be regarded as controlling an entity in accordance with IFRS 3.B2 when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. The existence of a contractual arrangement is critical to the existence of common control. In the absence of a contractual arrangement, a control group is deemed not to exist other than in close family relationships.

A family-owned business may consist of a number of separate entities that are not controlled by any one individual or collectively under the terms of a contractual arrangement. Control groups involving close family relationships should be assessed to see if common control exists based on the specific facts and circumstances. A control group exists in other circumstances only if there is a contractual arrangement.

Example 6-16 illustrates how to assess common control in transactions between family-owned or managed businesses.

EXAMPLE 6-16

Assessing common control in transactions between family-owned or managed businesses

The Smith family runs a retail business. The retail outlets are operated by seven companies that are owned in different proportions by Mr. Smith, his wife, and their three children. No one member of the family has more than 50% of the equity of any of the operating companies; and there is no contractual arrangement among the members of the family. None of the companies has previously acquired a business from a member of the family.

The family has been advised to consolidate their holdings for tax purposes. A new holding company, Company X, has been formed and will acquire all of the operating companies by issuing shares to Mr. and Mrs. Smith and their three children. Each family member will own 20% of Company X after the transaction.

How should the transaction between family-owned businesses be recorded?

Analysis

The Smith family together controls all of the combining entities before and after the transaction. The reorganization is a business combination involving entities under common control. The combining entities are Company X and the existing operating companies. Even though there is no contractual arrangement that gives the family common control, such an arrangement is deemed to exist due to the close family relationships.

Management has a choice of accounting treatment if this is the acquiring company's first common control business combination. All of the requirements of IFRS 3 are applied if the acquisition method is used. Company X cannot be the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in IFRS 3. All of the existing companies together should be identified as the acquirer if they are managed together as a single business. The accounting result would be similar to predecessor accounting in the case where all of the companies together are the acquirer under IFRS 3.

The Smith family is not a "parent" within the meaning of IFRS 10.2(a) if the predecessor values method is used. The Smith family has not previously prepared consolidated financial statements because these were not required. The assets and liabilities of the operating companies are recognized in Company X's consolidated financial statements using the carrying values in the financial statements of each company under the predecessor values method. This is because there are no consolidated financial statements from the highest level of common control. See BCG 6.3.5.1 for further information.

6.3.1.2 *Entities with a high degree of common ownership*

Transactions between entities with a high degree of common ownership or other joint arrangements must be assessed to determine if they are common control transactions. The assessment should determine whether the group collectively has control under IFRS 10 (e.g., as a result of a contractual arrangement).

Business combinations between entities that have a high degree of common ownership, but not common control, are not business combinations involving entities under common control. These business combinations are within the scope of IFRS 3 and should be accounted for using the acquisition method.

Examples 6-17 and 6-18 illustrate how to assess common control in transactions between entities with a high degree of common ownership.

EXAMPLE 6-17

Assessing common control in transactions between entities with a high degree of common ownership

Company A is owned 40%, 40%, and 20% by three unrelated shareholders. There is no contractual agreement in place that creates control for any single shareholder or group of shareholders. Company B is owned by the same shareholders in the same proportions.

Company A incorporates a new company, Company X, which issues shares and acquires 100% of the shares of Company A and Company B. The shareholders own 40%, 40%, and 20%, respectively, of Company X subsequent to the transaction.

Does the transaction represent a business combination between entities under common control?

Analysis

This is not a business combination between entities under common control. There is no contractual agreement in place that gives an individual shareholder or group of shareholders control of Company A or Company B. The acquisition method should be applied in this fact pattern. Company A or Company B should be identified as the acquirer.

Situations arise where two or more entities or individuals sometimes act collectively to manage and operate the activities of another entity. These arrangements may be joint arrangements in the context of the definition in IFRS 11.

EXAMPLE 6-18

Assessing common control in transactions between joint ventures

Three individuals, A, B, and C formed a joint arrangement, Company Y, in 20X5 that meets the criteria to be classified as a joint venture under IFRS 11. Company Y's activities are the evaluation and exploration of oil and gas reserves in a number of countries. A, B, and C formed another joint arrangement, Company Z, in 20X8 that meets the criteria to be classified as a joint venture under IFRS 11. Company Z transports the oil and gas extracted by Company Y to Western Europe. A, B, and C each hold a one-third interest in both Company Y and Company Z. The activities of Company Y and

Company Z are governed by agreements that establish joint control in accordance with the definition in IFRS 11.

The joint venture partners have been advised that tax savings can be achieved if Company Y and Company Z were combined into a single tax group. As a result, Company Y acquired all of the shares of Company Z from A, B, and C in a share-for-share exchange.

Is the acquisition by Company Y of the shares of Company Z a transaction under common control?

Analysis

The two combining entities are controlled collectively by the same group of shareholders. The entities were previously under the joint control of A, B, and C. This is not the formation of a joint venture, but rather a reorganization involving entities under common control. The combining entities are Company Y and Company Z. The joint venture partners jointly control both of the combining entities before and after the transaction because of the joint-control-sharing agreements in place.

Management has a choice of accounting treatment if this is the acquiring company's first common control business combination. The transaction can be accounted for using the acquisition method or using the predecessor values method. All of the requirements of IFRS 3 are applied if the acquisition method is used, including determination of the accounting acquirer. The assets and liabilities of Company Z are recognized in Company Y's consolidated financial statements using the carrying values in Company Z's financial statements if the predecessor method is used. This is because the joint venture partners did not prepare financial statements that included the two joint ventures prior to combining them. See BCG 6.3.5.1 for further guidance in these instances.

6.3.2 Transitory common control

For a transaction to qualify as a common control transaction, IFRS 3 requires that the combining entities or businesses are ultimately controlled by the same party or parties before and after the combination. The control must not be transitory. The reason for this condition is to prevent the use of "grooming transactions," whereby, for only a brief period immediately before the combination, the combining entities or businesses are under common control.

Examples 6-19 and 6-20 illustrate how to determine if common control is transitory.

EXAMPLE 6-19

Determining if common control is transitory

Two individuals, A and B, own competing grocery businesses, Company X and Company Y, respectively. A agreed to acquire B's business by acquiring all of Company Y's voting shares in his own name in exchange for 25% of his shares in Company X. Two months after this transaction, A transferred Company Y to Company X.

Is the acquisition of Company Y a transaction under common control?

Analysis

This is not a business combination involving entities under common control. The common control of Company X and Company Y was transitory because Company X and Company Y came under common control shortly before the transaction to effect the transaction. Company X has acquired Company Y and should apply the acquisition method in its consolidated financial statements.

A reorganization may involve the formation of a new entity to facilitate the sale of part of a group. The IFRIC considered whether this is a business combination under IFRS 3 if control of the new entity is transitory. In the IFRS Updates in March 2006 and July 2011, the IFRIC clarified that when combining entities or businesses have been under common control for a period before the combination, control is not considered transitory. A reorganization within a group to facilitate a spin-off or an initial public offering is a business combination involving entities under common control. This is still the case when the parent loses control shortly after the transaction. This constitutes a disposal transaction. The entity has lost control of the business. The disposal may be an acquisition by another party or it may be a disposal to the wider market. The reorganization that occurs before the disposal is not an acquisition under IFRS 3. It may be a business combination amongst entities under common control provided that more than one business is combined in the new entity.

EXAMPLE 6-20

Assessing if control is transitory in spin-off transactions

Company R is listed on the London Stock Exchange and operates bars, hotels, and casinos. The management of Company R plans to divide the company so that the bar business and the hotel and casino businesses are listed separately. A new entity, Company S, has been incorporated, and Company R will transfer the hotel and casino businesses to Company S in exchange for new Company S shares. Company R will then distribute the Company S shares pro-rata to the existing shareholders of Company R.

Is the distribution of the Company S shares a transaction under common control?

Analysis

This is a business combination involving entities under common control, because common control is not transitory. The combining entities are the hotel and casino businesses, which have been controlled by Company R in the period before and after the combination.

Management has a choice of accounting treatment because Company S has not established an accounting policy on accounting for common control business combinations. Company S can account for the business combination using the acquisition method or using the predecessor values method.

Company S cannot be the acquirer if the acquisition method is chosen. An acquirer must be identified among the hotel and casino businesses. The assets and liabilities of the hotel and casino businesses are recognized in Company S's consolidated financial statements using the carrying values in the financial statements of Company R if the predecessor values method is used.

6.3.3 *Nature of the acquisition—group of assets or net assets versus business*

Determining if a transfer between entities under common control constitutes the transfer of a group of assets or a business is critical. The transfer of a business accounted for under the predecessor values method will often result in the restatement of historical financial periods. The restatement is presented as if the entities were always combined, as further discussed in BCG 6.3.5.2. The acquisition of a group of assets or net assets should be accounted for as an asset acquisition under the requirements of IFRS 3.2(b), regardless of whether that acquisition is a common control transaction. Asset acquisitions are discussed further in BCG 9. The acquisition of a single asset is governed by other IFRS, for example, IAS 16, *Property, Plant and Equipment*, or IAS 38, *Intangible Assets*. Those standards would apply regardless of whether the transaction qualifies as a common control acquisition. The seller or transferor will account for the transaction under appropriate IFRS and may recognize a gain or loss on the transaction.

6.3.4 *Business combinations versus reorganisations*

It is not uncommon for a new parent company to be added to an existing group by setting up a new shell company that issues equity shares to the existing shareholders in exchange for the transfer of shares in the existing group, such that there is no change in the substance of the reporting entity. This may be done for a variety of reasons including taxation and profit distributions.

A new parent company added to an existing group is not an acquirer in a business combination. The transaction could be characterized as a reverse acquisition of the new company by the existing group if it was a business combination as defined by IFRS 3. However, IFRS 3.B19 contains guidance on reverse acquisitions that states that "the accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition." Therefore, the situation in which a new parent company is added to an existing group is not a business combination.

It can be argued that the transaction is a reorganization of an existing entity, and that the substance of the reporting entity has not changed. The consolidated financial statements of the new entity are presented using the values from the consolidated financial statements of the previous group holding company. The equity structure—that is, the issued share capital—would reflect that of the new company, with other amounts in equity (such as revaluation reserve, retained earnings, cumulative translation reserves) being those from the consolidated financial statements of the previous group holding company. The resulting difference would be recognized as a component of equity. Local regulatory or legal requirements may specify how this difference is presented; for example, it may be referred to as a reorganization reserve.

6.3.5 *Predecessor values method*

This section provides guidance on the accounting and reporting of common control transactions using the predecessor values method.

6.3.5.1 *Basis of transfer*

The predecessor values method requires the financial statements to be prepared using predecessor book values without any step up to fair value. There will likely be a difference between any consideration given and the aggregate book value of the assets and liabilities (as of the date of the transaction) of the acquired entity. This difference is recorded as an adjustment to equity. This may be recorded in retained earnings or as a separate reserve. No additional goodwill is created by the transaction.

The acquiree's book values are generally those in the consolidated financial statements of the highest entity that has common control for which consolidated financial statements are prepared. This includes any goodwill relating to the acquiree that appears in those consolidated financial statements. IFRS does not contain the concept of pushdown accounting unlike US GAAP. Pushdown accounting is not relevant in determining the basis of transfer. The values should be the same as those in the acquiree's own books when the acquiree has been under common control since it was formed. The values in the consolidated financial statements should be used, including goodwill, when the acquiree was previously acquired in a business combination. Predecessor values should be adjusted to ensure uniform accounting policies. It will be necessary to use predecessor amounts from a lower level where no financial statements have been prepared at the highest level of common control.

Examples 6-21 and 6-22 illustrate how to determine the predecessor value in a common control transaction.

EXAMPLE 6-21

Determining predecessor values when consolidated financial statements are prepared

Company Y has owned 100% of Company D, a dairy products business, for many years. Company Y acquired 100% of Company M, another dairy products company, from a competitor for cash in 20X4. Management decided to combine the two dairy products businesses two years after the acquisition of Company M. Management transferred all voting shares of Company M to Company D for nominal consideration. Company D has an existing policy of applying the predecessor values method for a common control business combination in its consolidated financial statements.

How should Company D record the transaction?

Analysis

This is a business combination involving entities under common control. Management must apply a consistent accounting policy and therefore, Company D will use the predecessor values method for this transaction. The book values used to record the assets and liabilities are those in the consolidated financial statements of the highest entity that has common control when the predecessor values method is applied. Company D should recognize the assets and liabilities of Company M using the values recorded in the consolidated financial statements of Company Y. The book values of the transferred business are not used.

EXAMPLE 6-22

Determining predecessor values when consolidated financial statements are not prepared

Company B is a wholly owned subsidiary of Entity T, an unincorporated government agency that is not required to prepare financial statements. Company B has an existing policy of applying the predecessor values method for a common control business combination.

Entity T acquired all the voting shares in Company N in January 20X7 for cash. Entity T did not prepare consolidated financial statements and has never produced IFRS 3 fair value information regarding its acquisition of Company N. In January 20X8, Entity T transferred the shares in Company N to Company B.

How should Company B record the transaction?

Analysis

Company B's acquisition of Company N is a business combination involving entities under common control. The business combination should be recorded using the predecessor values method. The predecessor values that should be used in Company B's consolidated financial statements are those from Company N's separate financial statements. Company B should account for the transaction using the predecessor values from the date that Company N has been under common control of Entity T, which is January 20X7. See BCG 6.3.5.2 for further information.

6.3.5.2 *Financial statement presentation*

The consolidated financial statements can be presented using one of two alternative methods under the predecessor values method. The consolidated financial statements can incorporate the acquired entity's results as if both entities (acquirer and acquiree) had always been combined (or from the date either entity joined the group where such a date is later). The consolidated financial statements will reflect both entities' full year's results, even though the business combination may have occurred part way through the year. The corresponding amounts for the previous years also reflect the combined results of both entities, even though the transaction did not occur until the current year.

Alternatively, the consolidated financial statements can incorporate the acquired entity's results only from the date on which the transaction occurred. Consequently, the consolidated financial statements do not reflect the results of the acquired entity for the period before the transaction occurred. The corresponding amounts for the previous year are also not restated.

Once a presentation method has been adopted it should be applied consistently for any common control transactions as a matter of accounting policy. The local regulator or market practice may dictate whether the first or second method can be used in some jurisdictions.

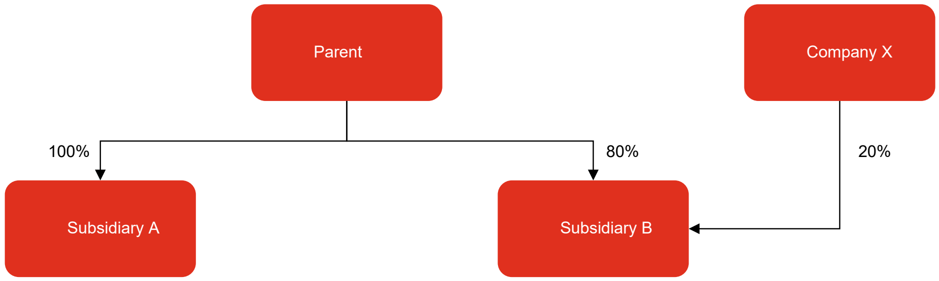
6.3.6 *Noncontrolling interest in a common control business combination*

IFRS 10 provides additional guidance on how to account for the noncontrolling interest. The application of this guidance in a business combination involving entities under common control is illustrated in Example 6-23.

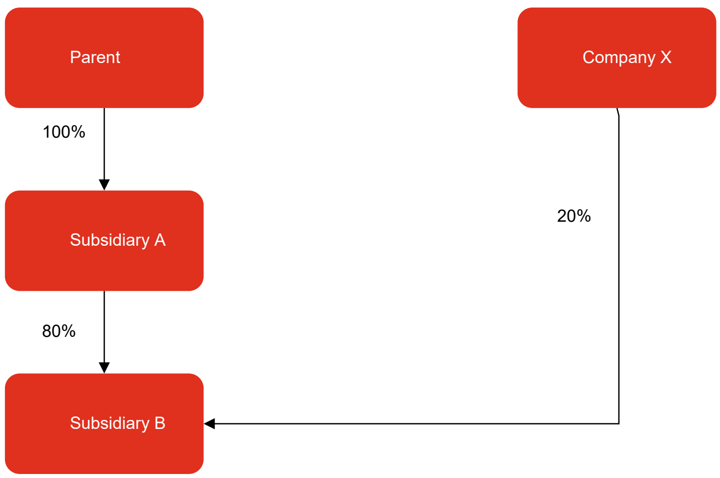
EXAMPLE 6-23

Acquisition of a noncontrolling interest in a common control business combination

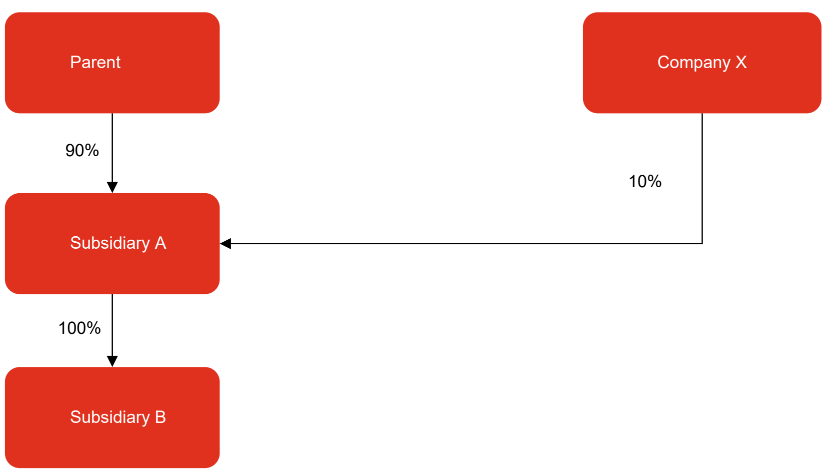
Parent owns 100% of Subsidiary A and 80% of Subsidiary B. Company X owns 20% of Subsidiary B.



Parent transfers its investment in Subsidiary B to Subsidiary A in a common control transaction.



Company X exchanges its 20% interest in Subsidiary B for a 10% interest in Subsidiary A in conjunction with the transaction.



Also assume the following additional facts:

	Fair value	Net book value
Subsidiary A	CU500	CU200
Subsidiary B	CU500	CU300

- Parent's basis in 100% of Subsidiary A is CU200.
- Parent's basis in 80% of Subsidiary B is CU240.
- In Parent's financial statements, Company X's noncontrolling interest in Subsidiary B is CU60.
- Fair value of 10% of Subsidiary A and Subsidiary B combined is CU100.

How should the transaction be recorded?

Analysis

Parent's contribution of subsidiary B to subsidiary A

The transfer by Parent of its investment in Subsidiary B to Subsidiary A is a common control transaction that 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

Subsidiary A acquires Company X's noncontrolling interest in Subsidiary B in exchange for a 10% noncontrolling interest in Subsidiary A. 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	CU60[1]	
Equity/APIC—parent		CU10[2]
NCI—Subsidiary A		CU50[3]

[1] Elimination of Company X's noncontrolling interest in Subsidiary B.

[2] The net increase in Parent's equity/APIC (additional paid-in capital) 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	CU200	—	CU20	CU20
Subsidiary B	CU300	CU(60)	30	(30)
Adjustment to parent's equity/APIC		CU(60)	CU50	CU(10)

The effect of the CU60 reduction in the noncontrolling interest in Subsidiary B and CU50 increase in the noncontrolling interest in Subsidiary A results in a net CU10 increase in Parent's equity/APIC in the consolidated financial statements. The changes in the noncontrolling interest are accounted for at carrying values. The option to fair value the noncontrolling interest is only available at the date of a business combination.

3 Recording of the new noncontrolling interest in Subsidiary A (consolidated net book value of CU500 × 10%).

Other considerations

There would be no entries to record in Parent's consolidated financial statements in the example above if Company X did not participate in the exchange (i.e., Company X maintained its 20% interest in Subsidiary B).

See BCG 6 for guidance and additional illustrative examples on how to account for transactions between the parent company and the noncontrolling interest.

6.3.7 *Accounting and reporting by the selling (contributing) entity*

When one party carries out a business combination involving entities under common control, another entity will have made a disposal. There is no specific guidance on how the selling (contributing) entity should account for the transfer of a business in a common control business combination. The selling entity in a business combination involving entities under common control may be required to prepare its own consolidated financial statements under IFRS.

The consolidated financial statements will not be affected if the contribution or sale is to one of the seller's own subsidiaries. There could be a contribution or sale to another party under common control that is not a subsidiary of the seller (e.g., a fellow subsidiary under a common parent). It will generally be appropriate to recognize a gain or loss on the sale based on the difference between the consideration received and the carrying value of the disposed business. The business that is disposed of should be deconsolidated only from the point that control is lost. "De-pooling" or retrospective presentation of the disposal is not appropriate under IFRS.

Chapter 7: Asset acquisitions

7.1 Chapter overview

BCG 1 addresses business combinations that are within the scope of the Standards and the difference between an acquisition of a business and an acquisition of an asset or group of assets. If an acquisition of an asset or group of assets does not meet the definition of a business, the transaction is accounted for as an asset acquisition. There are specific differences between the accounting for asset acquisitions and business combinations. An asset acquisition under both IFRS and US GAAP does not result in the recognition of goodwill; and transaction costs are capitalised as part of the cost of the asset or group of assets acquired. Additionally, under IFRS, the recognition of deferred taxes in an asset acquisition is very different from that in a business combination. Generally, no deferred taxes are recognised for book/tax differences on asset acquisitions under IFRS. These and other differences are described further below.

Refer to PPE 1 for additional information on the accounting for asset acquisitions.

Note about ongoing standard setting

US GAAP

In August 2017, the FASB decided to move forward with phase 3 of the definition of a business project, focusing on certain differences in the accounting for business combinations and asset acquisitions. The differences to be addressed include the accounting for transaction costs, in process research and development, and contingent consideration.

IFRS

The IASB has an active project related to the definition of a business. See BCG 1.1 for additional information.

7.2 Assets acquired in an exchange transaction

Assets are usually acquired through an exchange transaction, which can be a monetary or a nonmonetary exchange. This section discusses the accounting for assets acquired in an exchange transaction including the recognition and measurement under US GAAP and IFRS.

7.2.1 Initial recognition

An asset acquisition triggers the initial recognition of an asset acquired and may include a liability assumed. Assets are usually acquired through an exchange transaction, which can be a monetary or a nonmonetary exchange. Assets surrendered are derecognized at the date of acquisition. If liabilities are incurred or equity interests are issued as the consideration for an acquisition of an asset or group of assets, those liabilities and equity interests are recognized at the date of acquisition in accordance with ASC 805-50-25-1.

Goodwill is not recognized in an asset acquisition. The presence of excess consideration transferred may indicate that not all assets acquired have been recognized or that there are preexisting relationships being settled with the transaction that should be accounted for separately. As discussed in ASC 805-10-55-9 and IFRS 3.B12, in the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present is presumed to be a business.

New guidance

Upon adoption of ASU 2017-01, *Clarifying the Definition of a Business*, an entity can no longer assume that the presence of goodwill indicates that the acquired set is a business. However, the presence of more than an insignificant amount of goodwill may indicate that the acquired set is a business. Further, an acquired group may constitute a business without any goodwill being present. See BCG 1 for information regarding the effective date of ASU 2017-01.

7.2.2 Initial measurement

Asset acquisitions are measured based on their cost to the acquiring entity, which generally includes transaction costs. An asset's acquisition cost or the consideration transferred by the acquiring entity is assumed to be equal to the fair value of the net assets acquired, unless contrary evidence exists. Under ASC 805-50-30-1 and IAS 16.24, a gain or loss would be recognized by the acquirer if the fair value of nonmonetary assets given as consideration was different than their carrying amounts. Prior to adoption of ASU 2017-05, *Other Income—Gains and Losses from the derecognition of Nonfinancial Assets*, and under IAS 28.28, a gain may be limited in situations when a nonmonetary asset, for which the readily determinable fair value exceeds the carrying amount, is transferred to an entity in exchange for a noncontrolling ownership interest in that entity and that ownership interest is accounted for under the equity method. Upon adoption of ASU 2017-05, the partial sale of a nonfinancial asset is recognized if the selling entity (1) does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with ASC 810 and (2) transfers control of the asset in accordance with ASC 606. Once control is transferred, any noncontrolling interest received (or retained) is measured at fair value. Refer to PPE 5 for additional guidance.

If the consideration transferred is cash, measurement is based on the amount of cash paid to the seller as well as transaction costs incurred. Consideration given in the form of nonmonetary assets, liabilities incurred, or equity interests issued is measured based on either the cost to the acquiring entity or the fair value of the assets or net assets acquired, whichever is more clearly evident and, thus, reliably measurable, as described in ASC 805-50-30-2, IAS 16.24, and IAS 38.45.

There is a rebuttable presumption in IFRS 2 that the fair value of goods and services received can be reliably measured when consideration is given in the form of equity interests. In accordance with IFRS 2.13, the fair value of the equity interests issued as consideration can be used to determine the fair value of the consideration transferred only when this presumption is rebutted.

7.2.2.1 Nonmonetary transactions accounting—US GAAP

Most asset acquisitions involve exchanges of cash or other monetary assets or liabilities for the asset acquired. The amount of monetary assets or liabilities exchanged for nonmonetary assets generally provides an objective basis for measuring the fair value of the nonmonetary assets. Exchanges that involve little or no monetary assets or liabilities are commonly referred to as nonmonetary transactions.

ASU 2017-05, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets,* amended the scope of ASC 845. After adoption of the ASU, assets acquired in a nonmonetary exchange will generally be recorded at fair value unless the transaction lacks economic substance.

7.2.2.2 *Nonmonetary transactions accounting—IFRS*

The accounting under IFRS for nonmonetary exchanges is similar to current US GAAP. The cost of an item acquired in exchange for a nonmonetary asset or assets is measured at fair value unless (1) the exchange transaction lacks commercial substance or (2) the fair value of neither the asset received nor the asset given up is reliably measurable. In accordance with IAS 16.24, if the acquired item is not measured at fair value, it is measured at the carrying amount of the asset surrendered.

Nonmonetary exchanges of items that are similar in nature and value are not measured at fair value and do not result in the recognition of gains and losses. However, items that are considered similar are generally limited to commodities like oil or milk, when suppliers exchange or swap inventories in various locations to fulfill demand on a timely basis in a particular location. If the items exchanged are for dissimilar goods or services, the exchange is measured at fair value, resulting in the recognition of a gain or loss. An exchange is measured based on the fair value of the items received, adjusted by the amount of cash and cash equivalents transferred. As described in AIS 18.12, when the fair value of the items received cannot be measured reliably, the exchange is measured based on the fair value of the items given up, adjusted by the amount of any cash or cash equivalents transferred.

7.2.3 *Allocating cost (the fair value of consideration given)*

The cost of acquiring a group of assets is allocated to the individual assets within the group based on the relative fair values of the individual assets. Fair value is measured in accordance with ASC 820 or IFRS 13, as applicable. Therefore, the fair value of the consideration transferred, including transaction costs, is generally allocated to the assets acquired and liabilities assumed based on their relative fair values, as described in ASC 805-50-30-3. However, if the fair values of the assets acquired and liabilities assumed are more reliably determinable, the cost of the transaction would be based on the fair values of the assets acquired and liabilities assumed, as described in ASC 805-50-30-2, IAS 16.24, and IAS 38.45. No goodwill is recognized in an asset acquisition. Example 7-1 demonstrates the allocation of cost in an asset acquisition.

EXAMPLE 7-1

Measurement of an asset acquisition

Company X acquires a custom special-purpose machine and a patent in exchange for consideration transferred of CU1,000 cash and a warehouse facility. The fair value of the warehouse facility is CU600 and its carrying value is CU100. The fair values of the special-purpose machine and patent are estimated to be CU750 and CU1,250, respectively. The special-purpose machine and patent relate to a product that has just recently been commercialized. The market for this product is developing and uncertain. Assume Company X incurred no transaction costs. (For illustrative purposes, the tax consequences on the gain have been ignored.)

How should the asset acquisition be recorded?

Analysis

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. Company X concludes the fair value of the warehouse facility is more reliable than the fair value of the special-purpose machine and patent. The fair value of the consideration given is attributed to the individual assets acquired based on their relative fair values. Therefore, Company X would value the acquisition of the special-purpose machine and patent at CU1,600 (the total fair value of the consideration transferred). A CU500 gain is recorded by Company X for the difference between the fair value and carrying value of the warehouse facility. The special-purpose machine and patent are recorded at their relative fair values. The entry to record the transaction would be:

Machine	CU600[1]	
Patent	CU1,000[2]	
Cash		CU1,000[3]
Warehouse facility		CU100[4]
Gain on acquisition		CU500[4]

[1] The machine is recorded at its relative fair value ((CU750/CU2,000) × CU1,600 = CU600).

[2] The patent is recorded at its relative fair value ((CU1,250/CU2,000) × CU1,600 = CU1,000).

[3] Company X paid cash consideration of CU1,000.

[4] The carrying amount of the warehouse facility (CU100) is derecognized from the balance sheet and a gain is recorded for the difference between the carrying amount and the fair value at the date of derecognition (CU600 – CU100 = CU500).

7.2.4 *Accounting for an asset acquisition versus a business combination*

Figure 7-1 describes common areas where differences in accounting occur between an asset acquisition and a business combination.

Figure 7-1

Common differences between asset acquisition and business combination

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
Intangible assets including goodwill	Intangible assets are recognized at fair value if they meet the identifiable criteria. Goodwill is recognized as a separate asset [ASC 805-20-25-4 and ASC 805-30-30-1; IFRS 3.13, 32].	Intangible assets acquired in an asset acquisition are recognized in accordance with ASC 350. Goodwill is not recognized in an asset acquisition. Any excess consideration transferred over the fair value of the net assets acquired is reallocated to the identifiable assets[1] based on their relative fair values [ASC 805-50-30-3]. The accounting for intangible assets acquired in	Intangible assets acquired in an asset acquisition are recognized in accordance with IAS 38 and no goodwill is recognized. An intangible asset is measured initially at cost [IAS 38.24]. If the consideration transferred included nonmonetary assets, the cost of the acquired intangible assets is generally measured at fair value, and a gain or loss is recognized on the nonmonetary asset

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
		nonmonetary exchanges may differ based on the applicable guidance. See BCG 7.2.2.1.	transferred [IAS 38.45].
Intangible assets used in research and development activities (referred to as in-process research and development or IPR&D)	Intangible research and development acquired in a business combination is measured at fair value using market-participant assumptions and is capitalized as an indefinite-lived asset [not available for use]. Capitalized research and development assets will be either impaired or amortized in future periods, depending on the ability of the acquirer to use the acquired research and development in the postcombination period.	IPR&D is expensed for asset acquisitions at the acquisition date if it has no alternative future use. However, the costs of intangibles that are purchased from others and have alternative future uses (in other research and development projects or otherwise) shall be accounted for as an intangible asset and amortization of those intangible assets used in research and development activities is a research and development cost [ASC 730-10-25-2(c)].	An acquirer recognizes the IPR&D project as an asset if it meets the definition of an intangible asset and its fair value can be measured reliably. This criterion is always considered to be satisfied for separately acquired IPR&D assets [IAS 38.25].
Acquired contingencies	Under US GAAP, acquired contingencies should be recognized and measured at fair value if determinable at the acquisition date or during the measurement period using facts and circumstances that existed at the acquisition date. Otherwise, companies would typically account for the acquired contingencies in accordance with ASC 450. Under IFRS, an acquirer recognizes all contingent liabilities assumed at fair value on the acquisition date if they represent a	Contingencies acquired in an asset acquisition are accounted for in accordance with ASC 450. Asset acquisitions are not subject to the requirement to initially assess whether the acquisition date fair value of acquired contingencies is determinable. Subsequent changes in the recorded ASC 450 amount are recorded through earnings.	Contingencies acquired in an asset acquisition are recognized only if they meet the recognition criteria in IAS 37. As such, a provision is recorded when (1) an entity has a present obligation (legal or constructive) as a result of a past event, (2) it is probable (more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
	present obligation arising from past events and can be reliably measured [IFRS 3.23]. Under both US GAAP and IFRS, subsequent changes in the value of acquired contingencies are recorded through earnings until settled.		shall be recognized [IAS 37.14].
Transaction costs	In a business combination, transaction costs are expensed and not included as part of the consideration transferred [ASC 805-10-25-23; IFRS 3.53].	Transaction costs are generally a component of the consideration transferred to acquire the group of assets in an asset acquisition, and are capitalized as a component of the cost of the assets acquired in accordance with the applicable standards (e.g., CON 5 for property, plant, and equipment) [ASC 805-50-30-1;].	Transaction costs are generally a component of the consideration transferred to acquire the group of assets in an asset acquisition, and are capitalized as a component of the cost of the assets acquired in accordance with the applicable standards (e.g., IAS 16 for property, plant, and equipment) [IAS 16.16; IAS 38.27].
Deferred tax accounting	Deferred taxes are recorded on most temporary book/tax differences for assets acquired and liabilities assumed and tax attributes acquired in a business combination in accordance with ASC 740.	Deferred taxes are generally recorded on temporary book/tax differences in an asset acquisition using the simultaneous equations method in accordance with ASC 740-10-25-49 through 25-55. A reduction in the valuation allowance of the acquirer that is directly related to the asset acquisition will impact income tax expense. Further, any “negative goodwill” arising from the application of ASC 740-10-25-51(c) should first reduce the values assigned to the noncurrent assets, and any remaining deferred credit should be amortized to income	IFRS prohibits recognition of deferred taxes for temporary differences that arise upon recording an asset or liability in a transaction that (1) is not a business combination and (2) affects neither accounting nor taxable income [IAS 12.15]. Accordingly, deferred taxes generally are not recognized for book/tax differences on asset acquisitions. The tax law may provide for the acquirer’s tax on certain nonmonetary exchanges to be deferred and for the acquirer’s tax basis in the asset that was given

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
		tax expense in proportion to the realisation of the tax benefits that gave rise to the negative goodwill [ASC 740-10-35-5]. The tax law may provide for the acquirer's tax on certain nonmonetary exchanges to be deferred and for the acquirer's tax basis in the asset that was given up to carry over to the asset received. In those instances, a deferred tax liability may be recorded. See TX 10.10 for further information.	up to carry over to the asset received. In those instances, a deferred tax liability may be recorded. See TX 10.10 for further information.
Assembled workforce	An assembled workforce does not qualify as an identifiable intangible asset to be recognized separately from goodwill [ASC 805-20-55-6; IFRS 3.B37].	An assembled workforce intangible asset may be recognized and measured at fair value at the acquisition date if it is part of the asset or group of assets acquired that do not constitute a business [CON 5]. However, if a workforce is present, the group of acquired assets may qualify as a business, in which case, the provisions of ASC 805 should be applied.	An entity usually has insufficient control over the expected future economic benefits arising from its workforce to meet the definition of an intangible asset [IAS 38.15]. A workforce generally does not qualify as an identifiable intangible asset. Additionally, if a workforce is present, the group of acquired assets may qualify as a business, in which case, the provisions of IFRS 3 should be applied.
Accounting for the classification of a lease (regardless of whether the acquiree is a lessee or a lessor)	Classification of a lease contract is based on the contractual terms at the inception of the contract, unless the contract has been significantly modified [ASC 805-20-25-8; ASC 840-10-25-27; IFRS 3.17].	Classification of a lease contract should be reassessed by the acquirer [ASC 840-10-25-32].	Classification of a lease contract should be reassessed based on facts and circumstances, because no specific guidance is provided under IFRS.

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
Situations where the fair value of the assets acquired and liabilities assumed exceeds the fair value of consideration transferred (referred to as bargain purchases)	If the fair value of the assets acquired and liabilities assumed exceeds the fair value of the consideration transferred (taking into effect the fair value of any noncontrolling interest to be recorded and the fair value of the acquirer's previously held equity interests in the acquiree), a gain shall be recognized by the acquirer [ASC 805-30-25-2; IFRS 3.34].	Assets acquired and liabilities assumed are measured at the fair value of consideration transferred (unless the fair value of the assets acquired and liabilities assumed is more reliably determinable). Because the measurement principle for asset acquisitions continues to be based on cost, a gain is generally not recognized for a bargain purchase. Thus, we believe the bargain purchase element should be reflected as a reduction of the relative fair value of the nonmonetary long-lived assets acquired.	Assets acquired and liabilities assumed are measured at the fair value of consideration transferred (unless the fair value of the assets acquired and liabilities assumed is more reliably determinable). Because the measurement principle for asset acquisitions continues to be based on cost, a gain is generally not recognized for a bargain purchase. Thus, we believe the bargain purchase element should be reflected as a reduction of the relative fair value of the nonmonetary long-lived assets acquired.
Contingent consideration	Contingent consideration is recorded at fair value on the date of acquisition. Subsequent changes in the fair value of the contingent consideration not classified as equity are recorded through earnings until settled [ASC 805-30-25-5; IFRS 3.39].	Contingent consideration is generally recorded when probable and reasonably estimable. Subsequent changes in the recorded amount of the contingent consideration are recorded against cost [ASC 323-10-35-14A; ASC 360-10-30-1; ASC 450-20-25-2].	Contingent consideration is generally recorded at fair value on the date of purchase. An accounting policy election may be made to record the subsequent changes in fair value against cost [IAS 16] or in earnings [IFRS 9; IAS 39].
Measurement period adjustments	The acquirer has a period of time, referred to as the measurement period, to finalize the identification and measurement of assets acquired, liabilities assumed, and consideration transferred. Measurement period adjustments are recognized in the	The concept of measurement period adjustments does not exist for asset acquisitions. Assets acquired are recorded at fair value on the acquisition date [CON 5].	The concept of measurement period adjustments does not exist for asset acquisitions. Assets acquired are recorded at fair value on the acquisition date [IAS 16.6].

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
	reporting period in which the adjustment amount is determined [ASC 805-10-25-13, IFRS 3.45].		
Indemnifications	Indemnification assets are recognized and measured based on the related indemnified item [ASC 805-20-30-18, IFRS 3.27].	Indemnifications provided outside of a business combination are generally measured at fair value [ASC 450].	Indemnifications provided outside of a business combination are generally measured at fair value.
Fair value measurement date	The acquirer measures the assets acquired and liabilities assumed in a business combination on the date control is obtained [ASC 805-10-25-6, IFRS 3.8].	Assets acquired are generally measured at the fair value of the consideration transferred on the acquisition date.	Assets acquired are measured at the fair value of the consideration transferred on the date of acquisition, which is the date control is obtained [IAS 16.6, IFRS 2]
Remeasurement of a previously held noncontrolling interest	On the acquisition date, the change in the previously held equity interest in the acquiree is remeasured at fair value. The acquirer recognizes an unrealized gain or loss in earnings based on the re-measurement of the previously held interest [ASC 805-10-25; IFRS 3.42].	There is no guidance outside of a business combination requiring the remeasurement of a previously held interest.	There is no guidance outside of a business combination requiring the remeasurement of a previously held interest.
Reacquired rights	A reacquired right is generally an identifiable intangible asset that the acquirer recognizes separate from goodwill. Reacquired rights are measured based on the estimated cash flows over the remaining contractual life and not based on market participant assumptions (an exception to the fair value principle).	There is no guidance outside of a business combination on reacquired rights. An asset may be recognized at fair value if there is probable future economic benefit [CON 6].	There is no guidance outside of a business combination on the settlement of a pre-existing relationship. An asset may be recognized at fair value if it is controlled by the entity and future economic benefits are expected to flow to the entity [IAS 38.8].

Topic	Business combinations	Asset acquisition under US GAAP[2]	Asset acquisition under IFRS
	Any settlement gain or loss should be measured consistent with the guidance for pre-existing relationships [ASC 805-20-25-15; IFRS 3.B36].		
Settlement of pre-existing relationships	A pre-existing relationship can be contractual or noncontractual. The settlement of a contractual relationship is measured as the lesser of the amount the contract terms are favorable/unfavorable and the amount of any stated settlement provisions in the contract. The settlement of a noncontractual relationship is measured at fair value on the acquisition date. Any gain or loss on settlement is recognized in the income statement [ASC 805-10-55-21; IFRS 3.B52].	There is no guidance outside of a business combination on the settlement of a pre-existing relationship. Settlement gains and losses are generally recognized in the income statement consistent with the guidance for business combinations.	There is no guidance outside of a business combination on the settlement of a pre-existing relationship. Settlement gains and losses are generally recognized through profit and loss.

[1] Financial assets (excluding equity-method investments) and assets subject to recurring fair value impairment testing (e.g., indefinite-lived intangible assets) would not be allocated a portion of the excess consideration [ASC 805-50-30-3]. Increasing the accounting basis of these assets at acquisition would likely lead to an impairment at the next testing date.

[2] Refer to BCG 2.11 for additional guidance on applying business combination or asset acquisition guidance to variable interest entities.

Additional differences may exist for other items such as employee benefits, financial instruments, and common control transactions, which are described below.

Employee benefits

Employee benefits, such as share-based compensation plans, pension plans, are not a common element in asset transactions, except in instances when an acquired set is considered an asset as a result of the screen test (refer to BCG 1 for additional information on the screen test). In this case, any specific relief provisions in the business combination standards (ASC 805, IFRS 3) do not apply as an asset acquisition is not within the scope of those standards. Assume an acquired set includes employees with share-based compensation awards that are replaced with awards of the acquirer. If the set is determined to be a business, the replacement awards issued may represent consideration for precombination services, postcombination services, or both. Therefore, a portion of the expense may need to be attributed to the precombination period. See BCG 3.4 for further details. If the set is determined to be an asset, the full amount of the replacement awards would be considered new awards and accounted for prospectively, and recorded in the postcombination period. This may result in an increase in the postcombination expense in an asset acquisition as compared to a business combination.

Common control transactions

The accounting for common control transaction can differ depending on whether the transaction is a transfer of assets or a transfer of a business. See BCG 6 for further information.

Deferred taxes on the acquisition of in-process research and development (IPR&D)

Under US GAAP, IPR&D acquired in an asset acquisition is expensed if it has no alternative future use. Such write-off occurs on the acquisition date prior to the measurement of deferred taxes. Accordingly, deferred taxes are not provided on the initial differences between the amounts assigned for financial reporting and tax purposes, and IPR&D is charged to expense on a gross basis. However, in a non-taxable business combination, deferred taxes are measured and recorded on the acquired IPR&D at the acquisition date. Under IFRS, IPR&D is recognized as an asset in both a business combination and an asset acquisition (refer to Figure 7-1).

7.2.5 Accounting after acquisition

The subsequent accounting for an asset or liability is based on the nature of the asset and liability, not the manner of its acquisition. The basis for measuring the asset or liability, whether cost or fair value, has no impact on the accounting of the asset or liability after acquisition, as described in ASC 805-50-35-1 and IFRS 3.54.

7.2.6 Acquisition of intangible assets disclosures

Specific disclosures for intangible assets acquired in a transaction other than a business combination are required. US GAAP companies should follow the disclosure requirements of ASC 350-20-50-1 through 50-3 with respect to intangible assets acquired in an asset acquisition.

IFRS companies should follow the disclosure requirements of IAS 38.118-123 with respect to intangible assets acquired in an asset acquisition.

Chapter 8: Accounting for intangible assets postacquisition—US GAAP

8.1 Chapter overview

This chapter discusses the accounting for indefinite-lived intangible assets acquired in a business combination or an asset acquisition. It also addresses how to determine if an intangible asset is indefinite-lived and how to assess such assets for impairment.

The accounting for tangible and finite-lived intangible assets, including how to determine their depreciable lives and details on the various methods of depreciation are included in PPE 3. How to assess, calculate, and record impairments on these assets is included in PPE 4.

8.2 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 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 entity's cash flows. Support for such assertions may include inquiries of those individuals who are responsible for managing the intangible asset, discussions with valuation experts, and internal and external empirical data. 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.

Examples 8-1 and 8-2 illustrate the determination of useful lives.

EXAMPLE 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 the asset might be impaired in accordance with ASC 350-30-35-18.

EXAMPLE 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. The technology is not considered to be in-process research and development.

What useful life 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 be able to support Brand K having an indefinite life.

8.2.1 Reclassification of intangible assets between indefinite-life and finite-life categories

As described in ASC 350-30-35-17, when an entity subsequently determines that an indefinite-lived intangible asset has a finite useful life, the entity should test the asset for impairment as an indefinite-lived intangible asset prior to commencing amortization. The intangible asset should then be amortized 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, if a long-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. While the reclassification of an indefinite-lived intangible asset to a long-lived intangible asset may occur as a result of changes in circumstances, the reclassification of a long-lived intangible asset to an indefinite-lived intangible asset is expected to be rare.

8.2.2 Renewable intangible assets

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 intangibles, 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

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. Reacquired rights are addressed in PPE 3.2.2.2. See BCG 2.5.6.1 for further information on the determination of the value and useful life of reacquired rights.

8.2.4 Intangible assets used in research and developmental activities

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 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 would be impaired. If the activities are completed, the acquiring entity would make a determination of the useful lives and methods of amortization of those assets. 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 not be amortized; instead, they would be subject to an impairment assessment, at least annually. 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. Impairment of acquired research and development intangible assets immediately after acquisition is possible but rare.

ASC 805 and ASC 820 significantly changed the valuation and accounting for indefinite-lived intangible research and development assets acquired in a business combination. As a result, the AICPA issued the IPR&D Guide. The purpose of the IPR&D Guide is to provide a best practices publication addressing the financial reporting and emerging practice issues companies are dealing with in regards 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 BCG 7.2.4 for further information on research and development assets acquired outside of a business combination.

8.2.4.1 Enabling technology

The IPR&D Guide eliminates the concept of core technology and introduces the concept of enabling technology which is intended to have a narrower definition. Enabling technology is defined in the IPR&D Guide as follows:

Partial definition from IPR&D 6.51

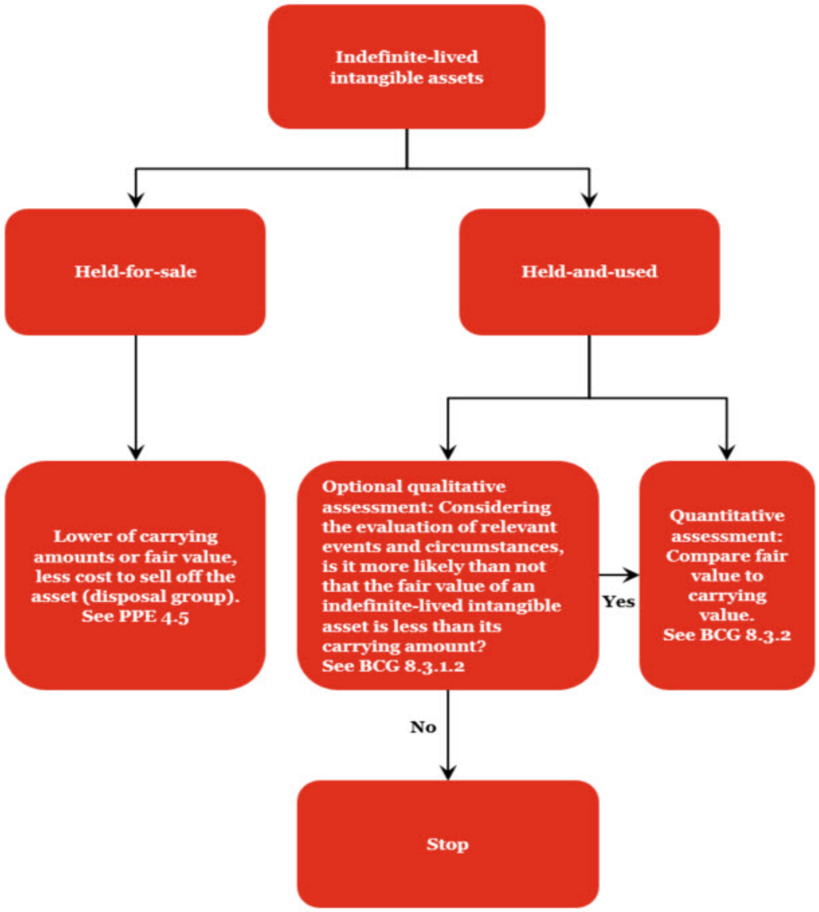
Enabling technology: …underlying technology that has value through its continued use or reuse across many products or product families.

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 account 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 will be recognized as a separate asset less frequently than core technology had previously been recognized, and that the introduction of enabling technology is not expected to significantly contribute to the amount of recognized goodwill. As a result, elements of value previously included in core technology likely will be recognized separately as identifiable intangible assets that increase the value of developed technology and/or an IPR&D asset.

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 is the condition that 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 to be impaired when the asset's carrying amount is greater than its fair value. There are various approaches to determine whether an impairment should be recognized and, if so, how to measure and record such impairment in the financial statements. The identification of the applicable impairment approach is an important part of assessing and measuring an asset's impairment.

Figure 8-1
Impairment approaches for indefinite-lived intangible assets



ASC 350 does not prescribe when to perform the annual impairment tests 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.

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. The impairment loss should be included in the subtotal "income from operations," if presented. 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 350-30-35-14.

8.3.1 The 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 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 The qualitative indefinite-lived intangible asset impairment assessment

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. Examples of such events and circumstances include:

- 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
- 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).
- Cost factors, such as increases in raw materials, labor, or other costs that will have a negative effect on future expected earnings and cash flows.
- Overall financial performance, such as negative or declining cash flows or a decline in actual or planned revenue or earnings
- Relevant entity-specific events, such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors.

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 Selecting an indefinite-lived intangible asset for the qualitative assessment

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 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 testing 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.

Question 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 Considering the results of prior fair value measurements in the qualitative assessment

When testing an indefinite-lived 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), 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 refreshing an indefinitve-lived asset's fair value*

Entities should consider periodically "refreshing" an indefinite-lived 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 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 *The quantitative indefinite-lived intangible asset impairment test*

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*

Some 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 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 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 intangible 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. ASC 350-30-35-23 and 35-24 provide a list of indicators (see table below) 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.

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.
	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. Also, when (1) the unit of accounting used to test indefinite-lived intangible assets for impairment is contained in a single reporting unit, and (2) a goodwill impairment loss for that reporting unit must be measured, an entity should use that same unit of accounting and the associated fair value for the indefinite-lived intangible assets in performing step two of the goodwill impairment test.

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 8-3 illustrates the determination of the unit of accounting for trade names.

EXAMPLE 8-3

Unit of accounting—trade names

Company Y purchases Company A, an international vacuum cleaner manufacturer, which sells vacuums under a well-known trade name. The operations of Company A are conducted through separate legal entities in three countries, and each of those legal entities owns the registered trade name used in that country. When the business combination was recorded, Company Y recorded three separate intangible trade name assets, because separate financial statements are required to be prepared for each separate legal entity. There are separate identifiable cash flows for each country, and each country represents an ASC 360-10 asset group. Each intangible trade name was deemed to have an indefinite life. A single brand manager is responsible for the combined trade name, the value of which is expected to be recovered from the worldwide sales of Company A's products.

What is the appropriate unit of account for the acquired trade names?

Analysis

The three separately-recorded trade name assets should be combined into a single unit of accounting for purposes of testing the acquired trade name for impairment at the consolidated reporting level. The three registered trade names were acquired in the same business combination and, absent the requirement to prepare separate financial statements for subsidiaries, would have been recorded as a single asset. The trade name is managed by a single brand manager. If sold, Company Y would most likely sell all three legally registered trade names as a single asset.

Unit of accounting for intangible assets used in research and development activities

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. Factors to consider in making this determination may include:

Jurisdictional asset:

- The nature of the activities and costs necessary to further develop the project are not substantially the same.
- The risks associated with the further development of the project are not substantially the same.
- The amount and timing of benefits expected to be derived in the future from the developed asset(s) are not substantially the same.
- Based on historical experience and current intent, once completed, the product (if ever 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 associated with the further development of the IPR&D project are substantially the same. For example, the development of the project will occur centrally and the company only intends to incur a small portion of the total development costs to obtain approval within each regulatory jurisdiction towards the later stages of testing.
- Advertising and selling costs will be managed from the perspective of a global brand, not the individual jurisdictions where the product is sold.
- The amount and timing of benefits expected to be derived in the future from the developed asset(s) and the expected economic life of the developed assets are substantially the same.
- Based on historical experience and current intentions, once completed, the compound (if ever transferred) would be transferred in one worldwide arrangement.

None of these factors are individually determinative, and the assessment should be based on the facts and circumstances specific to each situation.

Example 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 8-4

Unit of account

Company C acquired Company D, which is accounted for as an acquisition of a business. 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 for it 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 account 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.

8.4 Assets that an acquirer does not intend to actively use, including defensive assets

ASC 805-20-30-6 requires an entity to recognize and measure an asset acquired in a business combination at its fair value 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 for further discussion of potential issues associated with the use of market-participant assumptions, and the valuation techniques and approaches utilized.

A defensive asset is an intangible asset that an entity does not intend to actively use, but intends to prevent others from using. Notwithstanding the lack of active use by the buyer, ASC 805 requires that fair value be determined through the lens of a market-participant. In November 2008, the EITF concluded the following:

- A defensive asset should be considered a separate unit of accounting. This means that a defensive asset should be accounted for as an individual asset and should not be grouped with the acquirer's existing asset(s) whose value it may enhance.

- The useful life of a defensive asset should reflect the acquiring entity's consumption of the defensive asset's expected benefits. The consumption period should be the period over which the defensive asset is expected to contribute directly or indirectly to the acquiring entity's future cash flows.

- Classification of a defensive intangible asset as an indefinite-lived intangible asset would be rare, as the value will likely diminish over a period of time.

- A defensive intangible asset cannot be considered immediately abandoned following its acquisition.

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.

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. 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 8-5

Defensive intangible asset

Company Z purchases Company B, an international widget manufacturer, which sells its products under a well-known trade name. The trade name was deemed to have an indefinite life; its value is expected to be recovered from the worldwide sales of Company B's products.

Several years after the acquisition, Company Z made the strategic decision to consolidate its brands. The Company B trade name will be phased out and the company's products will be sold under another Company Z trade name. Company Z will continue to hold the trade name as a defensive asset but will no longer market it.

What is the impact on the useful life of the Company B trade name asset?

Analysis

As Company Z no longer intends to use the trade name indefinitely, it should likely assign a useful life to the trade name as the new strategy is to hold it as a defensive asset and not to continue to operate under the brand. The trade name fair value is expected to diminish over time as the trade name is no longer promoted. Therefore, the trade name useful life is based on the period it is expected to be used to defend Company Z's other trade name(s).

8.5 Financial statement presentation and disclosure guidance

ASC 350-30-50-1 through 50-3A include presentation and disclosure requirements for intangible assets. For public entities, Article 5-02 of Regulation S-X provides disclosure requirements for intangible assets that are in excess of five% of total assets and for accumulated amortization of intangible assets. For further details, refer to FSP 8.9.1.

Chapter 9: Accounting for goodwill postacquisition—US GAAP

9.1 Chapter overview

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, 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, including goodwill recognized by not-for-profit entities (ASC 958-805-35) and private companies applying ASU 2014-02, *Accounting for Goodwill*.

Under ASC 350, goodwill is not amortized. Rather, an entity's goodwill is subject to periodic impairment testing. ASC 350 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. 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 step one of 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 identify potential impairment and measure an impairment loss, if any.

To perform step one of 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

Prior to the adoption of ASU 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment* (discussed below), if a reporting unit fails step one (i.e., the reporting unit's carrying amount exceeds its fair value), step two requires an assignment of the reporting unit's fair value to the reporting unit's assets and liabilities, using the acquisition method accounting guidance in ASC 805 to determine the implied fair value of the reporting unit's goodwill.

The implied fair value of the reporting unit's goodwill is then compared to the carrying amount of the reporting unit's goodwill to determine the goodwill impairment loss to be recognized, if any.

In January 2014, the FASB and the Private Company Council (PCC) issued ASU 2014-02, *Accounting for Goodwill* (the "goodwill alternative"). Under the goodwill alternative, a private company is able to amortize goodwill on a straight-line basis over a period of ten years or over a shorter period if the company demonstrates that another useful life is more appropriate. Goodwill would only be subject to impairment testing upon the occurrence of a triggering event. Whether to test goodwill at the entity-wide or reporting unit level is a policy election that is required to be made on the date the goodwill alternative is adopted. See BCG 9.12 for more information on the US private company goodwill alternative. All other sections of this chapter address the accounting for goodwill by entities not applying this alternative.

New guidance

In January 2017, the FASB issued ASU 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*. The revised guidance eliminates step two of the goodwill impairment test, which requires a hypothetical purchase price allocation to measure goodwill impairment. A goodwill impairment loss will instead be measured at the amount by which a reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary.

The revised guidance will be effective for public business entities that are SEC filers for annual and interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Other public business entities will have an additional year. All other entities that have not elected the PCC alternative for goodwill will be required to apply the guidance in fiscal years beginning after December 15, 2021. Early adoption is permitted for any impairment test performed on testing dates after January 1, 2017 for financial statements that have not yet been issued.

9.2 Identify 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.

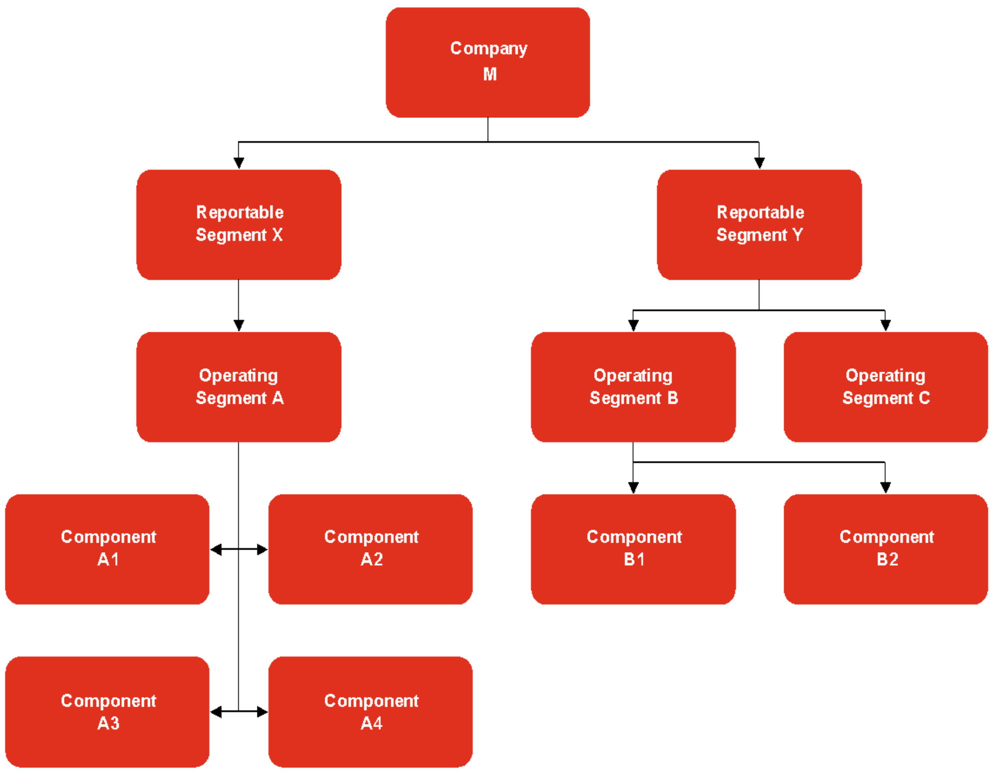
One level below an operating segment is referred to as a component. A component of an operating segment is required to be identified as a reporting unit if the component is a business for which discrete financial information is available and segment management regularly reviews the operating results.

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 9-1 is an example of a company's reporting structure used to determine its reporting units and will be referred to throughout this section.

Figure 9-1

Reporting structure used to determine reporting units



9.2.1 *Operating segments as the starting point for determining 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 earn 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 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 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. 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 an 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.

Two or more components of an operating segment, which would qualify as reporting units on their own as discussed in the preceding paragraph, should be aggregated and deemed a single reporting unit if the components have similar economic characteristics. For instance, in Figure 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 combined.

ASC 350-20 does not specifically address situations in which one or more components of an operating segment qualify as a reporting unit (or reporting units) while the remaining components do not qualify. 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 Discrete financial information and business requirement for components

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. The guidance states that such financial information can consist of as little as capsule 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, ASC 350-20-55-4 states that 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 Components are combined if economically similar

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 provides a list of other factors that an entity should consider in determining economic similarity. The following additional factors, as well as any other relevant factors, should be considered when evaluating economic similarity:

- The manner in which an entity operates its business and the nature of those operations
- Whether goodwill is recoverable from the separate operations of each component business or from two or more component businesses working in concert
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects

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. In addition, when a component extensively shares assets and other resources with other components of the operating segment, it may indicate that the component either is not a business or may be economically similar to those other components.

9.2.5 Aggregation of components across operating segments is not permitted

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 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.

9.2.7 Summary of impact of reporting levels on determining reporting units

Figure 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 9-2
Reportable segment versus operating segment versus component

Term and definition	Use in determining reporting units
Reportable segment	
▫ 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.	▫ 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.
Operating Segment	
▫ Engages in business activities from which it may earn revenues and incur expenses. ▫ Discrete financial information is available. ▫ Operating results are regularly reviewed by the CODM to allocate resources and assess performance.	An operating segment will be a reporting unit if: ▫ All of its components have similar economic characteristics. ▫ None of its components is a reporting unit. ▫ It comprises a single component.

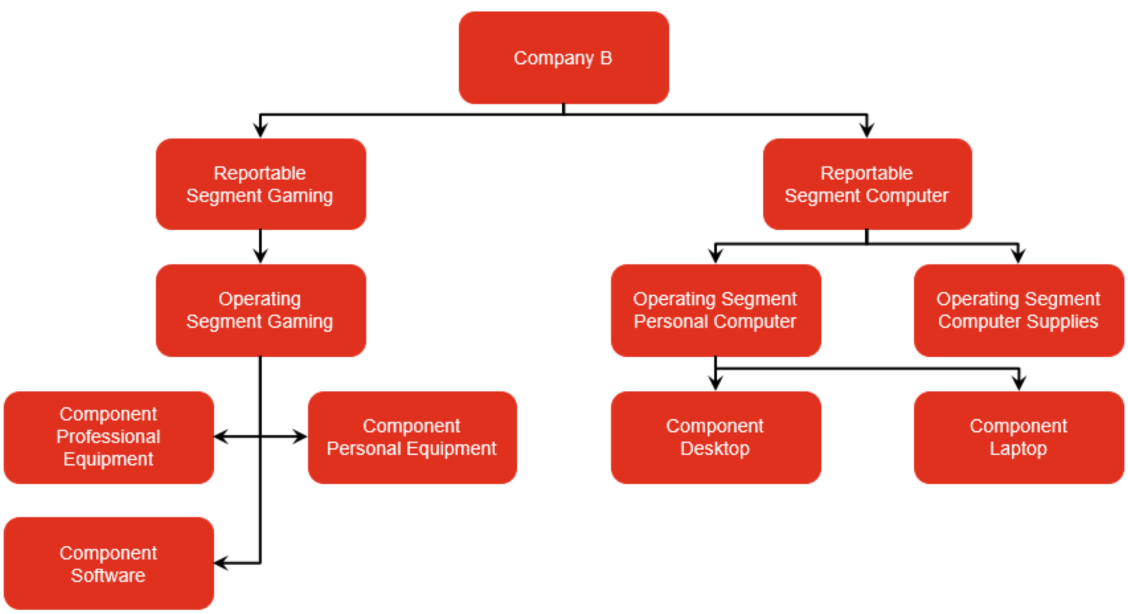
	Note: Unlike a component, as described below, an operating segment need not constitute a business to be deemed a reporting unit.
Component □ One level below an operating segment.	A component may be a reporting unit if: □ The component constitutes a business for which discrete financial information is available. □ Segment management regularly reviews the component's operating results. 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.

Example 9-1 provides an example of the identification of reporting units.

EXAMPLE 9-1

Identification of reporting units

Assume 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 resource allocation, 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. 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 concluded that:

- Component "Professional Equipment" is not economically similar to the components "Personal Equipment" and "Software"
- 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 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 and liabilities relating to 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 passed or failed step one of its goodwill impairment test.

Question 9-1

If a company has multiple reporting units, how should pension assets and liabilities be allocated 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 allocated 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 allocated to the reporting unit as a pension asset or liability would not transfer to an acquirer in a sale of the reporting unit.

Example 9-2 illustrates a method for assigning the carrying amount of an intangible asset employed in multiple reporting units.

EXAMPLE 9-2

Assignment of an intangible asset employed in multiple reporting units

An entity owns an acquired trade name that is used by several of its reporting units. The entity is determining the appropriate assignment of the trade name's recorded amount to the reporting units that use the name. The entity may not sell that trade name if the entity were to sell only one of the reporting units to a market participant. Rather, in exchange for a royalty on future product sales, the entity might grant an acquirer the right to continue using the trade name. The entity 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 entity 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 *Interaction between assigning assets and liabilities to reporting units and segment reporting*

ASC 280-10-50-20 through 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. Note, however, that in addition to ASC 280's segment disclosure requirements, 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.

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 or allocated 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. 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 intercompany contingent consideration obligations or assets in a reporting unit's carrying amount if an acquiring market participant would assume that obligation or asset.

- Deferred taxes other than for net operating losses (NOLs): 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 9-2 below.)

- Deferred taxes arising from NOLs and credit carryforwards: ASC 350-20 does not specifically address whether deferred tax assets arising from NOL and credit 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 credit 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 Examples 9-3 and 9-4 below.)

- Cumulative translation adjustments: Under ASC 830, 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. We believe the carrying amount of the reporting unit should include assets and liabilities at their currently translated amounts (i.e., the balance of the net assets, excluding the amount recorded as CTA in equity). (See Example 9-5 below.)

Question 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 step one of the 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 allocate 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 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 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, so do not meet the criteria in ASC 350-20-35-39.

EXAMPLE 9-5

Consideration of CTA in reporting units

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 CU300)	CU1,000
Total liabilities	(750)
Total net assets	CU250
Paid-in capital and retained earnings	CU(200)
Cumulative translation adjustment	(50)
Total equity	CU(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 step one of the goodwill impairment test would be CU250 million, which represents the net assets of the reporting unit at their currently translated amounts. Prior to adoption of ASU 2017-04, for step two of the goodwill impairment test, the carrying amount of the reporting unit's goodwill would be at the translated amount of CU300 million, and the implied fair value of goodwill would be determined based on the reporting unit's fair value at the impairment testing date.

9.4 Assigning all recorded goodwill to one or more reporting units

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 synergies of 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. In addition, the methodology should be consistent with the objectives of the approaches described in ASC 350-20-35-42 to 43. ASC 350-20-42 to 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 fair value of the existing reporting unit before and after the acquisition in determining the amount of goodwill to assign to that reporting unit.

Examples 9-6 and 9-7 illustrate these two approaches for purposes of assigning goodwill to reporting units.

EXAMPLE 9-6

Acquisition method approach

Company X acquires Company Y for CU1,500. The fair value of the identifiable net assets acquired is CU1,000. Company X assigns the identifiable net assets of the acquired entity with fair values of CU200 and CU800 to new Reporting Units A and B, respectively. The net assets assigned represent businesses whose fair values are CU500 and CU1,000, 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	CU500	CU1,000	CU1,500
Fair value of identifiable net assets assigned to reporting units (excluding goodwill)	(200)	(800)	(1,000)
Goodwill assigned	CU300	CU200	CU500

EXAMPLE 9-7

With-and-without approach

Company X acquires Company Y for CU1,500. The fair value of the identifiable net assets acquired is CU1,000. 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).

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			CU1,500
Fair value of identifiable net assets (excluding goodwill)		CU1,000	(1,000)
Fair value of unit C with acquisition	CU2,000		
Fair value of unit C without acquisition	(1,900)		
Goodwill assigned	CU100	CU400	CU500

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 allocation 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 Determination and 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.

Example 9-8 illustrates the full goodwill recognition method for partial acquisitions prescribed in ASC 805.

EXAMPLE 9-8

Goodwill in a partial acquisition

Company A obtains control of Company B by purchasing 80% of the equity interests in Company B for total consideration of CU800 million. The net aggregate value of Company B's identifiable assets and liabilities measured in accordance with ASC 805 is determined to be CU700 million, and the fair value of the noncontrolling interest is determined to be CU200 million.

What amount of goodwill should be recognized at the acquisition date?

Analysis

At the acquisition date, the acquirer should recognize (1) 100% of the identifiable net assets, (2) the noncontrolling interest at fair value, and (3) goodwill measured as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred measured in accordance with ASC 805, 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 net assets acquired, measured in accordance with ASC 805

(in millions)	
Fair value of the consideration transferred	CU800
Fair value of the noncontrolling interest	200[1]
Fair value of previously held equity interest	n/a
Subtotal (a)	1,000
Fair value of 100% of the identifiable net assets (b)	(700)[2]
Goodwill recognized (a – b)	CU300[3]

[1] As more fully described in BCG 5.4.4 and FV 7.3.5, the fair value of the noncontrolling interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the noncontrolling interest may have to be independently measured.

[2] The value of 100% of the identifiable net assets of Company B measured in accordance with ASC 805.

[3] The full amount of goodwill is recognized.

9.4.2 *Goodwill attributable to controlling and noncontrolling interests*

In partial acquisitions, goodwill is recognized for the controlling and the noncontrolling interests. Any future impairment loss will need to be attributed to the controlling and the noncontrolling interests on a rational basis in accordance with ASC 350-20-35-57A. See BCG 9.9.4 and 9.9.4.1 for examples of acceptable methods of attributing any impairment loss.

Example 9-9 continues the previous Example 9-8 and illustrates a rational method of attributing goodwill to the controlling and noncontrolling interests for purposes of allocating a goodwill impairment loss. See BCG 9.9.4 for further information.

EXAMPLE 9-9

Goodwill attributable to controlling and noncontrolling interests

Assuming the same facts as Example 9-8, how would goodwill be attributed to the controlling and noncontrolling interests?

Analysis

The total goodwill of CU300 million would be attributed as follows (in millions):

Fair value of the noncontrolling interest	CU200
Noncontrolling interest's share of the recognized net assets	(140)[1]
Goodwill attributable to the noncontrolling interest	CU60

Fair value of the consideration transferred	CU800
Controlling interest's share of the recognized net assets	(560)[2]
Goodwill attributable to the controlling interest	CU240

[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% × CU700).

[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% × CU700).

9.4.3 *Determination of fair value for the noncontrolling interest*

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 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 5.4.4 and FV 7.3.5 for further information on these techniques and methods.

9.4.4 *Reassignment of goodwill as an 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. 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 as outlined in ASC 350-20-35-45. See BCG 9.10 for further information. As a result, the amount of goodwill allocated 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 unit(s).

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. Examples 11-10 and 11-11 illustrate the reassignment of goodwill.

EXAMPLE 9-10

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, in connection with a corporate restructuring. The fair value of the transferred operations was determined to be CU50 million, with CU20 million assigned to the operations transferred to Reporting Unit B and CU30 million to operations associated with Reporting Unit C. The fair value of the remaining elements in Reporting Unit A is CU150 million. Total goodwill assigned to Reporting Unit A before the restructuring was CU40 million.

How should goodwill be reassigned for each reporting unit?

Analysis

The goodwill reassignment would be as follows (CUs in millions):

	Reporting Unit A	Reporting Unit B	Reporting Unit C	Total
Fair values	CU150	CU20	CU30	CU200
Relative fair value	75%	10%	15%	100%
Goodwill	CU30	CU4	CU6	CU40

EXAMPLE 9-11

Reassignment of goodwill when reporting structure changes

Company Z has 2 reporting units, Reporting Unit 1 and Reporting Unit 2, with goodwill of CU1 million and CU2 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, 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 allocated 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 re-allocated to the new reporting units (i.e., goodwill should not be aggregated for each reorganized reporting unit before the re-allocation).

In this case, CU1 million of goodwill from Reporting Unit 1 should be reallocated 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). CU 2 million of goodwill from Reporting Unit 2 should be allocated 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 reallocation of Reporting Unit 1	400,000	400,000	150,000	50,000		1,000,000
Goodwill reallocation 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

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.

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 9-12 illustrates the translation of goodwill assigned to a foreign entity.

EXAMPLE 9-12

Translation of goodwill assigned to a foreign entity

During the period, Company A acquired Business X in Europe, whose functional currency is the Euro. On the acquisition date, goodwill was determined to be €100 million, which was the equivalent of CU150 million, and was recorded at the parent level and not pushed down to Business X's general ledger. At period-end, the €/CU exchange rate is 1.25 (1€ for 1.25CU).

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 CU125 million with a corresponding charge to other comprehensive income of CU25 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.

Example 9-13 illustrates an acceptable method to assign a change in goodwill due to the effects of changes in foreign exchange rates.

EXAMPLE 9-13

Assigning changes in goodwill due to changes in foreign exchange rates

Assume from Example 9-12 that 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 CU 25 million in Example 9-12 be assigned to each reporting unit?

Analysis

The CU25 million decrease in goodwill resulting from foreign currency translation would be assigned, CU20 million (CU25 ×€80 / (€20 + €80)) to Reporting Unit 1 and CU5 million (CU25 ×€20 / (€20 + €80)) 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.

9.4.7 Other considerations

Two items that may impact the amount of recorded goodwill assigned to one or more reporting units include (1) subsequent changes in assets and liabilities recognized from acquisitions completed prior to the adoption of ASC 805 that may continue to impact goodwill and (2) the impact of litigation stemming from a business combination.

9.4.7.1 Subsequent resolution of certain matters arising from acquisitions recorded prior to the adoption of ASC 805 that may continue to impact goodwill

The accounting for changes in assets and liabilities that arose from business combinations consummated prior to the adoption of ASC 805 is not specifically addressed in ASC 805, except for income tax uncertainties and reductions in the valuation allowance recognized at the acquisition date for deferred tax assets, which are recognized through the income statement even if related to an acquisition consummated prior to the adoption of ASC 805. See TX 10.5.5 and TX 10.6.2 for further information. The accounting for the resolution of certain matters arising from acquisitions recorded prior to the adoption of ASC 805 is summarized below.

Resolution of contingent consideration

Under ASC 805, resolution of a contingent consideration arrangement in an amount different from that recorded at the acquisition date will be reflected in earnings or within equity if the arrangement is equity classified. See BCG 2.6.4.1 for further information. However, the resolution of a contingent consideration arrangement for business combinations accounted for under prior standards will generally be recorded as additional goodwill subsequent to the adoption of ASC 805.

Liabilities for exit activities

Previously, liabilities for exit activities planned in connection with a business combination could be established as an additional cost of the acquisition under EITF 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3), if certain conditions were met. Subsequent reductions of such liabilities when the original estimate of the liability exceeded the ultimate cost expended were usually recorded as an adjustment to goodwill, irrespective of when the adjustment was made. Conversely, subsequent increases to the original estimate of such liabilities were generally recorded in earnings.

Under ASC 805, companies must account for any exit activities, including those arising in connection with a business combination, using the guidance in ASC 420, which addresses the recognition and measurement of accruals for exit activities. For business combinations, exit activities stemming from the acquisition should be recorded through earnings in accordance with ASC 420. See BCG 2.5.15 for further information. However, liabilities previously established under EITF 95-3 (i.e., as an additional cost of the acquisition) are not eliminated under ASC 805, and the subsequent accounting for the difference, if any, between the ultimate cost of the exit plan and the original amount recorded as a liability will not change (i.e., reductions are recorded against goodwill and increases are generally recorded in earnings).

Tax benefits of nonqualified share-based payment awards

Under ASC 805, a deferred tax asset is recorded at the acquisition date related to the tax benefit derived from recording the fair value of nonqualified share-based payment awards (i.e., awards that would typically result in a tax deduction) that are issued as part of the consideration transferred for the acquiree. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is greater than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the tax benefit related to the excess tax deduction (i.e., windfall) should be recorded as an adjustment to additional paid-in capital. If the tax deduction received by the acquirer upon exercise of stock options or vesting of restricted shares is less than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the resulting difference (i.e., shortfall) should be charged first to additional paid-in capital, to the extent of the acquirer's pool of windfall benefits. Any remaining shortfall would be recognized in income tax expense. Windfalls and shortfalls generated from replacement awards would impact the acquirer's pool of windfall tax benefits as determined in accordance with ASC 718. As a result, adjustments are no longer made to goodwill for the subsequent income tax effects of replacement awards issued in an acquisition recorded under ASC 805.

New guidance

Upon adoption of ASU 2016-09, *Stock compensation*, any difference between the tax deduction reported on a tax return for a replacement award classified as equity and the fair value is recognized as income tax expense or benefit in the income statement of the acquirer.

ASU 2016-09 is effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. For all other entities, it is effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption.

9.4.7.2 Litigation stemming from a business combination

Generally, any economic consequences of legal claims between the acquirer and the former owners of the acquiree in a business combination should be reflected in earnings of the acquirer in the postcombination period.

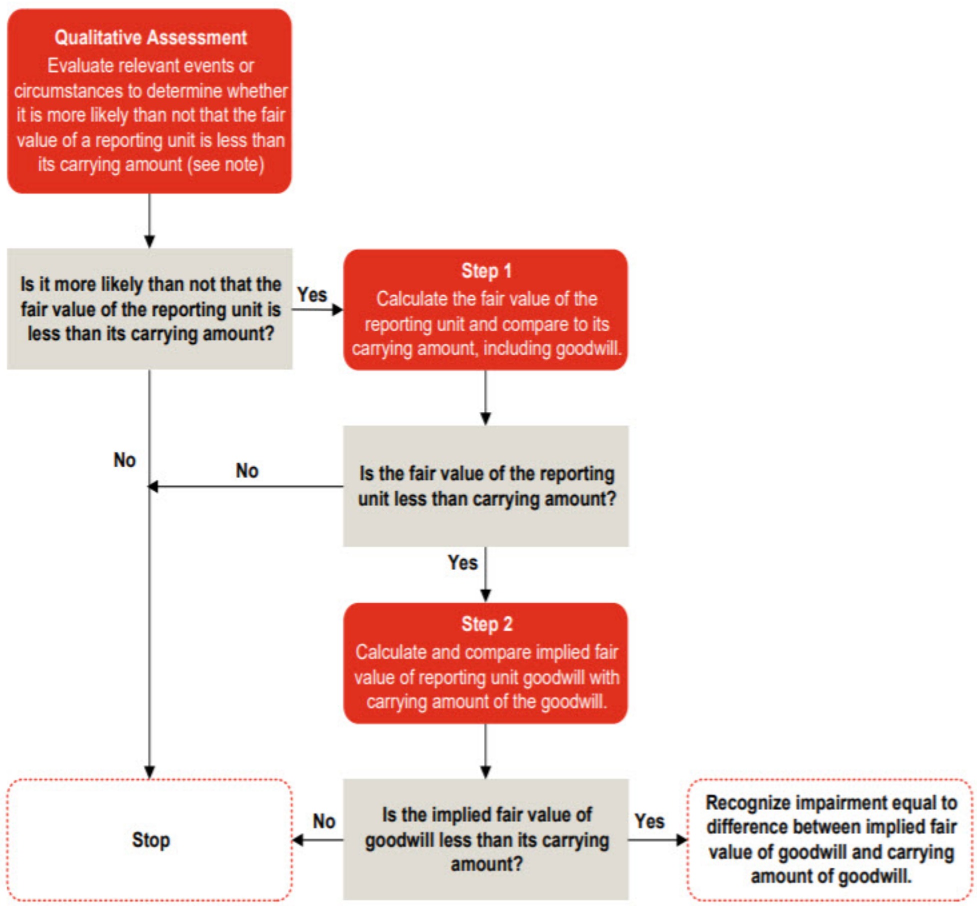
The SEC indicated in a speech by one of their staff members that the settlement of litigation regarding the acquisition price should only be accounted for as an adjustment to the initial acquisition accounting in situations where there is a clear and direct link between the litigation and the acquisition price. For example, 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. In contrast, 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.

9.5 *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 (refer to BCG 9.6).

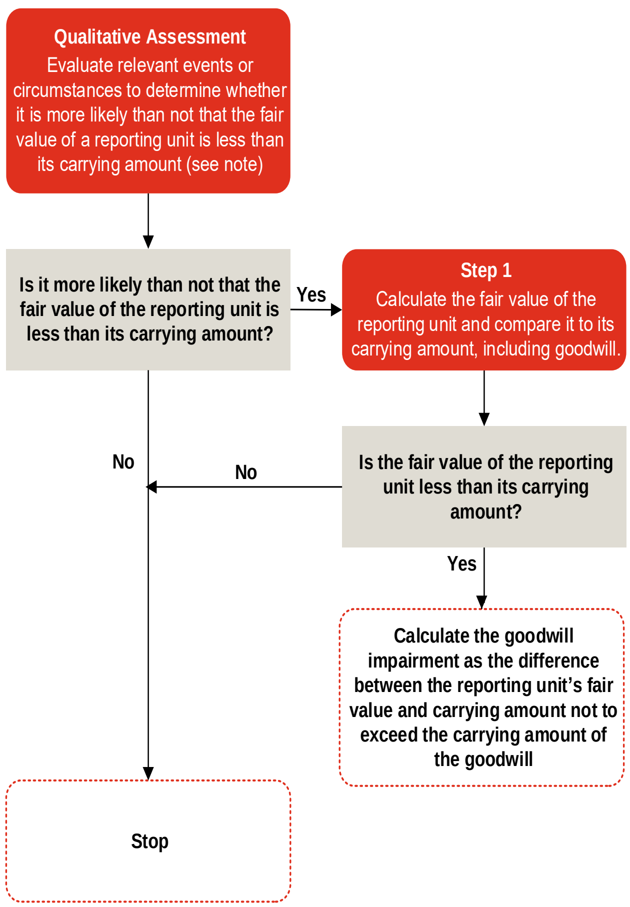
Under current guidance, if an entity bypasses the qualitative assessment or determines based on its qualitative assessment that further testing is required, the two-step goodwill impairment test should be followed. Step one of the goodwill impairment test entails identifying a potential impairment of goodwill (refer to BCG 9.8.1), while step two entails measuring the amount of impairment, if any (refer to BCG 9.8.2). Refer to Figure 9-3 below.

Figure 9-3
Current goodwill impairment model



In January 2017, the FASB issued ASU 2017-04, *Simplifying the accounting for goodwill impairment*. In the revised guidance, the optional qualitative assessment (step zero) and the first step of the quantitative assessment (step one) remain unchanged. Step two is eliminated. As a result, step one will be used to determine both the existence and amount of goodwill impairment. The revised guidance will be applied prospectively, and is effective for calendar year-end SEC filers in 2020. Other public business entities will have an additional year. Early adoption is permitted for any impairment tests performed after January 1, 2017. Once an entity has adopted ASU 2017-04, it must apply the revised impairment model for all future goodwill impairment tests. Adoption in a fiscal year is precluded if an impairment test earlier in that fiscal year (performed as of January 1, 2017 or later) applied the former impairment guidance. Refer to Figure 9-4 below for the revised impairment model.

Figure 9-4
Revised goodwill impairment model



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.

Under the current guidance, if the carrying amount of a reporting unit is zero or negative, goodwill of the reporting unit should be tested for impairment on an annual or interim basis if an event occurs or circumstances exist that indicate that it is "more likely than not" that a goodwill impairment exists. ASC 350-20-35-3A defines "more likely than not" as "a likelihood of more than 50%." The revised guidance eliminated this requirement. See BCG 9.8.1.3.

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, the goodwill of a reporting unit must also be tested for impairment if a portion of the reporting unit's goodwill has been included in the carrying amount of a business to be disposed of. See BCG 9.10 for further information.

Question 9-3

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.

The SEC staff provided the following additional examples of events that may indicate that an interim impairment test is necessary:

- 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 9-4

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. Additionally, if the carrying amount of a reporting unit is zero or negative prior to the adoption of ASU 2017-04, goodwill of that reporting unit should be tested for impairment on an interim basis if an event occurs or circumstances exist that indicate that it is more likely than not that a goodwill impairment exists.

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 9-5

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 the unit's carrying amount in step one (or if the implied fair value of goodwill is greater than its recorded amount under the step-two guidance), a company cannot record a goodwill impairment.

Question 9-6

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. 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 9-7

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 9-8

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.

Although annual goodwill impairment testing provides some assurance that goodwill impairment losses will be recognized in a timely manner, an entity's management should have appropriate processes and controls in place to monitor for interim triggering events. These processes and controls, however, may vary from entity to entity and from reporting unit to reporting unit, depending upon, among other things, the extent of differences that exist between a reporting unit's fair value and its carrying amount (i.e., cushion), the reporting unit's industry and relevant markets, the entity's experience, and the significance of goodwill recorded.

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, 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 dates

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. See BCG 9.8.2.5 for information on the accounting and disclosure considerations when an entity is unable to complete step two of the current goodwill impairment test prior to issuing its financial statements.

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). In addition, an entity with publicly traded securities in the United States is required to obtain a preferability letter from its auditor when making such a change. When an entity changes its annual goodwill impairment testing date, the period between annual impairment tests should not exceed 12 months.

Example 9-14 illustrates a change in the timing of the annual impairment test.

EXAMPLE 9-14

A change in timing of the annual 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 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 will 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 impairment test and, if so, performing step one of the 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 12 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 9-9

If a company performs step one of its annual goodwill impairment test at the beginning of the fourth quarter and passes step one, does the company need to further assess whether it may have a triggering event in the fourth quarter?

PwC response

While the company's reporting units passed step one 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 9-10

If a company performs its annual goodwill impairment test at the beginning of the fourth quarter and fails step one, 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 goodwill impairment test on October 1 and fails step one, and later in the fourth quarter, the company's stock price declines significantly, or other indicators of potential impairment arise, the company would need to give further consideration to the factors. Subsequent declines in a company's market capitalization may be an affirmation of facts and circumstances that existed as of the annual impairment test date or may represent new events that should be considered as an interim triggering event.

9.6 *The qualitative goodwill impairment assessment*

The following section applies to reporting units with a positive carrying amount. See BCG 9.6.5 for guidance regarding impairment testing of 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. Examples of such events and circumstances include:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline 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

- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

- Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more likely than not expectation of selling or disposing all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

- Share price. If applicable, a sustained decrease in share price—share price decreases should be considered not only in absolute terms but also relative to peers

These examples are not all-inclusive. An entity should consider other relevant events or circumstances specific to its reporting units when determining whether to perform step one of the 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 step one of the 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 step one of the 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 step one of the 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 potential goodwill impairment 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 9-15 illustrates the application of the qualitative goodwill impairment assessment by a company with two reporting units.

EXAMPLE 9-15

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 step one 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 step one 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 step one of the 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 step one of the 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 step one may still need to be performed, an entity may conclude it will be more efficient to perform a step one 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 step one of the 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 step one test, an entity may elect to perform a step one 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 ability of this reporting unit to pass step one to be highly sensitive to adverse changes in both 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 *Considering the results of prior fair value measurements in the 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 9-11

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 a step one 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 a 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 9-12

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 step one 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 step one 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 9-13

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 step one 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

9.6.5 Qualitative assessment for reporting units with zero or negative carrying amounts

Current guidance requires reporting units with zero or negative carrying amounts to be tested for impairment at least annually and, in certain circumstances, between annual tests. For these reporting units, an entity is required to qualitatively assess whether it is more likely than not that a goodwill impairment exists. If it is more likely than not that a goodwill impairment exists, the goodwill impairment test should be performed to measure the amount of impairment loss, if any.

In evaluating whether it is more likely than not that a goodwill impairment exists for these reporting units, an entity should, among other facts and circumstances, evaluate the same examples of qualitative factors as a reporting unit with a positive carrying amount described in BCG 9.6. In addition, an entity with a reporting unit with a zero or negative carrying amount should consider whether there are significant differences between the carrying amounts and the estimated fair values of the reporting unit's assets and liabilities, including unrecognized intangible assets. If the fair value of recognized assets are estimated to exceed their carrying amounts or if the fair value of unrecognized assets (e.g., a trade-name intangible asset) are significant, this will reduce the implied fair value of goodwill in the current step two test, and therefore, could impact the qualitative assessment.

As noted at BCG 9.8.1.3, the revised guidance in ASU 2017-04 eliminates the requirement to assess reporting units with zero or negative carrying amounts for goodwill impairment.

9.7 Fair value considerations

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 allocating 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 9-16, the premise used to allocate assets and liabilities to reporting units can impact the amount of goodwill impairment.

EXAMPLE 9-16

Impact of the valuation premise on goodwill impairment

Reporting Unit A has the following recorded assets and liabilities:

Goodwill	CU40
Other assets	CU60
Operating liabilities	CU(20)
Nonrecourse long-term debt	CU(60)

The fair value of Reporting Unit A excluding debt is CU50. 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	CU20[1]	CU80[2]
Fair value	0	50
Goodwill impairment	CU20	CU30

[1] CU40 (goodwill) + CU60 (Other assets) – CU20 (Operating liabilities) – CU60 (Long-term debt)

[2] CU40 (goodwill) + CU60 (Other assets) – CU20 (Operating liabilities)

9.7.2 *Determining the fair value of reporting units to which goodwill has been assigned*

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. 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, 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 make adjustments to 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, market, economic, and other factors that market participants typically take into account when determining the fair value of the entity.

Question 9-14

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 wellreasoned 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 9-15

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 9-16

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 allocating 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 for further information on ASC 820 and its impact on determining the fair value of reporting units.

9.7.3 Considerations unique to determining the fair value of reporting units when using the income approach

It is often necessary to make adjustments to 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. 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 a future acquisition as market participant cash flows typically would not include assumptions for acquisition activity.

- **Working capital:** The DCF method provides an indication of fair value that is consistent with normal levels of working capital. To the extent 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. Cash is generally excluded from working capital in the DCF model. Net working capital is generally calculated on a debt-free basis 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.

- **Nonoperating assets and liabilities:** To the extent nonoperating 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 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.

See FV 7.2.5.1 for further information about determining the fair value of a reporting unit using the income approach.

Question 9-17

If management uses a discounted cash flow approach to value a reporting unit and completes its annual budget process on 30 September, would it be reasonable for the company, which has 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 Considerations unique to determining the fair value of reporting units when 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 (for example, 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 subject is public), (2) have similar profitability (e.g., EBITDA, operating margin, contribution margin), (3) have similar anticipated 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 make adjustments to 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 step one of the 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 9-18

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 a reporting unit on a 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, as discussed in the preceding section, 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. However, stock prices after the impairment test date should not be considered unless those prices reflect the affirmation of events that existed as of the test date.

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 *Use of more than one valuation technique to estimate the fair value of a reporting unit*

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.

9.7.7 *Reconciling the aggregate fair values of the reporting units to market capitalization*

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 350-10, 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 step one 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 a step one 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 a step one 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 step one 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 9-19

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. Determining the factors affecting market capitalization and their impact on fair value requires the application of judgment.

Question 9-20

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 9-21

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 capitalization. Factors identified included 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 through either a one step (after adoption of ASU 2017-04) or two step (prior to adoption of ASU 2017-04) impairment test. Step one remains unchanged upon adoption of ASU 2017-04.

9.8.1 Step one: fair value of the reporting unit

Step one compares the fair value of the reporting unit with the reporting unit's carrying amount (book value), including goodwill, to identify any potential impairment. The book value in step one 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. Note that this assumes the reporting unit is not a disposal group or part of a disposal group under ASC 360. 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 considered not impaired, and step two is not performed.

- If the carrying amount of the reporting unit is greater than its fair value, the reporting unit's goodwill may be impaired, and step two must be completed to measure the amount of the goodwill impairment loss, if any, that may exist.

9.8.1.1 Additional considerations for performing step one – prior to adoption of ASU 2017-04

Step one of the goodwill impairment test serves as a "screening process" for determining whether goodwill might be impaired. As a result, the recorded amount of a reporting unit's goodwill may sometimes be "shielded" from an impairment loss, even if its implied value has decreased. This shielding in step one can arise from the fact that the carrying amount of the reporting unit does not reflect the value of any of the reporting unit's unrecognized assets, such as internally developed intangible assets, or any appreciation in the fair value of the reporting unit's recognized assets, such as real estate. However, such unrecognized assets, or assets recorded at less than their fair value, will increase the goodwill impairment loss if the performance of step two becomes necessary.

An entity is required to perform step one of the goodwill impairment test before performing step two, even if the entity believes goodwill is impaired. If a reporting unit passes step one, the entity does not proceed to step two. Example 9-17 illustrates how unrecognized assets could shield an entity from a goodwill impairment charge.

EXAMPLE 9-17

Shielding of goodwill with internally developed intangible assets

Company A operates in the pharmaceutical industry and has various reporting units based on geographic and operational criteria. Reporting Unit X encompasses its European operations, including sales and significant research and development (R&D) efforts. Reporting Unit Y is predominantly represented by the large manufacturing facilities in the United States.

Goodwill assigned to the two reporting units arose from an acquisition several years ago. An acquired product line, including brand names and customer relationships, has since deteriorated and is no longer a high market performer. This might indicate that the acquired goodwill has also lost some of its value and its implied fair value may have declined compared to its carrying amount.

In determining the fair values of the two reporting units for applying step one of the goodwill impairment test, management considered the following:

- Reporting Unit X has some promising new products arising from its internal R&D efforts, which are expected to drive significant cash flows over the next few years. The anticipated cash flows from the new products cause the fair value of the reporting unit to increase significantly without a corresponding asset recorded for the internally developed technology.

- Reporting Unit Y owns substantial parcels of land that are used for its manufacturing facilities or kept as a reserve for future expansion. A significant increase in the value of land in the region has resulted in an increase in the fair value of the reporting unit, without any recognition of the increase in land values in the reporting unit's carrying amount.

Should Company A recognize goodwill impairment for Reporting Units X and Y?

Analysis

Based on these facts, it is likely that management would conclude that the fair values were in excess of the carrying amounts of the reporting units, including goodwill. Thus, both reporting units would pass step one of the goodwill impairment test and management would not perform step two, even though there were indications that the goodwill's implied fair value was less than its book value.

9.8.1.2 Additional considerations for performing step one – after adoption of ASU 2017-04

There are certain incremental changes to consider with regard to how the quantitative test is performed under ASU 2017-04 related to the finalization of the goodwill impairment assessment and the impact of foreign currency translation adjustments.

Question 9-22

A company is performing its annual goodwill impairment test under ASU 2017-04. Can the company record a preliminary impairment in one period and determine the final amount of the impairment in a later period?

PwC response

No. Prior to the adoption of ASU 2017-04, current guidance permitted an entity to record a preliminary impairment in one period and determine the final amount of the impairment in a later period. This was permitted by the guidance because of the complexity involved in completing step two of the goodwill impairment test. This will no longer be allowed under the revised guidance.

The revised guidance simplifies financial reporting because it eliminates the need to determine the fair value of individual assets and liabilities of a reporting unit to measure any goodwill impairment. The amount of impairment recognized under the revised guidance could be larger or smaller than under today's model, largely depending on the difference between the carrying amount and fair value of assets and liabilities of the reporting unit.

As illustrated in Figure 9-5, an entity with significant unrecognized intangible assets or significantly appreciated assets may recognize a smaller goodwill impairment than today, whereas an entity with significant property, plant, and equipment with carrying amounts in excess of fair value (that did not trigger an impairment under ASC 360, *Property, Plant, and Equipment*) may recognize a larger goodwill impairment than today.

Additionally, under today's guidance, some companies may not recognize an impairment when they fail step one due to the mechanics of step two. Under the revised guidance, failing step 1 will always result in some goodwill impairment.

Question 9-23

How should foreign currency translation adjustments be treated when determining the carrying value of a reporting unit?

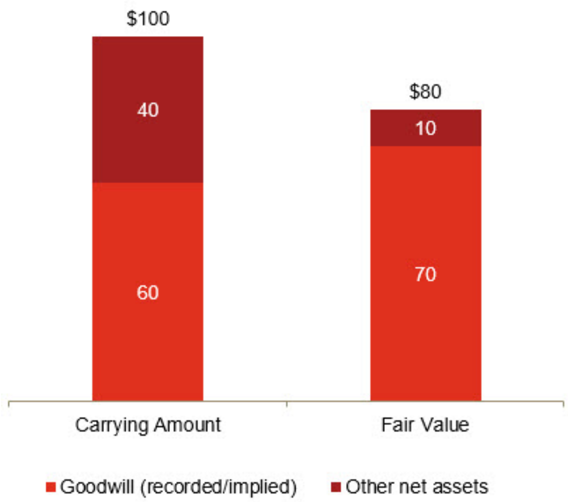
PwC response

The effect of translating assets and liabilities from a foreign currency can affect the difference between a reporting unit's fair value and its carrying amount. The revised guidance clarifies that foreign currency translation adjustments should not be allocated to a reporting unit from accumulated other comprehensive income.

Figure 9-5

The impact of the revised guidance on the amount of goodwill impairment

Reporting unit – Scenario 1



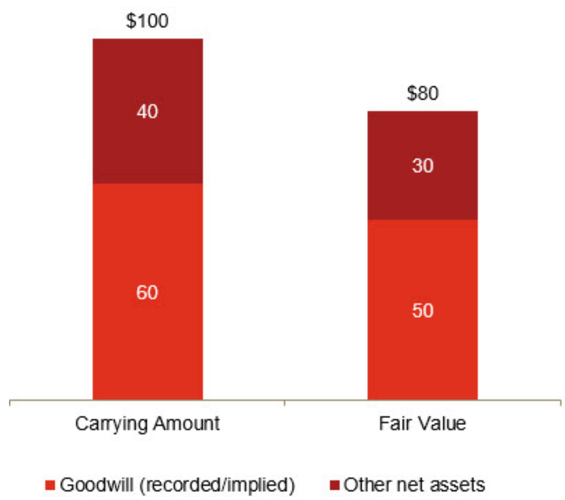
Goodwill impairment amount

Current guidance		Revised guidance
$30*	>	$20**

* $40 (carrying amount of goodwill) minus $10 (implied fair value of goodwill)

** $100 (carrying amount of Reporting Unit) minus $80 (fair value of Reporting Unit)

Reporting unit – Scenario 2



Goodwill impairment amount

Current guidance		Revised guidance
$10*	<	$20**

* $40 (carrying amount of goodwill) minus $30 (implied fair value of goodwill)

** $100 (carrying amount of Reporting Unit) minus $80 (fair value of Reporting Unit)

9.8.1.3 Reporting units with zero or negative carrying amounts – after adoption of ASU 2017-04

Under the revised guidance, the one-step impairment test will be applied to all reporting units, including those with zero or negative carrying amounts. The step two concept no longer exists even for reporting units with zero or negative carrying amounts. Due to this change, goodwill allocated to these reporting units generally will not be impaired as the fair value of a reporting unit is rarely negative.

The adoption of the revised guidance should not by itself trigger changes to the valuation premise used to fair value a reporting unit.   However, 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 step one.

The revised guidance includes a new requirement to disclose the amount of goodwill allocated to reporting units with zero or negative carrying amounts. This additional disclosure, especially for reporting units that are performing poorly, may increase the scrutiny from both investors and regulators.

9.8.2 Step two: implied fair value – before the adoption of ASU 2017-04

Step two compares the implied fair value of the reporting unit's goodwill to its carrying amount. If the carrying amount is greater than the implied fair value, an impairment loss must be recognized for the excess (i.e., recorded goodwill must be written down to the implied fair value of the reporting unit's goodwill).

After a goodwill impairment loss for a reporting unit is measured and recognized, the adjusted carrying amount of the reporting unit's goodwill becomes the new accounting basis. A subsequent reversal of previously recognized goodwill impairment losses is prohibited.

Figure 9-6 provides a basic example of the goodwill impairment test.

Figure 9-6
Basic goodwill impairment test

The following illustrates the application of the basic two-step goodwill impairment test approach to two hypothetical Reporting Units A and B (in millions):

Step one:	**Reporting Unit A**	**Reporting Unit B**
Fair value of reporting unit	CU1,000	CU500
Carrying amount of reporting unit (including CU200 goodwill each for A and B)	600	600
Difference	CU400	CU(100)
	Passed	Failed

Step two:	Reporting Unit A	Reporting Unit B
Fair value of reporting unit	n/a	CU500
Fair value of reporting unit's identifiable assets and liabilities determined in accordance with ASC 805		(425)
Implied fair value of goodwill		75
Carrying amount of reporting unit's goodwill		200
Goodwill impairment loss		CU(125)[1]

[1] Step two calculation does not consider deferred taxes.

9.8.2.1 *Application of step two of the impairment test for goodwill*

When an entity performs step two of the goodwill impairment test, it must determine the implied fair value of the reporting unit's goodwill. The fair value of goodwill can be measured only as a residual amount and cannot be determined directly. As a result, the implied fair value of a reporting unit's goodwill should be calculated in the same manner as the amount of goodwill that would be recognized in a business combination pursuant to ASC 805. This process involves measuring the fair value of the reporting unit's assets and liabilities (both recognized and unrecognized) at the time of the impairment test, using the guidance in ASC 805.

The difference between the reporting unit's fair value and the fair values assigned to the reporting unit's individual assets and liabilities (both recognized and unrecognized), is the implied fair value of the reporting unit's goodwill. It is important to note that this assignment process is performed only for the purpose of determining the implied fair value of the reporting unit's goodwill when testing goodwill for impairment. The carrying amount of the entity's other assets and liabilities should not be adjusted and previously unrecognized assets and liabilities should not be recognized. See FV 7.4.2 for the determination of the fair value of reporting units and certain assets and liabilities.

Question 9-24

If a company has concluded that a market participant would assume the pension obligations associated with the employees within a reporting unit if the reporting unit was sold, how should the pension obligation be measured when completing step two of the goodwill impairment test?

PwC response

When completing step two of the goodwill impairment test, a company is required to perform a hypothetical purchase price allocation as if the reporting unit was acquired on the test date. Therefore, the company should measure the projected benefit obligation and the fair value of the plan assets in accordance with ASC 715 as of the date of the test.

Question 9-25

In completing step two of the goodwill impairment test, would it be appropriate for a company to use the current carrying amounts of the assets and liabilities on its balance sheet as a proxy for fair value when determining the implied fair value of goodwill?

PwC response

No. The implied fair value of a reporting unit's goodwill should be calculated in the same manner as the amount of goodwill that is recognized in a purchase price allocation in a business combination. This process involves measuring the fair value of the reporting unit's assets and liabilities (both recognized and unrecognized) at the time of the impairment test to perform a hypothetical purchase price allocation. The current carrying amounts of assets and liabilities may not approximate their fair values when completing step two of the goodwill impairment test.

9.8.2.2 Step two may not always result in an impairment loss

In some cases, a reporting unit that has failed step one of the goodwill impairment test may not have a goodwill impairment loss to recognize in step two because the implied fair value of goodwill exceeds its carrying amount. For example, a reporting unit may fail step one because the carrying amounts of the long-lived assets exceed their fair values, but an impairment on the long-lived assets is not recognized because their carrying amounts are recoverable on a held and used basis (i.e., through undiscounted cash flows). In these cases, the implied fair value of goodwill may still exceed its carrying amount, and no goodwill impairment loss would be necessary.

We expect instances of a reporting unit failing step one but not recording a goodwill impairment test to be infrequent. Consideration should be given to whether all assets and liabilities have been appropriately considered for impairment prior to performing the goodwill impairment test.

9.8.2.3 Consistency between the fair values used to test indefinite-lived intangible assets for impairment and step two of the goodwill impairment test

Indefinite-lived intangible assets are tested for impairment based on their appropriate unit of accounting. If the unit of accounting of the indefinite-lived intangible assets is assigned to a single reporting unit, its associated fair value should be used for purposes of performing step two of the goodwill impairment test. If the unit of accounting of the indefinite-lived intangible assets is assigned to multiple reporting units, judgment should be applied to allocate the fair value of the intangible asset among the reporting units when performing step two of the goodwill impairment test.

9.8.2.4 Consistency of valuation methodologies between ASC 805 and step two of the goodwill impairment test

The valuation methods used to determine the fair value of a reporting unit's individual assets and liabilities for purposes of step two of the goodwill impairment test should be consistent with the valuation methods that were applied in the determination of fair value as of the acquisition date. However, an entity is not precluded from using a different valuation method if there are specific facts and circumstances that support a conclusion that another valuation method is equally or more representative of fair value in the circumstances. This may be the case in instances where new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve.

Example 9-18 illustrates the goodwill impairment test.

EXAMPLE 9-18

Detailed example of the goodwill impairment test

Assume Company A is performing its annual impairment test for goodwill, and management determines the fair value of Reporting Unit X to be CU1,000. Reporting Unit X's carrying amount is CU1,050. Because the carrying amount of the reporting unit exceeds its fair value, Company A has failed step one and will proceed to step two of the impairment test. All assets and liabilities have been tested for impairment under the applicable GAAP prior to testing goodwill for impairment. For simplicity, all tax effects have been ignored.

	Book value	Fair value
Working capital	CU80	CU80
Real estate	700	850
Notes receivable	100	100
Patent (finite-lived intangible)	50	40
Trade name (indefinite-lived intangible)	40	95
Notes payable	(200)	(185)
Net assets	770	980
Goodwill	280	
Total carrying amount of reporting unit X	1,050	
Fair value of reporting unit X		1,000
Implied fair value of goodwill		20
Carrying amount of goodwill		280
Goodwill impairment loss		CU(260)

What amount of impairment loss, if any, should Company A recognize for Reporting Unit X?

Analysis

The implied fair value of goodwill is equal to the fair value of Reporting Unit X of CU1,000, less the recorded value of its net assets of CU980 measured in accordance with ASC 805. Based on the results of step two of the impairment analysis, a goodwill impairment charge of CU260 is recognized. Note that in this scenario, the amount of the goodwill impairment is greater than CU50, which is simply the difference between the total carrying amount of the reporting unit and its fair value (CU1,050 – CU1,000) due to differences between the book value and fair value of other net assets of CU210 (CU980 – CU770). If the fair value of the reporting unit had exceeded its carrying value, a detailed determination of the fair values of the individual assets and liabilities would not be necessary and no goodwill impairment would be recorded. Company A should also reassess the useful life of the patent because the decline in value may be the result of factors that also suggest the patent will have a shorter useful life.

9.8.2.5 *Estimate of an impairment loss if assessment is not completed before issuing financial statements*

Because of the significant effort that may be required to determine the implied fair value of a reporting unit's goodwill in step two of the goodwill impairment test, there may be situations in which an entity is unable to complete this process before issuing its financial statements. ASC 350-20-35-18 states that when such a situation occurs and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of the loss should be recognized in the financial statements using the guidance in ASC 450, *Contingencies*. The fact that the amount of a goodwill impairment loss is an estimate and the reasons why it is an estimate must be disclosed in the financial statements. Upon completion of the measurement of the impairment loss, any adjustment made to the estimated loss should be recognized in the subsequent reporting period and the nature of the adjustment should be disclosed in accordance with ASC 350-20-35-19 and ASC 350-20-50-2(c). The provision does not apply after adoption of ASU 2017-04 (see BCG 9.8.1.2).

9.9 *Other impairment assessment considerations*

Additional complexities often arise in performing the quantitative impairment test.

9.9.1 *Deferred income tax considerations when determining the fair value of a reporting unit and the implied fair value of goodwill of a reporting unit*

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 step one of the goodwill impairment test and, prior to adopting the revised guidance in ASU 2017-04, determining the implied fair value of goodwill in step two of the 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 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. In making that determination, an entity should consider (1) whether the assumption is consistent with those that market participants would incorporate into their estimates of fair value, (2) the feasibility of the assumed structure, and (3) whether the assumed structure results in the highest economic value to the seller for the reporting unit, including consideration of related tax implications. In addition, in determining the feasibility of a nontaxable transaction, an entity should consider, among other relevant factors, (1) whether the reporting unit could be sold in a nontaxable transaction and (2) 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 in accordance with ASC 350-20-35-25 through 35-27. 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 9-26

How should income taxes be considered when determining the fair value of a reporting unit in step one of a goodwill impairment test?

PwC response

An entity should determine whether the estimate of 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 tax credit 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. 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 that provides the highest 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 step one of the 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.

Finally, ASC 350-20-35-20 through 35-21 requires that the implied fair value of the reporting unit's goodwill in step two of the goodwill impairment test be determined using the same taxable or nontaxable assumption used in determining the fair value of the reporting unit. See TX 10.4 for information on determining deferred taxes in a business combination.

Question 9-27

How should deferred income taxes be considered when performing step two of the goodwill impairment test using the current guidance?

PwC response

The implied fair value of goodwill in step two of a goodwill impairment test is determined in the same manner as the amount of goodwill recognized in a business combination. Deferred income taxes included in step two should be calculated using the same assumption (i.e., taxable or nontaxable) that was used in determining the fair value of the reporting unit in step one. In a nontaxable transaction, the historical tax bases, net operating losses, and other tax attributes of the target usually carry over to the acquirer, and there is no step-up of the underlying tax bases of the acquired net assets. However, as identifiable net assets will be reflected at fair value for financial reporting purposes, the amount of deferred income taxes should be calculated based on the difference between such fair value and the historical tax bases. The amount of deferred taxes will likely be different than if the acquirer had simply carried forward actual deferred tax balances. Following the guidance in ASC 805, a deferred tax asset is included in step two if there is carryover tax basis in tax-deductible goodwill and it exceeds the implied fair value of book goodwill. Determining the amount of a deferred tax asset on goodwill requires an iterative calculation. See TX 10.7.2.1 for further information.

Generally, in a taxable transaction, the acquirer does not carry over the existing tax bases of the assets and liabilities within the target, nor does it carry over net operating losses and other tax attributes. Instead, the acquirer's tax basis balance sheet reflects the acquired assets and the assumed liabilities at their respective fair values for tax reporting purposes (pursuant to applicable guidance). In this case, as the tax-basis in the acquired assets and assumed liabilities would generally equal the book basis, there would not be any temporary differences that would result in deferred taxes.

Examples 9-19 and 9-20 demonstrate the effect of deferred income taxes when testing goodwill for impairment.

EXAMPLE 9-19

Excess of book goodwill over tax goodwill

Company A has a reporting unit that it is testing for impairment. A sale of the reporting unit would be feasible in both a taxable and nontaxable transaction. Assume the following:

- The carrying amount of net assets, excluding goodwill and deferred taxes, is CU1,300.

- The fair value of identifiable net assets, excluding goodwill and deferred taxes, is CU1,400.
- The tax basis of net assets is CU900 and Company A's tax basis in the shares of the reporting unit is CU1,125. There is no tax-deductible goodwill.
- The nondeductible book goodwill is CU500.
- The net deferred tax liabilities are CU160 (CU1,300 carrying amount of net assets, excluding goodwill and deferred taxes, less CU900 tax basis of net assets at a 40% tax rate).
- In a taxable transaction, the reporting unit could be sold for CU1,600.
- In a taxable transaction, at a 40% tax rate, current taxes payable resulting from the transaction would be CU280 (CU1,600 fair value less CU900 tax basis at 40%).
- In a nontaxable transaction, the reporting unit could be sold for CU1,500.
- In a nontaxable transaction, current taxes payable resulting from the transaction are assumed to be CU150 (CU1,500 fair value less Company A's tax basis in the shares of CU1,125 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)	CU1,600	CU1,500
Tax arising from transaction	(280)	(150)
Economic value from the reporting unit	CU1,320	CU1,350

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 step one of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Net assets (excluding goodwill and deferred taxes)	1,300
Goodwill	500
Deferred taxes	(160)
Reporting unit carrying amount	1,640
Difference—Fails step one	CU(140)

For step one, 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, the reporting unit fails step one.

Performance of step two of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Less: fair value of identifiable net assets	(1,400)
Plus: net deferred tax liability	200[1]
Implied fair value of goodwill	300
Book value of goodwill	500
Impairment loss	CU(200)

[1] Determined as the fair value of the identifiable net assets of CU1,400 less the tax basis of CU900 at a 40% tax rate.

For step two, the implied fair value of goodwill is determined by comparing the fair value of the reporting unit of CU1,500 to the fair value of the identifiable net assets and any deferred taxes following the guidance in ASC 805. The implied fair value of goodwill of CU300 is then compared to the book value of goodwill of CU500, resulting in an impairment loss of CU200.

To illustrate the determination of an impairment loss in a taxable sale, assume in the above example that the company determined that the highest economic value could be realized in a taxable transaction. In that case, the fair value of the reporting unit of CU1,600 is compared to the carrying amount of the reporting unit of CU1,640, which fails step one. The fair value of the identifiable net assets remains at CU1,400, and deferred taxes are assumed to be zero because the book and tax bases will typically be the same in a taxable transaction, thus implying a goodwill fair value of CU200. When compared to the recorded amount of goodwill of CU500, the resulting impairment charge would be CU300.

EXAMPLE 9-20

Excess of tax goodwill over book goodwill

Assume the same facts from Example 9-19, except that the reporting unit has tax-deductible goodwill of CU600 at the impairment testing date.

What amount of impairment loss, if any, should be recognized?

Analysis

If the highest economic value could be obtained through a nontaxable transaction, the fair value of the reporting unit of CU1,500 is compared to the carrying amount of the reporting unit of CU1,640, which fails step one.

Performance of step two of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Less: fair value of identifiable net assets	(1,400)
Plus: net deferred tax liability on identifiable net assets	200[1]
Preliminary implied fair value of goodwill	300
Less: deferred tax asset for tax-deductible goodwill	(200)[2]
Implied fair value of goodwill	100
Book value of goodwill	500
Impairment loss	CU(400)

[1] Determined as the fair value of the identifiable net assets of CU1,400 less the tax-basis of CU900 at a 40% tax rate.

[2] Determined by applying the equation described in TX 10.7.2.1 (Tax Rate of 40% / (1 – Tax Rate of 40%)) × Preliminary Temporary Difference (Tax deductible goodwill of CU600 less preliminary implied fair value of goodwill of CU300).

For step two, because there is tax-deductible goodwill in excess of book goodwill, the implied fair value of goodwill is determined in a two-step process. The implied fair value of goodwill, before deferred taxes for tax-deductible goodwill, is determined by comparing the fair value of the reporting unit of CU1,500 to the fair value of the identifiable net assets, net of any deferred taxes associated with the identifiable net assets following the guidance in ASC 805. This preliminary implied fair value of goodwill is then utilized in determining the deferred tax asset associated with the tax-deductible goodwill by applying the equation discussed in TX 10.7.2.1, resulting in a deferred tax asset of CU200 and implied fair value of goodwill of CU100. The implied fair value of goodwill of CU100 is then compared to the book value of goodwill of CU500, resulting in an impairment loss of CU400.

See BCG 9.3.5 for further information on the assignment of net operating loss and tax credit carryforwards and see BCG 9.9.6 for further information on the allocation of a goodwill impairment loss to component-1 and component-2 goodwill.

9.9.1.1 *Income tax effect of goodwill impairment loss – after adoption of ASU 2017-04*

Taxable business combinations can generate goodwill that is deductible for tax purposes. When such goodwill is impaired for financial reporting purposes, there may be an impact on deferred taxes. In these cases, ASC 350-20-55-23A to 55-23D illustrates a simultaneous equation method that should be used to determine the goodwill impairment loss and associated income tax benefit. This is the same method used prior to ASC 2017-04 to determine the final goodwill and related deferred income tax amount in a nontaxable business combination. However, the impact from assuming a taxable or nontaxable transaction may be more pronounced due to the removal of step two.

EXAMPLE 9-21

Deferred tax impact of a goodwill impairment

Reporting unit A has a carrying amount of CU95 made up of:

Net assets (excl. goodwill and deferred income taxes)	CU65
Goodwill	40
Deferred taxes	(10)
Total carrying amount	CU95

Upon a triggering event, Company A performs a step one goodwill impairment test using the revised impairment guidance.

The reporting unit could be sold for CU80 in a nontaxable transaction and CU90 in a taxable transaction. The economic value (i.e., after tax proceeds) of a sale is CU68 in each scenario.

What is the impact of assuming a taxable or nontaxable transaction on the goodwill impairment?

Analysis

The assumption of a taxable or nontaxable transaction impacts the amount of impairment recorded since the fair value of the reporting unit usually differs based on the assumption used. Prior to ASC 2017-04, whether the sale was assumed to be taxable or nontaxable resulted in largely comparable goodwill impairment in step two.

As shown below, in the case of Company A, a nontaxable assumption results in an impairment of CU15 whereas a taxable assumption results in an impairment of CU5.

Estimating the fair value of a reporting unit based on an assumption that the reporting unit would be sold either in a taxable or a nontaxable transaction continues to require an assessment of which option is feasible and consistent with market participants' assumptions, and provides the highest economic value to the seller (including consideration of the related tax implication).

	Taxable	Nontaxable
Fair value of reporting unit	CU90	CU80
Less: fair value of identifiable assets	(65)	(65)
Plus: deferred tax liabilities	10	10
Less: carrying amount of goodwill	40	40
Goodwill impairment	CU5	CU15

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 measureable 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 4.4.1 and PPE 4.5.3 for further information on impairment testing of other assets under the held for use and held for sale approaches.

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 step one of the goodwill impairment test under ASC 350-20. However, if the reporting unit fails step one, such assets would be measured at fair value for purposes of measuring the implied fair value of goodwill in step two, which is required to be performed prior to the adoption of ASU 2017-04. It is important to note that the measurement of such assets is used only for the purpose of measuring the amount of the goodwill impairment and should not be used to adjust the carrying amount of such assets.

After the adoption of ASU 2017-04, a goodwill impairment would be recorded if the reporting unit fails step one and would be measured using the amount by which the reporting unit fails step one (i.e., step two is not performed).

9.9.4 Impairment testing when a noncontrolling interest 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.

Prior to the issuance of ASU 2017-04, ASC 350-20-35-57A stated that when a noncontrolling interest exists, the fair value of a reporting unit and the implied fair value of goodwill should be determined in the same manner as it would be determined in a business combination accounted for in accordance with ASC 805. ASC 2017-04 amended the guidance to remove reference to step two of the goodwill impairment test but retains the step one guidance that the fair value of the reporting unit should be compared to its carrying amount inclusive of any interest attributable to noncontrolling shareholders.

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. Under this methodology, any impairment loss resulting from step two of the test performed prior to the adoption of ASU 2017-04 would only be measured and recorded for the portion of goodwill related to the parent's controlling interest. 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 attributed entirely to the parent's controlling interest.

Subsequent to the adoption of ASU 2017-04, the methodology described above for performing step one of the goodwill impairment test remains appropriate and would be used to measure the amount of the impairment loss.

Any impairment loss measured in the goodwill impairment test must be attributed to the controlling and noncontrolling interests on a rational basis. In the case of a reporting unit containing an entity acquired before the adoption of ASC 805, which did not result in the recognition of goodwill attributable to the noncontrolling interest, the entire impairment loss would be attributed to the controlling interest.[1] If the reporting unit includes an entity for which goodwill was attributed to both the controlling interest and the noncontrolling interest, the goodwill impairment loss would be attributed to both.

Example 9-22 provides an example of a method for attributing a goodwill impairment loss to the controlling and noncontrolling interests.

EXAMPLE 9-22

Attribution of an 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 CU800 million. Company A determines that the fair value of the noncontrolling interest is CU200 million. The aggregate value of the identifiable assets acquired and liabilities assumed, measured in accordance with ASC 805, is determined to be CU700 million. Company A's determination of goodwill related to the acquisition of Company B for purposes of attributing a goodwill impairment loss is as follows (in millions):

Fair value of the consideration transferred	CU800
Fair value of the noncontrolling interest	200
	1,000
Values of 100% of the identifiable net assets	(700)
Goodwill recognized	CU300
Goodwill attributable to the noncontrolling interest	CU60[1]
Goodwill attributable to the controlling interest	CU240[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 (CU 60 = CU200 less 20% of CU700).

[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 (CU240 = CU800 less 80% of CU700).

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] Prior to the issuance of ASC 805, most entities did not record goodwill attributable to the noncontrolling interest in a partial business combination.

CU900 million and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that neither the carrying amount of Reporting Unit X nor the sum of the fair values of Reporting Unit X's identifiable net assets 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 any goodwill impairment at Reporting Unit X be attributed to the controlling and noncontrolling interest?

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows (in millions):

Step one:

Fair value of reporting unit	CU900	
Carrying amount of reporting unit	(1,000)	
Excess carrying amount	CU(100)	Failed

Step two:

Fair value of reporting unit	CU900
Values of 100% of the identifiable net assets	(700)
Implied fair value of goodwill	200
Carrying amount of goodwill	300
Goodwill impairment loss	CU(100)
Goodwill impairment loss attributed to the noncontrolling interest	CU(20)[1]
Goodwill impairment loss attributed to the controlling interest	CU(80)[2]

[1] The goodwill impairment loss attributed to the noncontrolling interest is determined based on the total amount of the impairment loss of CU100 multiplied by the 20% ownership interest of the noncontrolling interest. The impairment loss would be the same if it was attributed based on the relative interest of the goodwill prior to impairment (CU60 attributable to the noncontrolling interest of CU300 of total goodwill). Note, however, that the full impairment loss of CU100 would be recorded in the income statement.

[2] The goodwill impairment loss attributed to the controlling interest is determined based on the total amount of the impairment loss of CU100 multiplied by the 80% ownership interest of the controlling interest. The impairment loss would be the same if it was attributed based on the relative interest of the goodwill prior to impairment (CU240 attributable to the controlling interest of CU300 of total goodwill).

Subsequent to the adoption of ASU 2017-04, the amount of goodwill impairment would be the excess carrying amount of the reporting unit from step one of CU100. The attribution of the impairment to the controlling and noncontrolling interests in the example would not change.

In Example 9-22, the goodwill impairment loss was attributed 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 9-23 demonstrates one approach to attributing the impairment loss to the controlling and noncontrolling interests in this case.

EXAMPLE 9-23

Attribution of goodwill 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 CU1,000. The value of the identifiable assets and liabilities measured in accordance with ASC 805 is determined to be CU700, and the fair value of the noncontrolling interest is determined to be CU200. Company A's determination of goodwill related to the acquisition of Company B is as follows:

Fair value of the consideration transferred	CU1,000
Fair value of the noncontrolling interest	200
	1,200
Fair values identifiable net assets	(700)
Goodwill recognized	CU500
Goodwill attributable to the noncontrolling interest	CU60[1]
Goodwill attributable to the controlling interest	CU440[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 (CU60 = CU200 less 20% of CU700).

[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 (CU440 = CU1,000 less 80% of CU700).

Because Company A paid a premium to acquire a controlling interest in Company B, Company A's interest in goodwill is 88% (CU440 / CU500). 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 CU1,100 and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that neither the carrying amount of Reporting Unit X nor the sum of the fair values of Reporting Unit X's assets and liabilities 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 any goodwill impairment at Reporting Unit X be attributed to the controlling and noncontrolling interest?

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows:

Step one:

Fair value of reporting unit	CU1,100	
Carrying amount of reporting unit	(1,200)	
Excess carrying amount	CU(100)	Failed

Step two:

Fair value of reporting unit	CU1,100
Fair values of identifiable net assets	(700)
Implied fair value of goodwill	400
Carrying amount of goodwill	500
Goodwill impairment loss	CU(100)
Goodwill impairment loss attributed to the noncontrolling interest	CU(12)[1]
Goodwill impairment loss attributed to the controlling interest	CU(88)[2]

1 The goodwill impairment loss attributed to the noncontrolling interest is determined based on the carrying amount of the goodwill attributable to the noncontrolling interest prior to impairment of CU60 relative to the total goodwill of CU500 (CU12 = (CU60 / CU500) ×CU100). Note, however, that the full impairment loss of CU100 would be recorded in the income statement.

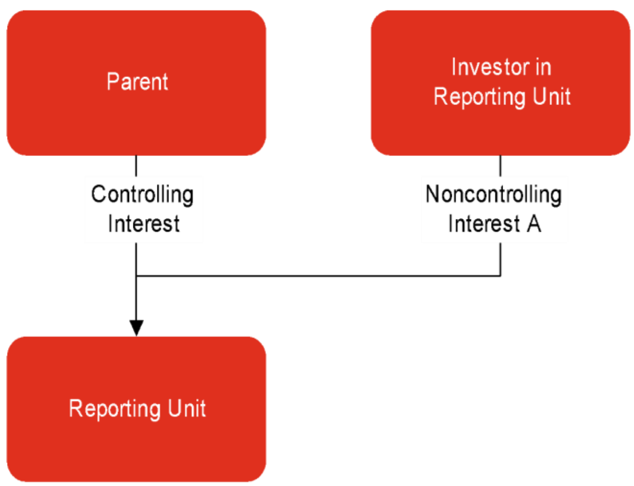
2 The goodwill impairment loss attributed to the controlling interest is determined based on the carrying amount of the goodwill attributable to the controlling interest prior to impairment of CU440 relative to the total goodwill of CU500 (CU88 = (CU440 / CU500) ×CU100).

Subsequent to the adoption of ASU 2017-04, the amount of goodwill impairment would be the excess carrying amount of the reporting unit from step one of CU100. The attribution of the impairment to the controlling and noncontrolling interests in the example would not change.

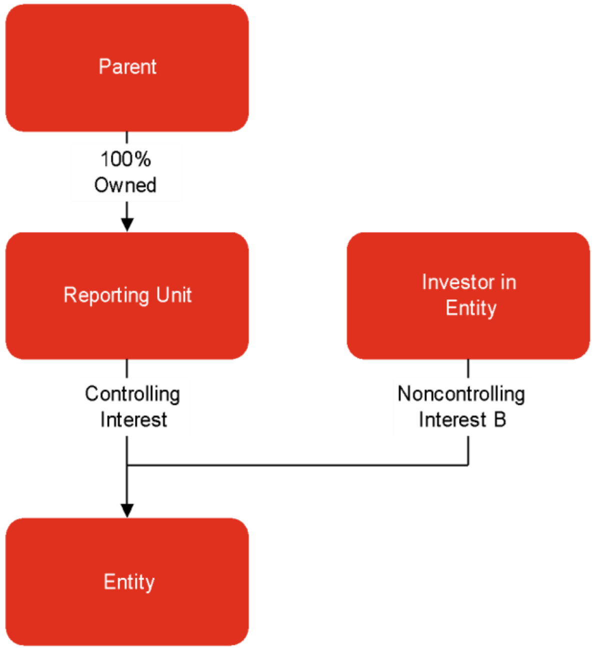
The attribution of any goodwill impairment loss to the controlling interest and the noncontrolling interest will not change unless there is a change in the relative ownership interests. If there is a change in ownership interests, any subsequent goodwill impairment charge is attributed to the controlling and noncontrolling interests on a rational basis.

9.9.4.1 Fair value of a noncontrolling interest may differ depending on whether a noncontrolling interest exists above the reporting unit or within the reporting unit

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. See noncontrolling interest A in the following diagram.



In another example, the reporting unit might be wholly owned but it may consolidate an entity that is partially owned by the reporting unit. See noncontrolling interest B in the following diagram.



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 the example above), 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 the example above), 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 Impairment testing when a noncontrolling interest exists and the reporting unit contains goodwill from multiple acquisitions

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 attribute goodwill impairment charges between the controlling and noncontrolling interests.

The exposure draft on business combinations released by the Boards in 2005 proposed to amend ASC 350-20 to provide guidance on how to determine and attribute 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 attributing any such loss. The allocation approach provided was:

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 attributed to the controlling and noncontrolling interests pro rata based on the relative carrying amounts of goodwill attributed to those interests.

Example 9-24 provides an example of this allocation approach.

EXAMPLE 9-24

Attribution of 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 CU200 million. At the time of the acquisition of Subsidiary Z, the carrying amount of goodwill in Reporting Unit X was CU500 million, of which CU300 million is allocated to partially-owned Subsidiary Z, and of that amount, CU75 million is attributable to the noncontrolling interest.

How should the impairment loss be attributed to the noncontrolling interest in Subsidiary Z?

Analysis

The impairment loss of CU200 million should be attributed 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:

CU200 ×(CU300 / CU500) = CU120

Step two: Attribute the impairment loss attributable to the partially-owned subsidiary to the controlling and noncontrolling interests

Controlling interest of Subsidiary Z:

CU120 ×(CU225 / CU300) = CU90

Noncontrolling interest of Subsidiary Z:

CU120 ×(CU75 / CU300) = CU30

Step three: Sum the controlling and noncontrolling interests' allocations

Impairment loss attributed to the controlling interest of Reporting Unit X:

CU80 + CU90 = CU170

Impairment loss attributed to the noncontrolling interest of Reporting Unit X = CU30

The attribution 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 the preceding example, 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 testing of goodwill for 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 a subsidiary level on impairment testing at the parent level

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 unit(s) that includes a subsidiary's reporting unit(s) 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 value(s) of the consolidated entity's reporting unit(s) below the carrying amount of the reporting unit(s). 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 unit(s).

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 9-25 demonstrates the necessary consideration of the impact of a subsidiary impairment loss at the consolidated level.

EXAMPLE 9-25

Considering a subsidiary impairment loss at the consolidated level

Subsidiary A is issuing standalone financial statements. Subsidiary A has goodwill of CU300 million. At Parent X, Subsidiary A and Subsidiary B combine to form one reporting unit, which includes goodwill of CU300 million (all Subsidiary A goodwill). Based on the completion of step one of the annual 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 CU100 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 CU100 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 indicated by step one of the annual goodwill impairment test.

9.9.5 Equity-method investment goodwill not subject to the ASC 350-20 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 neither amortized nor separately reported outside the equity-method investment. The total carrying amount of the equity-method investment should be reviewed for impairment in accordance with ASC 350-20-35-59. 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 asset(s), 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 purposes 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 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 10.7 for further guidance on separating goodwill into its two components.

ASC 805 prescribes the recognition of a deferred tax benefit resulting from tax-deductible goodwill that is in excess of book goodwill. 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.

Any difference that arises between the book and tax bases of component-1 goodwill in future years (e.g., 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 create 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 reduction in book goodwill 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 deferred tax effect and results in a permanent difference.

Example 9-26 demonstrates the tax effect of a goodwill impairment loss when there is excess goodwill for financial reporting purposes at acquisition over the amount of tax-deductible goodwill.

EXAMPLE 9-26

Deferred tax effect of a goodwill impairment loss: excess book-over-tax-goodwill at acquisition prior to the adoption of ASU 2017-04

Company A acquired reporting unit X four years ago in a taxable asset acquisition accounted for as a business combination. As a result of applying acquisition accounting, Company A recognized goodwill of CU1,200 million for book purposes; tax deductible goodwill was CU900 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 goodwill for reporting unit X suffered an impairment loss of CU400 million. Assume an applicable tax rate of 40%.

What is the deferred tax effect of a goodwill impairment loss prior to the adoption of ASU 2017-04?

Analysis

Deferred taxes result from the temporary difference between component-1 goodwill and its tax basis multiplied by the applicable tax rate. Just prior to the impairment, a deferred tax liability of CU96 million exists as a result of four years of amortization of component-1 goodwill for tax purposes. The goodwill impairment charge of CU400 million would be allocated proportionately to component-1 and component-2 book goodwill based on their relative carrying amounts. The following table illustrates the changes in book and tax goodwill.

	Component-1 goodwill	Component-2 goodwill	Book basis	Tax basis	Deferred taxes
Balance at acquisition date	CU900	CU300	CU1,200	CU900	CU—
Tax amortization	—	—	—	(240)	(96)
Balance before impairment test	900	300	1,200	660	(96)
Impairment loss	(300)[1]	(100)[1]	(400)	—	120
Ending balance	CU600	CU200	CU800	CU660	CU24

1 The total impairment of CU400 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).

No tax benefit would be recorded for the portion of the impairment allocated to component-2 goodwill. Thus, in connection with recording the goodwill impairment loss of CU400 million, Company A would record a tax benefit of only CU120 million, 40% of the CU300 million impairment loss allocated to the component-1 goodwill, assuming a valuation allowance is not necessary.

EXAMPLE 9-27

Deferred tax effect of a goodwill impairment loss: excess book-over-tax-goodwill at acquisition subsequent to the adoption of ASU 2017-04

Assume the same facts as Example 9-26 except that Company A has adopted ASU 2017-04. Under ASU 2017-04, the carrying amount of reporting unit X is compared to its fair value in step one. The result is an excess carrying amount of CU400 million.

What is the deferred tax effect of a goodwill impairment loss subsequent to the adoption of ASU 2017-04?

Analysis

Unlike Example 9-26 in which a deferred tax benefit reduces the net effect of the impairment, ASU 2017-04 requires that a net impairment charge of CU400 million be recognized. The iterative calculation described below and referenced at ASU 350-20-35-8B is used to determine the "pre-tax" goodwill impairment and related deferred tax benefit to arrive at a net CU400 million charge. The allocation of the impairment proportionally to the book carrying amount of component-1 and component-2 goodwill is illustrated as follows:

	Component-1 goodwill	Component-2 goodwill	Book basis	Tax basis	Deferred taxes
Balance at acquisition date	CU900	CU300	CU1,200	CU900	CU—
Tax amortization	—	—	—	(240)	(96)
Balance before impairment test	900	300	1,200	660	(96)
Impairment loss	(428)[1]	(143)[1]	(571)	—	171
Ending balance	CU472	CU157	CU629	CU660	CU75

[1] The total impairment of CU571 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:

Step 1: Determine the ratio of component-1 goodwill to total goodwill – in this case CU900/CU1200 or 75%

Step 2: Determine the "effective" tax rate for the impairment charge by applying the component-1 ratio to the applicable tax rate – in this case 30% (75% ×40%)

Step 3: Calculate the "iterative effective" tax rate using a simultaneous calculation demonstrated in paragraphs 805-740-55-9 through 55-13 – in this case, 42.86% (30% / (1- 30%))

Step 4: Apply the iterative effective tax rate to the preliminary goodwill impairment of CU400 to determine the total deferred tax benefit - in this case, CU171 (CU400 ×42.86%)

Step 5: Add the amount determined in Step 4 to the preliminary goodwill impairment to compute the total pretax impairment of CU571 (CU400 + CU171)

Following this approach, the tax benefit of the goodwill impairment equals CU171 million (CU571 million at an "effective" tax rate of 30%) and the net deductible temporary difference between the tax basis in goodwill of CU660 million and the remaining book basis in component-1 goodwill of CU472 million is CU188 million. Multiplying that amount at the 40% applicable tax rate results in a deferred tax asset of CU75 million.

The following table shows a summarized version of the results of the above calculation:

	Carrying Amount before Impairment		**Preliminary Impairment**	**Adjustment for Equation**	**Carrying Amount after Impairment**	
	$	**%**			**$**	**%**
Component-1 goodwill	CU900	75%	CU(300)	CU(128)	CU472	75%
Component-2 goodwill	300	25%	(100)	(43)	157	25%
Deferred taxes	(96)	n/a		171	75	n/a

Example 9-28 illustrates the tax effect of a goodwill impairment loss when there is excess tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition.

EXAMPLE 9-28

Deferred tax effect of a goodwill impairment loss: excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition (prior to the adoption of ASU 2017-04)

Company A acquired a business in a nontaxable transaction. At the acquisition date, Company A has goodwill for financial reporting purposes of CU400 and tax-deductible goodwill of CU900 (carried over from a prior acquisition). A deferred tax asset of CU200 is recorded 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 tests and concludes that the goodwill for reporting unit X suffered an impairment loss of CU200.

What is the deferred tax effect of a goodwill impairment loss (prior to the adoption of ASU 2017-04) when there is excess tax-over-book goodwill at acquisition?

Analysis

When a DTA is recorded on the acquisition date for excess tax-deductible goodwill, subsequent impairment charges will cause a re-measurement of deferred taxes.

In this example, activity for years 1–4 is presented below (in millions):

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortization	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
Year 1	400	810	90	164
2	400	720	90	128
3	400	630	90	92
4	400	540	90	56
Book impairment loss	(200)	—	—	80
Post-impairment carrying amount (Year 4)	CU200	CU540	CU —	CU136

In general, when tax-deductible goodwill exceeds goodwill for financial reporting purposes, the decrease in tax basis from tax amortization first reduces the DTA recorded on the acquisition date before creating a deferred tax liability (DTL). The goodwill impairment loss reduces the carrying amount of book goodwill. There is no component-2 book goodwill, so there is no need to allocate the impairment between components. In this example, the book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes and results in an increase in the existing DTA. The resulting post-impairment DTA of CU136 ((CU540 – CU200) ×40%) would require a valuation allowance if its realization is not "more likely than not."

In contrast, an impairment loss in later years may reduce an existing DTL. For example, assume reporting unit X suffered a CU200 impairment loss in year 8.

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortization	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
Year 1	400	810	90	164
2	400	720	90	128
...				
7	400	270	90	(52)
8	400	180	90	(88)
Book impairment loss	(200)	—	—	80
Post-impairment carrying amount (year 8)	CU200	CU180	CU —	CU(8)

In this case, the CU200 book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes, and reduces the existing DTL from CU88 to CU8.

Example 9-29 illustrates the accounting for a goodwill impairment charge subsequent to the adoption of ASU 2017-04 when excess tax-deductible goodwill is present.

EXAMPLE 9-29

Deferred tax effect of a goodwill impairment loss: excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition (subsequent to the adoption of ASU 2017-04)

Assume the same facts as Example 9-28 except that Company A has adopted ASU 2017-04. Under ASU 2017-04, the carrying amount of reporting unit X is compared to its fair value in step one. The result is an excess carrying amount of CU200.

What is the deferred tax effect of a goodwill impairment loss (subsequent to the adoption of ASU 2017-04) when there is excess tax-over-book goodwill at acquisition?

Analysis

Unlike Example 9-28 in which a net impairment charge of CU120 was recognized, ASU 2017-04 requires a CU200 charge be recognized in year 4. Performing the iterative calculation discussed in Example 9-27, the preliminary goodwill impairment of CU200 would be grossed up by CU133 (CU200 ×40%/1-40%) to arrive at the total impairment charge. The resulting deferred tax asset is CU189 ((tax basis of CU540 less book basis of CU67) ×40%).

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortization	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
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)	CU67	CU540	CU —	CU189

The impairment charge noted in Example 9-28 in year 8 would result in a net charge of CU200. To arrive at a net CU200 charge, a goodwill impairment charge of CU333 and a deferred tax benefit of CU133 would be recorded.

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortization	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
Year 1	400	810	90	164
2	400	720	90	128
...				
7	400	270	90	(52)
8	400	180	90	(88)
Book impairment loss	(333)	—	—	133
Post-impairment carrying amount (year 8)	CU67	CU180	CU —	CU45

9.9.7 *Different aggregation of goodwill for ASC 740-10 and ASC 350-20*

The determination of tax goodwill must be performed on a jurisdictional basis and not on a reporting unit basis or some higher level of aggregation. However, when assigning goodwill for financial reporting purposes, ASC 350-20 requires that goodwill be assigned at the reporting unit level. Reporting units, therefore, 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*

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 allocated 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 allocate 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 through 35-53, the amount of goodwill that is allocated 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. Prior to the changes discussed in BCG 1.3, the broad definition of a business in ASC 805 results in many disposals of such groups qualifying as sales of a business.

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 allocated 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 in connection with the 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 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 still need to consider whether to revise the remaining estimated useful lives of the assets, even if the entity determines the business does not yet meet the held-for-sale criteria. See PPE 4.3 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. For example, the following discussion focuses on the sale of an asset group (either all, or a portion of a reporting unit) that constitutes a business for which goodwill is included in the disposal group.

9.10.2 *Expectation of a disposal*

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*

A disposal group that is classified as held for sale should be measured at the lower of its carrying amount 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

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 9-30 demonstrates the goodwill accounting considerations when disposing of a business that is a portion of a reporting unit.

EXAMPLE 9-30

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. 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 testing in November 20X7 indicated that the CU1,100 carrying amount of the electronics reporting unit's goodwill was not impaired because the unit's fair value of CU5,500 exceeded the unit's carrying amount of CU5,100. For simplicity, all tax effects have been ignored, and assume that there is no change in other net assets throughout the example and it has 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 20X8, 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 20X8. 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. The electronics reporting unit fails step one of the goodwill impairment test because the fair value of the reporting unit has declined, and step two results in a CU100 goodwill impairment loss. After the entity recognizes the goodwill impairment loss, the carrying amount of the electronics reporting unit is as follows:

	Carrying Amount
Goodwill	CU1,000
Other net assets:	
US electronics business	2,300
European electronics business	1,700
Total	CU5,000

European electronics business is held for sale

In September 20X8, Company A's management commits to a plan to sell the European electronics business. That plan meets all of ASC 360-10's criteria for the European electronics business to be (1) classified as held for sale (i.e., a disposal group), 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 allocation as follows:

	US	Europe	Total
Fair values	CU3,000	CU2,000	CU5,000
Relative fair value	60%	40%	100%
Goodwill	CU600	CU400	CU1,000

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' (a reporting unit) carrying amount of CU2,100 (goodwill of CU400 and other net assets of CU1,700) exceeds the business' fair value of CU2,000. The European electronics business fails step one of the goodwill impairment test.

Step two:	Total
Fair value of European's electronics business	CU2,000
Fair value of European's net assets, excluding goodwill	(1,700)
Implied fair value of goodwill	300
Allocated goodwill	400
Impairment loss	CU(100)

In its third quarter financial statements, Company A would recognize the loss of CU100. 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 CU600 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' fair value of CU3,000 exceeds its carrying amount of CU2,900 (goodwill of CU600 and other net assets of CU2,300).

European electronics business is sold

In December 20X8, Company A sells the European electronics business for CU1,800. The sales price is below Company A's previous estimates of the European electronics business' fair value because the business lost another major customer in November 20X8. In its fourth quarter financial statements, Company A would recognize an additional CU200 loss (sales proceeds of CU1,800 minus a carrying amount of CU2,000) on the disposal of discontinued operations. The total loss on the disposal of the discontinued business would be CU300 (CU100 recognized in the third quarter plus CU200 in the fourth quarter) representing accumulated losses, since it was determined that the discontinued operation met the held-for-sale criteria. The goodwill impairment loss of CU100 recognized in May of 20X8 on the electronics reporting unit would not be included in the loss on disposal but would be shown as an impairment prior to disposal.

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. However, if Company A had an annual impairment test date of 31 December, it would still have to perform the impairment test for the remaining US electronics business at that time.

9.10.5 Allocation of goodwill in a spin-off

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 allocated to and included in the distributed carrying value at the distribution date. In determining the goodwill to be allocated to the spin-off transaction, the parent would usually follow the relative fair value approach discussed above (assuming the parent is spinning off a portion of the reporting unit), and the goodwill allocated 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 disposal group 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 allocating 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 allocated 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 *Allocation of goodwill for a nonmonetary exchange transaction*

The SEC indicated in an announcement made by one of their staff members at an EITF meeting that if an SEC registrant engages in a transaction that involves the exchange of a business for any nonmonetary asset(s) (including an equity-method investment), such transactions must be accounted for at fair value, unless fair value is not determinable within reasonable limits. We believe that when a portion of a reporting unit that constitutes a business is to be disposed of in a nonmonetary exchange transaction that will be accounted for at fair value, a portion of the reporting unit's goodwill should be allocated to the business in the same manner as discussed above for a disposal by sale.

Question 9-28

Should goodwill be allocated 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, "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., a sale or spin-off). Further, the FASB clarified in ASU 2010-02 that the guidance in ASC 810-10 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 allocation of goodwill.

Following allocation 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 Presentation and disclosures

ASC 350-20-45 and ASC 350-20-50 describe disclosure requirements for goodwill. Article 5-02(16) of Regulation S-X requires that the amount of accumulated amortization of intangible assets (including goodwill) be set forth separately in the balance sheet or in a note thereto. It should be noted that if accumulated amortization of intangible assets (including goodwill) relates to assets held for sale at the balance sheet date, it would need to be presented as a separate line item in the statement of financial position in accordance with ASC 360-10-45-14.

See FSP 8.9.2 for further information on disclosure requirements relating to goodwill and recognized or potential impairments.

9.12 Private company accounting alternative

In 2014, the FASB issued ASU 2014-02, *Accounting for Goodwill* (the "goodwill alternative"). For private companies, the goodwill alternative represents a fundamental overhaul of the existing accounting model for goodwill. Application of the goodwill alternative is optional, and a private company can continue to follow the existing goodwill accounting guidance. An eligible company that elects the goodwill alternative will be able to apply a simplified impairment test but also will be required to amortize goodwill.

ASU 2014-02 was effective for years beginning after December 15, 2014. However, eligible companies have a one-time option to elect to adopt the alternative at any time without an assessment of preferability.

Only private companies are eligible to elect the goodwill alternative. Companies considering adoption should carefully review the definition of a public business entity, as defined in ASU 2013-12, *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, not-for-profit entities and employee benefit plans are not eligible to adopt PCC accounting alternatives.

ASU 2013-12 defines a public business entity as a business entity meeting any one of the following criteria:

- It is required by the 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 the filing).

- 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.

- 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.

- 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.

- 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 US GAAP financial statements (including footnotes) 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.

Question 9-29

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), 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 it is eligible to adopt the goodwill alternative, a company 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 9-7.

Figure 9-7

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
Measurement of impairment	Single step test, which compares the fair value of the entity (or reporting unit) to its carrying amount	Two-step test prior to the adoption of ASU 2017-04: In the first step, the fair value of each reporting unit is compared to its carrying amount. If the fair value of the reporting unit is

		less than its carrying amount, a second step is used to measure any impairment. This second step requires the preparation of a hypothetical purchase price allocation to determine the implied fair value of goodwill. The impairment, if any, is the amount by which the carrying amount of the reporting unit's goodwill exceeds its implied fair value
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
Disposal of business that constitutes a portion of an entity (or reporting unit)	Goodwill allocated to disposed business using a reasonable and rational approach	Goodwill allocated based on the relative fair value of the business disposed of to the portion of the reporting unit being retained

The remainder of this section addresses the provisions of the goodwill alternative.

9.12.1 Amortization of goodwill

If elected, a company 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.

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. In no circumstances is a company permitted to assign a useful life in excess of ten years to its goodwill.

9.12.2 Amortization after initial adoption

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.

9.12.3 Impairment model

The goodwill alternative simplifies many aspects of the goodwill impairment model for private companies 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 4.4.1 and PPE 4.5.3.

9.12.4 Level to test goodwill for impairment

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 allocate goodwill to its reporting units. See BCG 9.2, 9.3 and 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.

9.12.5 Frequency of impairment testing

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 no longer required to assess goodwill for impairment on an annual basis.

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.

9.12.6 The goodwill impairment test

Upon the occurrence of a triggering event, 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. See BCG 9.6 for a discussion of how to apply the qualitative impairment test. An entity is also permitted to bypass the qualitative assessment and proceed directly to the quantitative test. If a company elects 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 a quantitative impairment test.

Similar to step one for public business entities, 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 measured and recorded.

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 single step 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.

9.12.7 Measurement of an impairment loss

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 9-30

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 allocate 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 allocate 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 9-32 demonstrates measurement of an impairment loss under the goodwill alternative.

EXAMPLE 9-32

Measurement of an impairment loss

Company A has elected to assess its goodwill for impairment at the entity-wide level. During 20x4, Company A experiences a decline in its consolidated earnings and operating cash flows, and on June 30, 20x4, 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, the carrying amount of Company A's consolidated net assets is CU950, which includes goodwill of CU200.

How would Company A measure and record an impairment loss?

Analysis

Company A is required to assess its goodwill for impairment on June 30, 20x4, 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 35-27 (i.e., the guidance for determining the fair value of a reporting unit). Company A concludes that its fair value is CU800. Therefore, Company A's carrying amount exceeds its fair value by CU150. Company A should recognize a goodwill impairment loss of CU150, thus reducing the carrying amount of its goodwill to CU50.

Alternatively, if the carrying amount of Company A's goodwill was CU100 on June 30, 20x4, the impairment loss would be limited to CU100 because the total impairment loss cannot exceed the carrying amount of goodwill.

ASU 2017-04 amended ASC 350-20-35-73 to require a private company 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). See BCG 9.9.6.

Question 9-31

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. Therefore, it would appear that in these circumstances, the guidance in ASC 350-20-35-8A should be followed. See BCG 9.6.5 for more discussion of the impairment test for entities (or reporting units) with zero or negative carrying amounts. However, as noted at BCG 9.8.1.3, the revised guidance in ASU 2017-04 eliminates the requirement to assess goodwill impairment at reporting units with zero or negative carrying amounts.

For fiscal years beginning after December 15, 2020 (the effective date of ASU 2017-04), and any time prior, private companies that have elected the PCC alternative for goodwill but not the PCC alternative to subsume certain intangible assets into goodwill (ASU 2014-08) have a one-time election to adopt ASU 2017-04. The accounting policy change from amortizing goodwill to testing goodwill for impairment under the revised guidance would be made prospectively without having to justify preferability. This is a one-time accommodation provided by the FASB in order to make it easier for certain private companies to change from the PCC goodwill alternative to the revised guidance.

Private companies that have elected both the PCC alternative for goodwill and the PCC alternative for intangible can only adopt the revised guidance retrospectively in accordance with ASC 250, *Accounting Changes and Error Corrections*, after they have justified that it is preferable to change the accounting policy.

9.12.8 Allocation of an impairment loss

A company should allocate the 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 9-33 demonstrates the allocation of a goodwill impairment loss to amortizable units of goodwill.

EXAMPLE 9-33

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 20x5, Company A performs the goodwill impairment test and determines that it has a goodwill impairment loss of CU100 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	CU300	5 years
Unit 2	20x3 acquisition	CU150	8 years
Unit 3	20x4 acquisition	CU50	9 years
Total		CU500	

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 (CU300 / CU500). Unit 2's goodwill represents 30% of the total (CU150 / CU500). Unit 3's goodwill represents 10% of the total (CU50 / CU500). Using a pro rata allocation, Company A should allocate 60% of the impairment loss (CU60) to Unit 1, 30% (CU30) to Unit 2, and 10% (CU10) to Unit 3. The allocation of the impairment loss will impact the amount of amortization expense that will be recognized in each future period.

9.12.9 Disposal considerations

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 allocate to a disposed business should be determined using a reasonable and rational approach. A relative fair value approach would generally be considered a reasonable and rational approach. Other approaches may be considered reasonable and rational, depending on a company's specific facts and circumstances.

Under the existing guidance, the amount of goodwill to allocate to the business to be disposed of is determined based on the relative fair values of (1) the business being sold and (2) the portion of the reporting unit that will be retained unless the business to be disposed of was never integrated into the reporting unit (see BCG 9.10). In most cases it is difficult to establish that the benefits of the acquired goodwill were never realized by the rest of the reporting unit. Therefore, the relative fair value approach generally will be the most appropriate method of allocating goodwill to a disposed business for companies adopting the goodwill alternative.

9.12.10 Presentation and disclosure

ASC 350-20-45 and ASC 350-20-50 describe the presentation and disclosure requirements under the goodwill alternative, which are generally consistent with the disclosures required under the existing goodwill model. Key differences include the removal of the requirement for a company to disclose a tabular reconciliation of the beginning balance, ending balance, and activity in the goodwill balance from period to period and the addition of requirement to disclose the weighted-average amortization period of goodwill.

ASC 350-20-45-5

The aggregate amount of goodwill net of accumulated amortization and impairment shall be presented as a separate line item in the statement of financial position.

ASC 350-20-45-6

The amortization and aggregate amount of impairment of goodwill shall be presented in income statement line items within continuing operations (or similar caption) unless the amortization or a goodwill impairment loss is associated with a discontinued operation.

ASC 350-20-45-7

The amortization and impairment of goodwill associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.

ASC 350-20-50-4

The following information shall be disclosed in the notes to financial statements for any additions to goodwill in each period for which a statement of financial position is presented:

a. The amount assigned to goodwill in total and by major business combination or by reorganization event resulting in fresh-start reporting

b. The weighted-average amortization period in total and the amortization period by major business combination or by reorganization event resulting in fresh-start reporting.

ASC 350-20-50-5

The following information shall be disclosed in the financial statements or the notes to the financial statements for each period for which a statement of financial position is presented:

a. The gross carrying amounts of goodwill, accumulated amortization, and accumulated impairment loss

b. The aggregate amortization expense for the period

c. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale.

ASC 350-20-50-6

For each goodwill impairment loss recognized, the following information shall be disclosed in the notes to the financial statements that include the period in which the impairment loss is recognized:

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the entity or the reporting unit (whether based on prices of comparable businesses, a present value or other valuation technique, or a combination of those methods)

c. The caption in the income statement in which the impairment loss is included

d. The method of allocating the impairment loss to the individual amortizable units of goodwill.

ASC 350-20-50-7

The quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2(bbb) are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

Chapter 10: Postacquisition accounting issues—IFRS

10.1 Chapter overview

This chapter addresses certain issues arising in postacquisition accounting for the acquired assets, assumed liabilities, and contingent liabilities of the acquired business. There are few explicit changes in postacquisition accounting under IFRS 3; those limited changes are highlighted in this chapter. The chapter also addresses some of the challenging issues in applying the postacquisition accounting guidance to assets typically acquired in a business combination, such as intangible assets and goodwill. Also covered is the subsequent accounting for the assets and liabilities of the acquirer that may arise in a business combination from seller-granted indemnities, and contingent consideration classified as a liability.

IFRS permits or requires the use of fair value for the subsequent measurement of investment properties, biological assets, property, plant and equipment, and a limited category of intangible assets. This chapter does not address subsequent measurement for these assets or other tangible fixed assets. There are few specific accounting issues that arise if these types of assets are acquired in a business combination.

New guidance

As of the content cutoff date of this guide (December 2017), active IASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter. Specifically, the IASB has initiated a research project to explore whether the existing impairment test for goodwill can be improved or simplified, whether goodwill should be amortized and whether intangible assets should be separated from goodwill. The project is in the research stage and no decision has been made by the IASB. Financial statement preparers and other users of this publication are encouraged to monitor the status of this project, and if issued, evaluate the effective date of the new guidance and determine the implications on presentation and disclosure.

10.2 Overview of impairment testing under IAS 36

This section presents an overview of impairment testing under IAS 36. See BCG 10.4.9 and BCG 10.5 for information on specific issues relevant to testing intangible assets and goodwill, respectively. See BCG 10.6 for further information on the requirements of impairment testing.

An asset may not be carried in the balance sheet at more than its recoverable amount. The carrying amount is reduced to the recoverable amount if an asset's carrying amount is in excess of its recoverable amount. Carrying amount is the amount at which the asset is recognized after deducting accumulated depreciation or amortization and accumulated impairment losses.

Assets should be tested for impairment at the lowest level possible in accordance with IAS 36.22, which may be the individual asset level. Few assets generate cash inflows largely independent of the cash inflows generated by other assets or groups of assets. Therefore, most assets are tested within a CGU. As defined in IAS 36.6, a CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Assets that do not yet generate cash flows, such as intangible assets not yet in use, are tested separately for impairment.

Certain assets, such as goodwill and corporate assets, provide benefits to more than one CGU and are tested with groups of CGUs. The goodwill is added to the carrying value of the group of CGUs for purposes of impairment testing. Goodwill is tested at the lowest level monitored by management. In no case can the group of CGUs that the goodwill is associated with be larger than an operating segment as defined in IFRS 8, *Operating Segments*. Corporate assets may provide benefits to the entire entity and should be grouped with the CGUs comprising the entity for purposes of impairment testing.

An asset's (or CGU's or group of CGUs') recoverable amount is the greater of fair value less costs of disposal (FVLCOD) or value in use (VIU). FVLCOD is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market-participants at the measurement date, less the costs of disposal. VIU is the present value of the future cash flows expected to be derived from the asset or CGU in its current condition. VIU is a discounted cash flow approach with a number of elements and assumptions prescribed by the standard. FVLCOD is also often based on a discounted cash flow approach, but uses assumptions that a market-participant might use to value the asset or CGU.

The recoverable amount is compared to the carrying amount, and any impairment loss is recorded first against goodwill then pro rata against the carrying value of assets within the scope of IAS 36. Impairments of assets, other than goodwill, can be reversed when certain criteria are met. See BCG 10.6.11 for further information. Impairments of goodwill are never reversed.

Assets or CGU(s) are tested for impairment when there are indicators present, or at least annually in the cases of goodwill, indefinite-lived intangible assets, and intangible assets not yet ready for use.

10.3 Accounting issues for the acquirer

While primarily related to acquisition accounting, IFRS 3 also addresses the postacquisition accounting for certain assets and liabilities of the acquirer. Postacquisition accounting guidance includes seller-granted indemnities and contingent consideration classified as a liability or an asset.

10.3.1 Indemnification assets

Indemnification assets are an exception to the recognition and fair value measurement principles. They are recognized and measured differently from contingent assets. Indemnification assets (sometimes referred to as "seller indemnifications") may be recognized if the seller contractually indemnifies, in whole or in part, the acquirer for a particular uncertainty. Contractual indemnities are common for litigation contingencies and uncertain tax positions.

The recognition and measurement of an indemnification asset is based on the related indemnified item. The acquirer should recognize an indemnification asset at the same time that it recognizes the indemnified item. The indemnification asset is measured on the same basis as the indemnified item, subject to collectibility or any contractual limitations. The acquirer should recognize an indemnification asset at its fair value on the acquisition date if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its fair value. A separate valuation allowance for credit risk is not necessary if an indemnification asset is measured at fair value. The fair value measurement will reflect any uncertainties in future cash flows.

Seller indemnifications may relate to indemnified items that are not recorded at the date of acquisition. For example, a contingent liability might not be recognized at the acquisition date because it cannot be reliably measured. The contingent liability is recognized when it subsequently becomes reliably measurable. An indemnification asset is recorded at the same time and on the same basis (subject to contractual limitations on the indemnified amount and management's assessment of collectibility) as the contingent liability, regardless of whether the recognition is within the measurement period.

Indemnification assets continue to be measured on the same basis as the related indemnified item, giving effect to the collectibility and contractual terms. Final measurement occurs when the indemnified item is collected, sold, or cancelled, or when the entity otherwise loses the right to it in the postacquisition period.

An indemnification asset might relate to any asset, liability, or contingent liability of the acquired business. The indemnified item might be an employee benefit obligation measured under IAS 19, a provision under IAS 37, or an uncertain tax position. The entity should measure the indemnification asset on the same basis as the related indemnified item, subject to any restrictions in the contractual terms. Restrictions include ceilings on the amount payable and adjustments for the creditworthiness of the seller.

The indemnified item might be a contingent liability. The contingent liability would be remeasured only if an outflow of resources embodying economic benefits to settle the liability is probable within the meaning of IAS 37 (i.e., more likely than not to occur) and was accounted for under that standard. The difference between the previously recorded amount and the best estimate of the future outflow would be recorded as an increase in the liability and the indemnification asset if the full amount of the contingency was subject to the indemnity and the outflow of resources became probable. The contingent liability also might be derecognized without payment. Derecognition of the contingency without payment would occur if the entity was released from the obligation. Both the indemnification asset and the liability would be derecognized then.

10.3.2 Contingent consideration

Contingent consideration under IFRS 3.39 is recognized and measured at its fair value as of the acquisition date. In accordance with IFRS 3.40, an acquirer's right to receive contingent consideration (i.e., contingently returnable consideration) should be classified as an asset. Also, an acquirer's obligation to pay contingent consideration that meets the definition of a financial instrument should be classified as a financial liability or equity based on the definitions in IAS 32.11. A financial liability is (1) a contractual obligation to deliver cash or other financial assets, or exchange financial assets or liabilities under conditions that are potentially unfavorable; or (2) a contract that will or may be settled in the entity's own equity instruments and is a:

- Nonderivative for which an entity is or may be obliged to deliver a variable number of its own equity shares

- Derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of its own equity instruments

Under IAS 32.11 an equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

The accounting for contingent consideration in the postacquisition period is determined by the classification of the contingent consideration. Contingent consideration that is classified as an asset or liability (financial or non-financial) should be remeasured to fair value at each reporting date, and changes in fair value should be included in profit or loss in accordance with IAS 39 or IFRS 9. Contingent consideration that is classified as an equity instrument is not remeasured.

Recognition of contingent consideration receivable from the seller seldom occurs in practice. However, if recognized, such receivable would likely be categorized under IFRS 9 as an asset measured at fair value through profit or loss.

See BCG 2.6.4.2 for further information on contingent consideration.

10.4 Intangible assets

An acquirer must recognize all of the identifiable intangible assets acquired in a business combination. In accordance with IAS 38.12, an intangible asset is identifiable if it meets the contractual-legal criterion (i.e., arises from contractual or other legal rights) or the separability criterion (i.e., capable of being separated from the entity and sold, transferred, licensed, rented, or exchanged). The recognition of intangible assets in a business combination gives rise to a number of postacquisition accounting issues. This section addresses the grouping of intangible assets that have similar attributes and lives; selection of useful lives, including the assessment of an indefinite useful life; amortization methods; and specific issues relating to impairment testing.

10.4.1 Grouping intangible assets

Groups of similar or related assets are often acquired in a business combination. Some intangible assets are recognized only in conjunction with other assets. This is the case when the similar or related assets could only be disposed of in a group. Complementary assets can be grouped if the assets have similar useful lives. An example might be the group of trade names and trademarks collectively described as a brand.

A group of complementary assets might include tangible and intangible assets. This would be appropriate when the assets cannot be separated because the individual fair values cannot be reliably measured. Examples are a license to operate a nuclear power plant and the physical fixed assets of the plant, or a brand name for spring water and the source of the spring water.

Assets that are dissimilar or have different useful lives cannot be grouped or recognized as a single asset. An example might be a group of in-process research and development assets. The individual assets arise from the research activities of the acquired business. These assets are inherently unique and may have very different useful lives when brought into use. For example, one research project may be abandoned soon after the date of the business combination and then impaired. A different project may be the subject of further development for a number of years and then become a marketed product. Amortization would begin when the project was completed and placed in service.

Customer-related intangible assets present similar challenges. A number of different assets might arise from the customers of the acquired business. These might include a customer list, order backlog, and customer relationships. The assets might have different useful lives, because the customer relationship might be amortized over the customer churn period, whereas the order backlog would be amortized only over the fulfillment period.

10.4.2 Intangible assets—useful lives

Intangible assets that have a determinable useful life are amortized over that useful life using an appropriate method. In IAS 38.8, useful life is defined as:

- The period over which an asset is expected to be available for use by an entity, or
- The number of production or similar units expected to be produced from the asset by an entity

Useful lives are usually determined by reference to time periods, except for those assets, such as mineral resources, that are clearly consumed through use. Economic and legal factors may influence the useful life of an intangible asset. Economic factors determine the period over which future economic benefits will be received by the entity. Legal factors may restrict the period over which the entity controls access to those benefits. The useful life is generally the shorter of the legal period and the period in which the entity expects to benefit from the asset, as outlined in IAS 38.94-95.

10.4.3 Renewal periods

Some legal rights remain in force indefinitely, can be continually renewed by the acquirer (e.g., trademarks that secure brand names), or can be renewed by the entity without substantial cost. Any one of these circumstances may support a useful life beyond the legal or contractual period.

The useful life of an intangible asset (other than reacquired rights, further described in BCG 10.4.4) arising from contractual or legal rights can extend beyond the period of the contractual or legal rights only if appropriate evidence is available to support renewal by the entity. IAS 38.96 includes examples of the evidence necessary to extend the useful life of an asset, including:

- Evidence, possibly based on experience, that the contractual or legal rights will be renewed. This includes evidence that if the consent of a third party is required, then such consent will be forthcoming.
- Evidence that any conditions necessary to obtain renewal will be satisfied. This would include evidence that no conditions that have to be complied with in respect of renewal have been or will be breached (e.g., evidence that a train operating company has met operational targets that are a condition of renewal of its operating license).
- Evidence that the cost of renewal to the entity is not significant when compared with the future economic benefits expected from the renewal.

A significant renewal cost represents, in substance, the cost of acquiring a new intangible asset at the renewal date. The carrying amount of the intangible asset should be fully amortized by the renewal date, and the renewal cost is then capitalized as a new intangible asset.

10.4.4 Reacquired rights

IFRS 3 gives specific guidance for the accounting for reacquired rights. An entity may reacquire a right in a business combination that it had previously granted to the acquiree to use the acquirer's intangible assets. Such rights are recognized as intangible assets and measured at fair value based on the term of the related contract. This measurement excludes the effects of expected contractual renewals. After initial recognition, the assets are amortized over the remaining period of the contract in which the right was granted. The amortization period also excludes any renewals and extensions. A reacquired right may be perpetual if there are no contractual renewals and the remaining contractual life is not limited. Such a reacquired right may have an indefinite useful life. See BCG 2.5.6.1 for further information.

10.4.5 Indefinite useful lives

Indefinite-lived intangible assets are not amortized. They are tested annually for impairment and whenever indicators of impairment are present in accordance with IAS 38.107,108. Indefinite-lived intangible assets are tested with the CGU or group of CGUs that derive benefit from the intangible asset. *Indefinite* is not the same as an *infinite useful life*. Under IAS 38.91, indefinite indicates there is no foreseeable limit on the ability to derive benefits from the asset.

Support for an indefinite life for an intangible asset generally requires a business, industry, or product to have a track record of stability and financial achievement, as well as barriers to market entry. Established brands or leading brands in a mature industry may have an indefinite useful life. Finite lives may be appropriate for other brands and publishing titles that are relatively new, dependent on an individual's reputation, or that operate in more volatile sectors.

10.4.6 Acquired in-process research and development

Another intangible asset commonly acquired in a business combination is in-process research and development (IPR&D). IPR&D is used to describe research and development projects, not products or processes already in service or being sold. It is not amortized as it is not yet ready for use. It is tested annually for impairment or when there are indicators of impairment. IPR&D assets are tested separately for impairment as they do not yet produce cash flows. They are usually tested using a FVLCOD approach, similar to the valuation method used for initial recognition.

10.4.7 Intangible assets that the acquirer does not intend to use

An entity may acquire intangible assets that it does not intend to use. The entity may continue to receive indirect benefits from the asset if it prevents the asset from being used by others. The fair value of these intangible assets should be recognized at the acquisition date based upon market-participant assumptions. See BCG 4.5 for further information.

The acquirer's intentions or subsequent use of the asset will affect the asset's useful life after the acquisition date. The useful life should reflect the acquiring entity's consumption of the asset's expected benefits. This is the time period over which the asset is expected to contribute directly or indirectly to the acquiring entity's future cash flows. These defensive intangible assets are rarely expensed immediately at the date of acquisition, or rarely have an indefinite useful life.

These intangible assets will need to be reviewed and tested for impairment when appropriate under IAS 36 in the postcombination period.

10.4.8 Amortization

The method of amortization for all intangible assets with a finite life should reflect the pattern in which the economic benefits are expected to be consumed by the entity as discussed in IAS 38.97. In May 2014, the IASB issued Clarification of Acceptable Methods of Depreciation and Amortisation (Amendments to IAS 16 and IAS 38), which established a rebuttable presumption that using a revenue-based method of amortization for an intangible asset is not acceptable. IAS 38.98A allows the rebuttable presumption to be overcome only when:

- the intangible asset is expressed as a measure of revenue, as described in paragraph 98C; or
- it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

IAS 38.98C clarifies that an intangible asset is expressed as a measure of revenue when the "predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold." Amortization charges should be recognized as an expense, unless they are included in the carrying amount of another asset as permitted, or required, by another standard. For example, IAS 38.99 states that amortization may be included in inventory or work-in-progress as part of an allocation of overhead, in accordance with IAS 2.

Amortization applies to all long-lived tangible or intangible assets that have a finite useful life, whether held at historical cost or revalued. The amortization method should reflect the pattern in which future economic benefits of the intangible asset are expected to be consumed. This could be straight line, diminishing returns, or a units-of-production method.

10.4.9 Specific issues in impairment testing of intangible assets

A number of issues arise in impairment testing related to intangible assets. Intangible assets that are in service seldom give rise to independent cash flows. They are used in conjunction with other assets of the entity to generate cash flows. Common examples are licenses to provide mobile phone services, brands, technology, software, and drugs in patent. These intangible assets cannot be tested separately for impairment under IAS 36. They must be tested as part of a CGU, a group of CGUs, or as corporate assets. Assets must be tested at the lowest level of largely independent cash flows. The individual CGUs should be tested first if indicators of impairment exist. Any resulting impairment loss should be recognized before testing for impairment of intangible assets and goodwill that relate to that group of CGUs. The nature of the intangible asset, and the rights or know-how it conveys to the entity, is crucial to understanding how it contributes to the generation of cash flows. An intangible asset that gives an entity a right to operate a service or sell a product in a particular country would contribute to the ability to generate cash flows in that country. The intangible asset would be grouped with the CGU or group of CGUs from that country for the purposes of impairment testing. See BCG 10.6 for further information on impairment testing.

Example 10-1 provides an example of the grouping of intangible assets with a CGU or group of CGUs.

EXAMPLE 10-1

Impairment testing—intangible assets

An entity that provides mobile telephone services in a number of countries under a single strong global brand is acquired. The acquirer recognizes the license to provide services in each country and recognizes a group of trademarks and trade names that it groups as the brand. The brand is assigned an indefinite useful life. The licenses have fixed terms with significant costs to renew or a requirement to renew at an auction, and have all been assigned finite useful lives.

For the purpose of impairment testing, how should the licenses and the brand be grouped?

Analysis

The license in each country should be grouped with the CGU or CGUs in each country for the purpose of impairment testing. The individual CGUs should be tested first for impairment if there are indicators of impairment. The brand would need to be included in the group of CGUs comprising all of the countries that benefit from the brand. This group of CGUs might be the entire entity. The existence of the brand, an indefinite-lived intangible asset, imposes a requirement for annual impairment testing for the groups of CGUs that benefit from it.

The recognition of indefinite-lived intangible assets in a business combination is almost always accompanied by the recognition of goodwill. The existence of goodwill can complicate impairment testing and the allocation of the impairment loss. Annual testing of indefinite-lived intangible assets and goodwill is required. An entity should consider whether there are indicators of impairment in any individual CGUs that will require separate impairment testing before performing the annual testing. Any impairment loss at the individual CGUs should be recognized in the income statement and as a reduction in the carrying amount of the related group of CGUs. An impairment loss has occurred if the recoverable amount of the group of assets comprising the brand, the allocated goodwill, and the associated CGUs is below the carrying amount (after reflecting all individual CGU impairments). The goodwill is written off first in accordance with the hierarchy for allocating impairment losses. The impairment loss is allocated to tangible and intangible assets of the brand and to the other assets within the scope of IAS 36 after goodwill is written off. See BCG 10.6.10 for further information.

Example 10-2 provides an example of applying the hierarchy of allocating impairment losses.

EXAMPLE 10-2

Allocation of an impairment loss to goodwill and brands

An entity is performing the annual impairment test for goodwill and two brands with indefinite useful lives and the group of CGUs that are associated with the brands and the goodwill. The carrying amount of the CGUs (after reflecting any individual CGU impairments), including the brands and goodwill, is higher than the recoverable amount. The recorded amount of goodwill is CU12 million, the carrying amount of Brand X is CU5 million, and the carrying amount of Brand Y is CU6 million. The amount of the impairment loss is CU10 million. Management believes that the impairment loss is largely the result of the poor performance of Brand X and wants to allocate the impairment loss first to Brand X and then to other assets.

How should the impairment loss be allocated?

Analysis

The impairment loss must be allocated first to goodwill. Recorded goodwill exceeds the total amount of the impairment loss, so none of the loss would be allocated to the brands or to the other assets of the CGUs.

10.5 Goodwill

Goodwill must be tested annually for impairment in accordance with IAS 36.10(b). Goodwill must be allocated to one or more CGUs for the purpose of impairment testing because it does not generate independent cash inflows. Goodwill is commonly allocated to groups of CGUs for the purpose of impairment testing.

In accordance with IAS 36.80, goodwill is allocated to the CGUs that are expected to benefit from the synergies of the combination, both existing and acquired CGUs. The group of CGUs to which goodwill is allocated shall represent the lowest level at which the goodwill will be monitored and managed. The group of CGUs cannot be larger than an operating segment as defined in IFRS 8. It is possible that goodwill recognized in a less-than-100% acquisition will be allocated to a CGU or group of CGUs in which the noncontrolling interest does not have an interest. This will have an impact on the impairment testing of goodwill and the allocation of any impairment loss to the controlling and noncontrolling interests. See BCG 10.5.2 for further information.

Goodwill is the residual in a business combination after all of the identifiable assets, liabilities, and contingent liabilities of the acquiree have been recognized. Goodwill may include:

- The fair value of expected synergies from the combination

- Assets that are not capable of recognition (e.g., skilled workforce, noncontractual customer relationships)

- Assets and liabilities that are not measured at fair value, such as deferred tax and employee benefits

Identification of the constituent parts of goodwill (a qualitative discussion is a required disclosure of IFRS 3) may assist in allocating the goodwill to the CGUs or groups of CGUs that are expected to benefit from the synergies, or to which the unrecognized assets have been deployed.

The allocated goodwill forms part of the CGU's carrying amount. Potential impairment of the CGU is measured by comparing its carrying value, including any allocated goodwill, to its recoverable amount. The goodwill forms part of the total carrying amount of the group of CGUs for impairment testing purposes when goodwill is allocated to a group of CGUs rather than an individual CGU.

The fair values of identifiable net assets recognized in a business combination may be based on the provisional fair values available at the time of the acquisition. The fair value of these assets and liabilities and the resulting amount of any goodwill must be finalized no later than 12 months from the acquisition date. Goodwill, as the residual, is not finally determined until the fair value exercise is complete. A change to goodwill arising from the completion of the fair value exercise is not an impairment.

Goodwill acquired in a business combination during the period may not have been allocated to a CGU or group of CGUs at the reporting date. In accordance with IAS 36.133, the reasons why a portion has not been allocated, and the amount of unallocated goodwill, should be disclosed. Goodwill must be allocated to CGUs by the end of the year following the year of the business combination. Entities should not avoid an impairment charge as a result of goodwill not being allocated. Entities should allocate the goodwill, even if provisionally, and perform impairment testing if indications of impairment exist.

10.5.1 Goodwill and the valuation choice for noncontrolling interests

A parent company that has done only 100% acquisitions does not need to apply the gross-up method or the allocation method described in this section because the parent does not have noncontrolling interest in its consolidated financial statements. A parent company that has acquired goodwill and has any noncontrolling interest needs to consider carefully the calculation and allocation of any impairment loss. The allocation methodology in IAS 36, Appendix C, paragraphs 5–9, must be applied if an entity has acquired goodwill and there are noncontrolling interests in the CGU or groups of CGUs that goodwill has been allocated. The application of the gross-up method interacts with the allocation of any impairment loss.

IFRS 3 (2004) required an entity to record noncontrolling interest as the proportionate share of the recognized amount of the acquiree's identifiable net assets at the acquisition date (proportionate share method). IFRS 3 (2008) allows an entity the choice of measuring the noncontrolling interest at fair value (fair value method) or the proportionate share method. The discussion that follows applies to any situation where the proportionate share method was applied in a business combination of less than 100%, whether it was required under IFRS 3 (2004), or a choice under IFRS 3 (2008). A number of factors will impact the impairment testing of goodwill, potentially increasing or decreasing the complexity of the process. The factors that will impact how goodwill is tested for impairment include:

- The existence of any noncontrolling interests
- One or more business combinations of less than 100% using the proportionate share method for measurement of noncontrolling interest
- One or more business combinations of less than 100% using the fair value method for measurement of the noncontrolling interest
- How the entity groups CGUs for the testing of goodwill

IFRS 3.19 allows the accounting choice of proportionate share method or fair value method can be elected on a transaction-by-transaction basis and does not require an entity to make an accounting policy choice. An entity that chooses the fair value method recognizes goodwill relating to both the controlling and the noncontrolling interests. The valuation method chosen will have ongoing consequences for the impairment testing of goodwill and the associated recordkeeping. An acquisitive group with one or more noncontrolling interests will face significant challenges. The challenges increase if the entity tests goodwill with groups of CGUs that include controlling and noncontrolling interests. See BCG 5.2 for further information on the measurement of noncontrolling interest.

The requirement to gross-up goodwill for impairment testing applies when an entity has used the proportionate share method. This creates an ongoing requirement to track goodwill by transaction to determine whether the goodwill was recognized under the proportionate share or fair value method. The gross-up requirement is driven by the origin of the goodwill, not by whether there is a noncontrolling interest in the CGU or groups of CGUs to which the goodwill has been allocated.

Goodwill that is recorded under the fair value method is subject to the ordinary impairment testing requirements of IAS 36. Any impairment loss is allocated to the controlling and noncontrolling interests as described in BCG 10.5.2. The allocation method will be impacted by the grouping of CGUs.
Goodwill that is recorded under the proportionate share method must be grossed up for impairment testing in accordance with IAS 36.C4. The recorded goodwill and the notional amount of goodwill allocable to the noncontrolling interest (equaling the grossed-up goodwill) are included in the carrying amount of the CGU or group of CGUs being tested and compared to the recoverable amount. Any impairment loss calculated on the gross-up method is then segregated into the amount relating to recorded goodwill and notional goodwill. The amount that relates to the notional goodwill is not recognized as a loss as the related "asset" has never been recognized. The amount that relates to recorded goodwill is recognized as an impairment loss in the income statement and subject to the allocation method described in BCG 10.5.2. The allocation method may be impacted by the grouping of CGUs. Partially owned CGUs may be grouped with wholly owned CGUs for impairment testing purposes.

10.5.2 Allocating goodwill impairment losses to controlling and noncontrolling interests

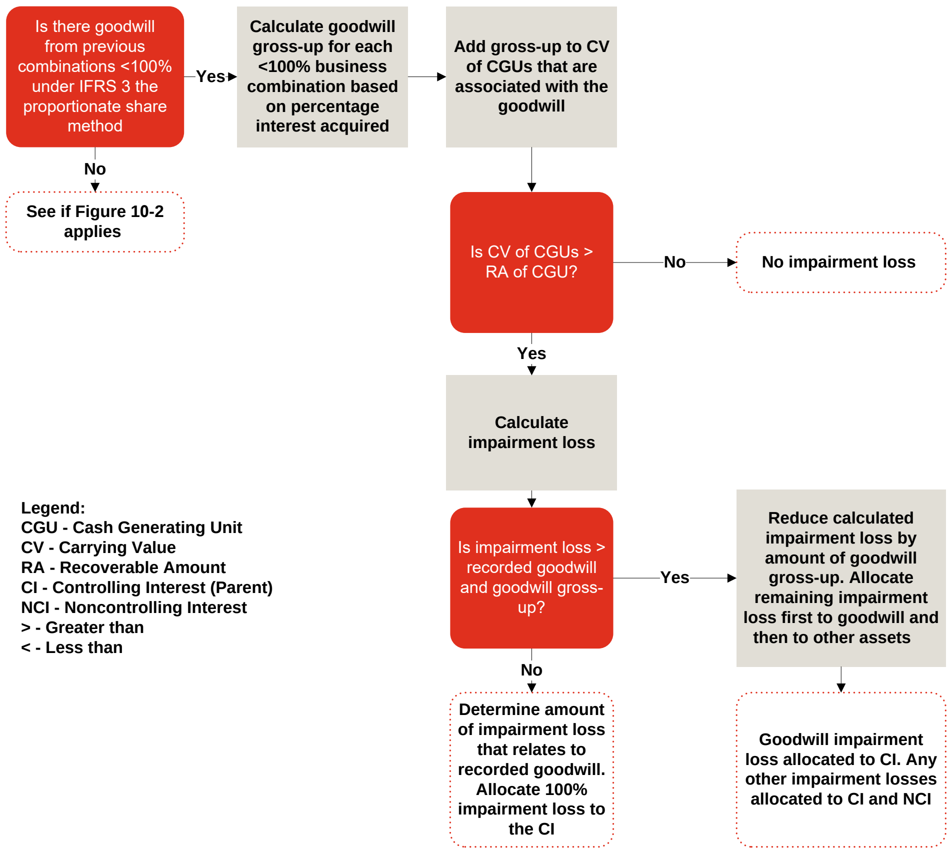
The allocation of impairment losses can be complex under both the proportionate share method and the fair value method. Some potentially significant complications to the allocation of impairment losses are created by the fair value method for measuring the noncontrolling interest, combined with the guidance in IAS 36. IAS 36 allows the grouping of CGUs for purposes of impairment testing.

The choice of measuring the noncontrolling interest using the proportionate share method or the fair value method will need to be tracked to determine whether the gross-up method is required. Goodwill must continue to be specifically identified and tracked where CGUs are grouped for the purpose of goodwill impairment testing. The goodwill allocated to such a grouping of CGUs may combine goodwill from 100% business combinations and goodwill from business combinations where only the controlling shareholder's proportion of goodwill was recognized. It may be necessary to allocate impairment losses between the controlling and noncontrolling interests.

Figure 10-1 illustrates the process for determining whether goodwill needs to be grossed up for impairment testing, the calculation of impairment losses for goodwill, and the allocation of losses between the controlling and noncontrolling interests if the proportionate share method is chosen.

Figure 10-1

Impairment testing and allocation of impairment losses using the proportionate share method



Example 10-3 provides an example that illustrates the impact of grouping wholly owned CGUs with CGUs containing a noncontrolling interest when testing goodwill for impairment if the proportionate share method is chosen.

EXAMPLE 10-3

Allocation of an impairment loss to controlling and noncontrolling interests if the proportionate share method is chosen

An entity has recorded goodwill of CU400 in an 80% acquisition and applied the proportionate share method to the valuation of the noncontrolling interest. The goodwill is allocated to a group of CGUs for impairment testing, including some wholly owned CGUs of the entity. There is no other goodwill. The group of CGUs is tested for impairment annually. The carrying amount of the CGUs and recorded goodwill is CU1,400. The recoverable amount of the CGUs is CU1,100.

Using the proportionate share method, what amount of goodwill should be allocated to the recorded and the unrecorded (notional) goodwill?

Analysis

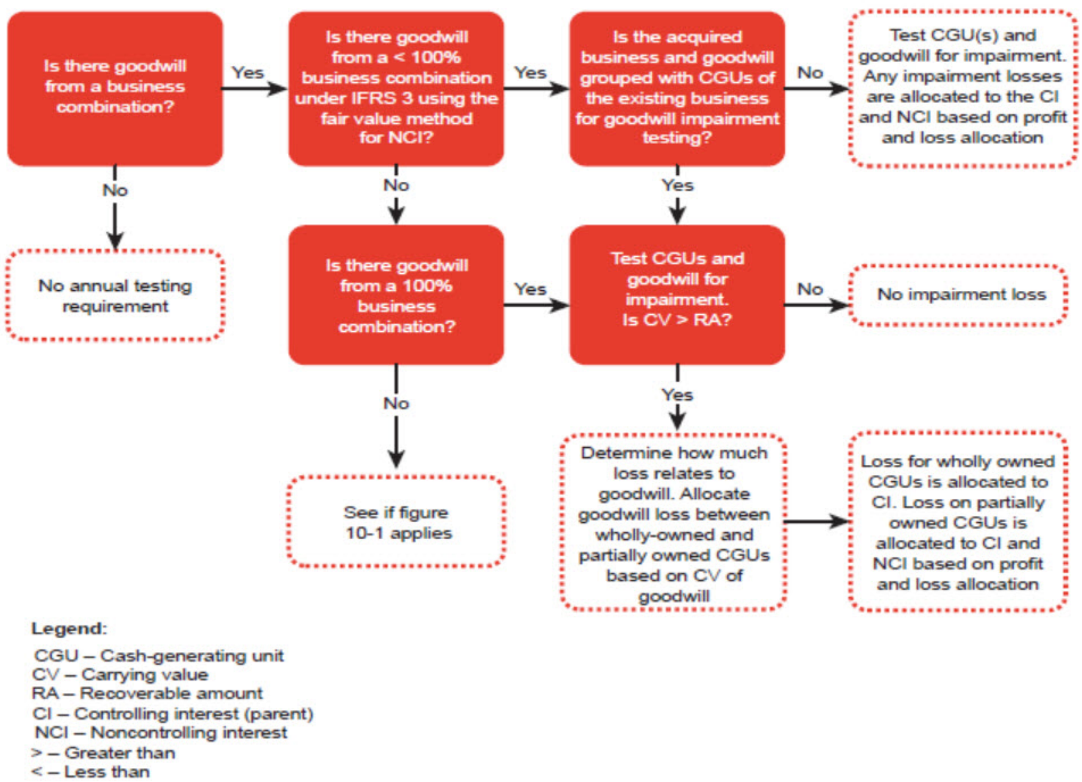
The goodwill gross-up, or notional goodwill, is CU100 (CU400 / 80% – CU400). This amount would be added to the carrying value of the group of CGUs. The carrying value for the purposes of testing goodwill is CU1,500 (CU1,400 + CU100). The recoverable amount is less than the adjusted carrying value, so there is an impairment loss of CU400 (CU1,100 – CU1,500). The impairment loss is less than the total of recorded goodwill plus notional goodwill of CU500. As a result it must be allocated between the recorded and the unrecorded (notional) elements.

The impairment loss of CU400 would be allocated CU320 (CU400 x CU400 / CU500) to the recorded portion of goodwill and recorded as an expense and a reduction of recorded goodwill. It would be allocated in total to the controlling interest. The remaining CU80 of the impairment loss relates to the noncontrolling interest, but is effectively ignored because it relates to unrecorded notional goodwill.

Figure 10-2 illustrates the process for the calculation of impairment losses for goodwill and the allocation of losses between the controlling and noncontrolling interests if the fair value method is chosen.

Figure 10-2

Impairment testing and allocation of impairment losses using the fair value method



A group of CGUs that goodwill has been allocated to may include wholly owned CGUs and CGUs with a noncontrolling interest. An entity that has acquired goodwill from a less than 100% acquisition using the proportionate share method first calculates the gross-up of goodwill. Any impairment loss is then calculated. The impairment loss is applied first to the goodwill in accordance with the hierarchy for allocating impairment losses.

An entity that has applied only the fair value method of measuring noncontrolling interests does not need to calculate the goodwill gross-up. Some of the goodwill may be allocated to a group of CGUs that include both wholly owned CGUs and CGUs that have noncontrolling interests. This goodwill is tested for impairment as part of the carrying value of the group of CGUs. Any impairment loss is allocated between the wholly owned and partially owned CGUs based on the relative carrying amounts of goodwill. Any impairment loss on the portion allocated to the wholly owned CGUs is allocated to the controlling interest. Any impairment loss on the portion allocated to the CGUs with a noncontrolling interest is allocated between the controlling and noncontrolling interests in the same way that profit and loss is allocated as specified in IAS 36.C6.

An entity that has applied both the proportionate share method and the fair value method to measure noncontrolling interest will face challenges in calculating and recording any goodwill impairment when it incorporates a newly acquired business into a group of existing CGUs with goodwill.

Example 10-4 provides an example that illustrates the allocation of an impairment loss for testing goodwill when there are wholly owned CGUs grouped with CGUs with a noncontrolling interest.

EXAMPLE 10-4

Allocation of an impairment loss to controlling and noncontrolling interests with preexisting goodwill

An entity has previously recorded goodwill of CU800, all arising from 100% acquisitions that occurred under IFRS 3 (2004). It subsequently records goodwill of CU500 in an 80% acquisition and applies the fair value method to the valuation of the noncontrolling interest. The acquired business is a single CGU, but is grouped with a number of wholly owned CGUs for impairment testing. The CU800 of previously recorded goodwill is also allocated to that group of CGUs. There is no other noncontrolling interest. Profit or loss of the acquired business is allocated on the basis of the common shareholding. The group of CGUs is tested for impairment annually. The annual testing indicated that the carrying value of the CGUs and the goodwill that is tested with them is less than the recoverable amount by CU500, resulting in an impairment loss.

How should the impairment loss be allocated?

Analysis

Goodwill gross-up is not required. All existing goodwill arose in 100% acquisitions and a partial acquisition using the fair value method to value the noncontrolling interest. The impairment loss would first be allocated between the wholly-owned portion of the group of CGUs and the portion with controlling and noncontrolling interests based on the relative carrying amounts of goodwill. A goodwill impairment loss of CU307 (CU500 x CU800/CU1,300) would be allocated to the wholly-owned portion of the group of CGUs. All of this loss would be allocated to the controlling interest.

A goodwill impairment of CU193 (CU500 x CU500/ CU1,300) would be allocated to the CGU that includes the controlling and noncontrolling interests. This would be further allocated between the controlling and noncontrolling interests on the same basis as profit and loss. Therefore, the amount of impairment loss attributed to the controlling interest is CU154 (CU193 x 80%), and the amount allocated to the noncontrolling interest is CU39 (CU193 x 20%). The total impairment loss allocated to the controlling interest is CU461 (CU307 + CU154).

10.5.3 Disposals and group reorganizations with goodwill

Goodwill that has been allocated to a CGU or group of CGUs is included in the carrying amount of the operation when calculating the profit or loss on disposal.

The goodwill attributable to the disposed operation and the part of the CGU that is retained is based on relative fair values. This method is applied unless the entity can demonstrate that some other method better reflects the goodwill attributable to the operation being disposed of. The relative fair value method is the method commonly used in practice. It is very difficult to demonstrate that another method better represents how goodwill might be attributed.

An entity might reorganize its business and change the composition of one or more CGUs to which goodwill has been allocated. The goodwill attributable to operations that are moved between CGUs is calculated using the relative fair values of the CGUs transferred and remaining in the CGU. In accordance with IAS 36.87, this method is applied unless the entity can demonstrate that another allocation method better reflects the goodwill attributable to the transferred operations.

10.6 Impairment of assets

An asset is impaired when its carrying amount exceeds its recoverable amount. IAS 36 sets out the requirements for impairment testing for all assets not specifically covered by other standards. An asset's recoverable amount is the higher of its VIU and its FVLCOD. If the asset's carrying amount exceeds its recoverable amount, the asset is impaired, and it is written down to its recoverable amount through recognition of an impairment loss.

Certain assets are tested for impairment at least every year: goodwill, indefinite-lived intangible assets, and assets not subject to depreciation or amortization, because they are not yet ready for use.

10.6.1 Scope of IAS 36

All assets are within the scope of IAS 36 unless specifically excluded. IAS 36.2 scopes out the following assets:

- Inventories
- Assets arising from construction contracts
- Deferred tax assets
- Assets arising from employee benefits
- Assets carried at fair value under International Accounting Standard 40, *Investment Property* (IAS 40), and International Accounting Standard 41, *Agriculture* (IAS 41)
- Financial assets within the scope of IAS 39
- Assets within the scope of IFRS 4
- Assets held-for-sale within the scope of IFRS 5

Investments in subsidiaries, joint ventures, and associates are within the scope of IAS 36.

10.6.2 Indicators of impairment

In accordance with IAS 36.9, an entity must determine at each reporting date whether there is any indication that an asset is impaired. The asset's recoverable amount must be determined and compared with its carrying amount to assess the amount of any impairment if an indicator of impairment exists. This requirement extends to goodwill, indefinite-lived intangible assets, and assets not yet subject to depreciation or amortization.

Indicators of impairment may arise from the external environment in which the entity operates, or from within the entity's own operating environment. IAS 36.12 lists examples of impairment indicators, as follows.

External indicators:

- Significant decline in the asset's market value
- Adverse changes in technology, the market, the economic or legal environment
- Increases in market interest rates
- Carrying amount of the entity's net assets exceeds its market capitalization

Internal indicators:

- Evidence of obsolescence
- Plans to discontinue use of the asset or to dispose of it
- Change from indefinite to determinable useful life for an intangible asset
- Evidence that the asset is performing below expectations

Downturns caused by general economic conditions or specific company circumstances often present indicators of impairment. Although not an exhaustive list, examples of these types of indicators include:

- Actual results significantly lower than budgeted
- Cash flows significantly lower than forecasted
- Material decreases in mid-term or long-term growth rates
- Significant or prolonged decrease in the entity's stock price
- Announced change in business model, restructuring, or discontinued operations
- Increase in the entity's cost of capital
- Change of market interest rates or other market rates of return

- Fluctuations in foreign exchange rates or commodity prices that impact the entity's cash flows
- Deferral of investment projects

Management should not limit the assessment of indicators to those noted above. It is necessary to consider and evaluate any adverse change in circumstances as a potential indicator of impairment.

10.6.3 Determination of cash-generating units

The existence of independent cash flows and the identity of an entity's CGUs is usually a matter of fact rather than judgment. The independence of cash inflows will often be evident. Management can gain valuable insights from additional information that is readily available. IAS 36 focuses on cash inflows, not net cash flows. Shared support assets and infrastructure do not undermine the independence of cash inflows. Such assets are tested with the groups of CGUs they support, or as corporate assets by reference to the totality of cash flows of the entity.

The existence of an active market for the output of an asset or group of assets is evidence that cash inflows are independent. Such an asset or group of assets will be a CGU, even if the output is consumed internally. Examples of outputs from assets for which an active market exists include oil, gold, and electricity.

In accordance with IAS 36.72, the identification of CGUs should be consistent from period to period. An asset that was previously part of a CGU, but is no longer utilized, should be excluded from the CGU and assessed separately for impairment.

Examples 10-5 to 10-7 provide examples that illustrate the identification of CGUs.

EXAMPLE 10-5

Identification of CGUs within entities that operate at different locations

An entity operates at many different locations, such as hotels, transport entities, and retail operations. Management is considering how to identify and group CGUs for impairment testing.

How should CGUs be identified and grouped at the entity's different locations for the purposes of impairment testing?

Analysis

Hotels: Individual hotels usually generate income/cash inflows that are independent of others. Management monitors their performance on an individual basis. Each hotel should be considered to be an individual CGU, even if sales and marketing and finance functions are centralized.

Transport entities: Entities involved in the transport business commonly provide services on a number of routes. The assets deployed to each route and that route's cash inflows can usually be separately identified. Each route can be identified as a CGU even though the entity may market its services on a regional basis.

Loss-making routes will be an indicator of impairment, except if a regulatory requirement dictates that these routes be serviced alongside the entity's more profitable routes.

Retail Operations: Each individual store would generally be a CGU because it generates independent cash inflows.

Management may monitor goodwill on a regional basis by aggregating stores, hotels, or transport routes by region or by some other criteria that relate to how the entity is managed. Goodwill is reviewed at the higher level.

EXAMPLE 10-6

Identification of CGUs in an entity that has vertically integrated operations

The reporting entity has two plants. Plant A produces raw material that is sold to Plant B of the same entity. The raw material is sold by Plant A to Plant B at a price that transfers all the margins to Plant B. Plant A sells 100% of its production to Plant B. All of the production of Plant B is sold to external customers.

How should CGUs be identified for Plant A and Plant B?

Analysis

If there is an active market for Plant A's production, it is likely that Plant A is a separate CGU. Plant B would also be a separate CGU because it sells all of its output externally. Plant B generates cash inflows that are largely independent of the cash flows from the other assets of the reporting entity. The internal transfer prices for the production sold by Plant A to Plant B should be adjusted to arm's length prices in the financial forecasts and budgets used for determining value in use for both Plant A and Plant B.

If there was no active market for the output of Plant A, the cash inflows of Plant A would depend on the demand for the product sold by Plant B. Plant A does not generate cash flows that are largely independent of the cash flows of assets operated by Plant B. The use of internal transfer prices demonstrates the two plants are managed together. As a result, the two plants should be treated as one CGU.

10.6.4 Grouping cash-generating units

Goodwill does not generate cash flows independent of other assets or groups of assets. It often benefits or contributes to the cash flows of more than one CGU. Goodwill that contributes to the cash flows of more than one CGU should not be arbitrarily allocated to the individual CGUs but should be allocated to the group of CGUs that is benefited for the purposes of impairment testing. In accordance with IAS 36.80, the group of CGUs that goodwill is allocated to should be the lowest level at which management monitors goodwill for impairment and cannot exceed an operating segment as defined in IFRS 8. Goodwill is allocated to the CGU or group of CGUs that will benefit from the business combination, including the existing business of the acquirer. See BCG 10.5 for further information on the elements of goodwill which may assist in allocating goodwill to a group of CGUs.

CGUs can be grouped for the purposes of testing goodwill for impairment when they benefit from the business combination that gave rise to the goodwill, subject to the ceiling of an operating segment.

EXAMPLE 10-7

Identification of CGUs if an entity operates at different locations, but with centralized functions

Entity A runs a fast food restaurant chain. Each restaurant is supplied by Entity A's central purchasing and distribution system. There are five restaurants in London (but in different neighborhoods), and another 50 in other cities and towns in the United Kingdom. All of the restaurants are managed in the same way. Pricing, marketing, advertising, and personnel policy (except for the local recruitment of waiters and kitchen staff) is decided centrally by Entity A. Seven of the restaurants were purchased five years ago, and goodwill was recognized.

How should CGUs be identified and grouped at the entity's different locations for the purposes of impairment testing? How should goodwill arising on the acquisition of the seven restaurants be allocated?

Analysis

In determining the CGU in this situation, several factors should be considered, including whether:

- Performance is monitored on an individual restaurant basis, or at regional or other levels—for example, considering the lowest level at which meaningful profitability statements are produced.
- Product offering and investment decisions are made at individual, regional, or other grouping levels.
- Individual outlets generate business for other parts of the network.
- Units are managed on a combined basis, share systems, centralized purchasing, and distribution functions.
- Product pricing is determined locally or on a regional or national basis.

All the restaurants are in different neighborhoods and probably have different customer bases. Each restaurant generates cash inflows that are largely independent from the cash flows of the other restaurants, and therefore it is likely that each restaurant is a CGU in this situation. The goodwill arising on the acquisition of the seven restaurants would have been allocated to the group of CGUs that incorporated the seven restaurants or other CGUs that benefited from the business combination.

Each restaurant (CGU) should be tested for impairment when there is an indicator. Only after the underlying assets are tested for impairment should the group of restaurants and goodwill be tested for impairment.

10.6.5 Allocating assets and liabilities to cash-generating units

The recoverable amount of a CGU is the higher of VIU and FVLCOD for the CGU. The manner in which the carrying value of the CGU is determined should be consistent with the manner in which the recoverable amount is determined. Thus, different assets and liabilities may be included in the carrying amount for comparison between a VIU and a FVLCOD calculation.

The carrying amount of the CGU is established by identifying the assets and liabilities of the individual CGU plus any assets, such as goodwill or corporate assets that can be allocated to it on a nonarbitrary basis. The carrying amount of a CGU consists of:

- Assets that are directly and specifically attributable to the CGU (e.g., machinery or a factory building)

- An allocation of assets that are indirectly attributable on a reasonable and consistent basis, including corporate assets (e.g., delivery trucks based on the relevant number of trips made to each location, supported from a central depot) and goodwill (if an acquired business is a single CGU, or goodwill can be allocated on a nonarbitrary basis)

- Recognized liabilities to the extent that the recoverable amount of the CGU cannot be determined without consideration of those liabilities

Cash flows prepared for a VIU calculation would exclude working capital cash flows; therefore, the carrying amount of the CGU should also exclude working capital. VIU is a pretax approach, and the carrying amount should exclude tax assets and liabilities, whereas FVLCOD is often calculated on a post-tax basis; thus, tax cash flows and tax assets and liabilities are included. Liabilities that relate to financing the operations of a CGU are also excluded when determining the recoverable amount for VIU and FVLCOD.

Many entities do not allocate goodwill or corporate assets to individual CGUs because often there is no basis to do so at this lowest level other than on an arbitrary one. Instead, CGUs are most often grouped. Goodwill and corporate assets are allocated to groups of CGUs. Some corporate assets, such as the head office building and a global brand, would typically be tested at the level of the whole entity.

10.6.6 Determining recoverable amount—fair value less costs of disposal

Fair value should be measured in accordance with IFRS 13.9. The expected costs of disposal should be deducted to calculate FVLCOD. Costs of disposal are only the direct incremental costs of the disposal.

IFRS 13.77 states that a quoted price in an active market provides the most reliable evidence of fair value. However, few assets (or businesses) tested for impairment under IAS 36 are traded in an active market and therefore a valuation technique often will be used to measure fair value.

There are a number of valuation methodologies that are used to assess the value of a business or an asset under FVLCOD. More than one methodology is normally used to ensure that the valuations are cross-checked and considered in light of appropriate market evidence. The replacement cost method is not appropriate for the purpose of impairment testing, as it does not reflect the economic benefits recoverable from use or disposal.

For some assets, particularly land and buildings, fair value measured by using the market approach may be most appropriate, as there is usually market data on sales or rentals. For many assets and businesses, however, fair value measured by an income approach will be appropriate. See FV 4.4 for information on valuation techniques used to measure fair value.

10.6.7 Determining recoverable amount—value in use

An asset or CGU's VIU is the present value of the future cash flows expected to be derived from the use of an asset or CGU and from its disposal. VIU is calculated by applying an appropriate pretax discount rate to the asset or CGU's estimated future pretax cash flows. The VIU calculation is not a fair value calculation and VIU is not a proxy for fair value. VIU is a prescribed form of cash flow model described in IAS 36 for the purposes of comparability in the testing of goodwill.

10.6.8 Cash flows for value in use

Cash flow projections for a VIU calculation should be based on reasonable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Management must assess the reasonableness of the assumptions used as the basis for the current cash flow projections, and give greater weight to assumptions supported by external market data. Management should consider the extent to which its previous forecasts have proved reliable and the reasons for variances in assessing assumptions, in accordance with IAS 36.34.

Two approaches for constructing a cash flow projection for value in use include:

- The *traditional* approach, consisting of a single set of estimated cash flows and a single discount rate. Uncertainties are reflected through the risk premium included in the discount rate.

- The *expected cash flow* approach, consisting of all expectations about possible cash flows instead of the most likely cash flow. Uncertainties are reflected through probability-weighted cash flows.

Theoretically, these two approaches should provide the same result. However, determining the risk premium to include in the discount rate under the traditional approach can be challenging. Therefore, management should consider probability-weighting different scenarios to estimate the expected cash flows.

The cash flow projections must be based on the most recent financial budgets that have been approved by management. The projections, using specific assumptions, should cover a maximum period of five years, unless a longer period can be justified, in accordance with IAS 36.33(b). The cash flows associated with assets under construction include expenditures necessary to get the asset ready for use.

Cash flow projections beyond five years are estimated by extrapolating the projections for the first five years using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. Under IAS 36.33(c), the growth rate should not exceed the long-term average growth rate for the products, industries, or countries in which the entity operates, or for the market in which the asset is used, unless justifiable.

Cash flow projections exclude expenditures related to (and benefits of) any restructuring plan for which management has not created a constructive obligation. The projections also exclude any future capital expenditure that will improve or enhance the asset's or CGU's performance. The asset or CGU is assessed for impairment in its current condition, not as a modified asset or CGU that the entity might own in the future.

The cash flows include any costs payable at the end of the asset's life (for example, decommissioning costs) and any amounts receivable on disposal. The carrying amount of the asset or CGU should also include any liabilities if the recoverable amount of the CGU or asset cannot be determined without consideration of the liability.

The cash flows should exclude any financing cash flows and any tax cash flows, in accordance with IAS 36.50. They should also exclude any cash flows to the lessor regarding assets of the CGU held under a finance lease. Central overhead costs should be considered based on how the related assets are tested. For example, if the head office is tested as a corporate asset, the related costs are included in the cash flows for that CGU or group of CGUs that include the corporate asset.

10.6.9 Selection of a discount rate

The discount rate used is the pretax rate that reflects the specific risks of the asset or CGU. Different CGUs will often warrant different discount rates. The discount rate should not be adjusted for risks that have already been considered in projecting future cash flows.

Management might consider the entity's weighted average cost of capital or its incremental borrowing rate when determining an appropriate discount rate. Consideration should also be given to country risk, currency risk, and cash flow risk. Different rates should be used for different future periods with different risks where appropriate.

The discount rate does not simply result from the application of a formula but requires the exercise of judgment. If the cash flows do not incorporate a sufficient level of risk and uncertainty (for example, through probability weighting of cash flow scenarios), the discount rate should be adjusted to include an additional risk premium. However, management should attempt to adjust the cash flows prior to making adjustments to the discount rate, as it is generally more difficult to estimate and support the amount by which the discount rate should be adjusted.

10.6.10 Recognizing an impairment loss

An impairment loss should be recognized if the carrying amount of an asset, CGU, or group of CGUs is greater than the recoverable amount. The carrying amount should be reduced to the recoverable amount, in accordance with IAS 36.59–60. The corresponding charge is recognized in the income statement, unless there are assets accounted for under the revaluation model. An impairment charge is recognized against a revaluation surplus to the extent that it reverses a previous revaluation uplift for that asset, in accordance with IAS 36.60.

The future depreciation or amortization of any impaired assets is adjusted to reflect the revised carrying amount. The asset's remaining useful economic life should also be reviewed.

In accordance with IAS 36.104, an impairment loss arising in a CGU or a group of CGUs is allocated to reduce the carrying amounts of the individual nonmonetary assets on the following basis:

- First, to goodwill allocated to the CGU or group of CGUs
- Second, to the other nonmonetary assets in proportion to their carrying amounts, subject to the limits set out below

The other nonmonetary assets are likely to include property, plant and equipment, and intangible assets.

In accordance with IAS 36.105, the carrying amount of each asset within the CGU is reduced to the higher of:

- Its FVLCOD (if determinable)
- Its VIU (if determinable)
- Zero

Any unallocated impairment is reallocated to the nonmonetary assets, subject to the same limits. This could result in an iterative process, continuing until the impairment charge is fully allocated or until each of the CGU's nonmonetary assets have been reduced to the higher of each asset's FVLCOD, VIU, and zero. The recognition of an impairment loss shall not result in the recognition of a liability, unless it meets the definition of a liability under another IFRS Standard.

See BCG 10 for information on the allocation of impairment to goodwill and how this interacts with the valuation choice for the noncontrolling interest under IFRS 3.

10.6.11 Reversing an impairment loss

Impaired assets, other than goodwill, are assessed in subsequent years for indications that the impairment may have reversed. The indicators are generally the converse of those used to identify impairment. A reversal is recognized when it arises from a change in the estimates used to calculate the recoverable amount.

The asset's recoverable amount is recalculated, and its carrying amount increased to the revised recoverable amount, subject to the following limits:

- Goodwill impairment is never reversed.
- The increased carrying amount due to the impairment reversal is limited to the amount that would have been recognized had the original impairment not occurred, after allowing for depreciation or amortization in the intervening period.

The same principles apply to the reversal of an impairment of a CGU. The allocation of the reversal is made to assets, other than goodwill, on a pro rata basis. In accordance with IAS 36.123, when reversing impairment losses previously applied to assets within a CGU, the carrying amount of each asset cannot be increased above the lower of:

- Its recoverable amount.
- Its carrying amount if no impairment loss had been recognized after allowing for depreciation and amortization in the intervening period. The determination of this amount also requires detailed recordkeeping.

Chapter 11: Other business combination considerations

11.1 Chapter overview

This chapter covers additional considerations applicable to companies engaged in acquisitions of entities in the insurance industry and push down accounting under US GAAP. Specifically, the following topics are covered:

- Companies in the insurance industry – The application of acquisition accounting to business combinations in the insurance industry may be complex due to limited insurance-specific guidance in the Standards.

- Pushdown accounting – The application of pushdown accounting establishes a new basis for the assets and liabilities of the acquired company based on a "push down" of the acquirer's stepped-up basis. This is a US GAAP concept only. Push down is not permitted under IFRS.

11.2 Insurance industry considerations

This section highlights the key accounting issues that companies in the insurance industry may encounter when entering into a business combination. The specific facts and circumstances surrounding the transaction will result in other challenges and issues not addressed in this section.

Recent IASB projects will result in amendments to existing guidance within this chapter. Specifically, IFRS 17, issued in May 2017, addresses the recognition, measurement, presentation, and disclosure of insurance contracts. The standard is effective for annual periods beginning on or after January 1, 2021, with earlier application permitted if IFRS 15, *Revenue from Contracts with Customers*, and IFRS 9, *Financial Instruments*, are adopted at the same time.

In addition, the FASB has an active targeted improvements project for insurance contracts. The project includes a reconsideration of the measurement models for long duration contracts and the amortization of deferred acquisition costs. This could impact the insurance liability and related intangible asset (or other liability), allocations of fair value, and the subsequent accounting for both the insurance liabilities and intangible asset (or other liability) amortization.

11.2.1 Accounting for business combinations

The Standards provide some insurance-specific guidance for business combinations, principally:

- Requiring the acquisition method in accounting for combinations of mutual insurance entities, in accordance with ASC 805-30-55-3 through 55-5 and IFRS 3.32-33.

- Requiring that insurance contracts acquired in a business combination be considered by the acquirer as new contracts for measurement and accounting purposes, discussed in ASC 944-805-25-1 and IFRS 3.

- Carrying forward the acquiree's classification of an acquired contract as an insurance or reinsurance contract or a deposit contract (and thus not evaluating whether the contracts transfer significant insurance risk) based on the terms of the contract at contract inception or, if that classification changes due to subsequent modification of those terms (which may occur at the acquisition date), based on the modified terms in accordance with ASC 805-20-25-8, ASC 944-805-25-2, and IFRS 3.17.

- Recognizing the fair value of the assets and liabilities arising from the rights and obligations of the insurance contract in two components. These components consist of (1) assets and liabilities measured in accordance with the acquirer's existing accounting policies and (2) an intangible asset (or other liability) recognized for the difference between the fair value of the insurance and reinsurance contracts and the amount recognized in accordance with the acquirer's existing accounting policies (hereafter referred to as the "insurance contract intangible asset"). Under ASC 944-805-30-1 and IFRS 4.31, the recognition of the insurance contract intangible asset is required for US GAAP companies and is optional for IFRS companies. IFRS companies have a policy choice of whether to use this expanded presentation.

- Requiring contingent commissions and claim liability guarantees to be accounted for in the same manner as other contingencies in the Standards, as detailed in ASC 944-805-25-4 and ASC 944-805-25-5.

- Affirming that insurers using IFRS should apply IFRS 4 to insurance contracts acquired in a business combination, in accordance with IFRS 3.BC189 and BC196.

The application of acquisition accounting to insurance transactions presents unique issues due to the limited insurance-specific guidance in the Standards. These include:

- Distinguishing between a business combination, a reinsurance transaction (including a portfolio transfer), and asset acquisitions.

- Recording insurance contracts at fair value and determining the allocation between the insurance contract liabilities and related insurance contract intangible asset.

- Identifying and recording any other separately identifiable intangible assets at fair value, including renewal rights on short-duration contracts, customer relationships, and distribution relationships.

- Determining the postacquisition amortization approaches for the insurance contract intangible asset and for any other separately identified intangible assets.

11.2.2 *Distinguishing between a business combination, a reinsurance transaction, and an asset acquisition*

Transactions in the insurance industry may take various legal forms. It is not uncommon for a transaction to include one or more indemnification or novation reinsurance transactions along with the acquisition of renewal rights, the purchase of certain legal entities, the purchase of assets, or various combinations thereof. In many cases, the acquired items taken as a whole, including the reinsurance components, may meet the definition of a business (as discussed in BCG 1) and, therefore, will be accounted for as a business combination under the Standards. Factors to consider in making that determination include whether the rights and obligations of the in-force block of insurance and investment contracts have been transferred, and whether various other components of the business have been transferred, such as the employees and staff, the policy administration function, financial reporting functions, or distribution systems.

If the transaction does not qualify as a business combination, asset acquisition (or liability assumption) accounting is applied based on the fair value(s) determined at the acquisition date. No goodwill is recognized, and any acquired in-force blocks of insurance/investment contracts are assessed for contract classification in accordance with reinsurance risk transfer guidance under US

GAAP and contract classification guidance under IFRS. For liabilities assumed in a transaction accounted for as reinsurance (referred to as "portfolio transfers" under IFRS), the expanded presentation, similar to that noted previously for business combinations, is common practice under US GAAP and is permissible under IFRS. That is, the difference between the consideration received and the liabilities recorded is presented as an intangible asset. Asset acquisitions would include the purchase of identifiable intangible assets and other assets, which would be subject to the guidance in ASC 350 and ASC 360 for US GAAP, and IAS 16 and IAS 38 for IFRS.

11.2.3 Acquired insurance and reinsurance contracts in a business combination

Acquired insurance and reinsurance contracts are recorded at fair value and are considered to be new contracts for measurement and accounting purposes (i.e., a fresh start basis applies). However, there is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the acquisition date (i.e., no reassessment of whether the contracts transfer significant insurance risk), unless the contracts were modified substantively in the business combination, as discussed in ASC 805-20-25-8, ASC 944-805-25-2, or IFRS 3.17. Consistent with the general notion of acquisition accounting and fair value, deferred costs of the acquiree, such as deferred acquisition costs and unearned premiums that do not represent future cash flows, are not carried forward by the acquirer in acquisition accounting, as discussed in ASC 944-805-30-1 and IFRS 3.1.

See FV 4 for a discussion of valuation techniques and approaches.

11.2.4 Insurance contract intangible assets and liabilities related to insurance contracts acquired in a business combination

For all US GAAP companies, and IFRS companies choosing a similar presentation approach, the fair value of the acquired insurance contracts is divided into two basic components: (1) assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds and (2) the insurance contract intangible asset described in BCG 11.2.1. In addition, US GAAP explicitly acknowledges in ASC 944-805-30-1 that the second component may be an additional liability (rather than an asset) on those occasions where the fair value of the insurance contract exceeds the value of the insurance contract liability measured in accordance with the acquirer's accounting policies, whereas IFRS is silent on this matter.

For IFRS companies, there is no requirement to measure the acquired insurance liabilities using the acquirer's accounting policies. That is, IFRS 4 allows insurers to continue to use non-uniform accounting policies for insurance contracts of subsidiaries, but it does not allow a change in accounting policies among subsidiaries that would introduce more diversity. The Standards do not provide specific guidance on how to determine the assets and liabilities measured in accordance with the acquirer's accounting policies, except that under US GAAP, the amounts are based on the acquirer's accounting policies for insurance contracts that it issues or holds.

11.2.4.1 Insurance contract intangible asset and liabilities related to acquired non-life short-duration and financial guarantee insurance contracts under US GAAP

Non-life short-duration insurance contracts

ASC 944-805-30-1 requires that assets and liabilities be measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds. The guidance notes that examples of liabilities include a liability to pay future contract claims and expenses on the unexpired portion of the acquired contracts, and a liability to pay incurred contract claims and claims expenses. Similarly, recorded liabilities for non-life short-duration contracts in non-acquisition situations typically include both a claim liability (for reported claims as well as for incurred but not reported claims) and an unearned premium liability relating to the unexpired portion of an insurance contract.

As noted in BCG 11.2.3 above, there is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the acquisition date, unless the contracts were modified substantively in the business combination. However, as also noted above, under US GAAP, insurance contracts acquired in a business combination are considered by the acquirer as new contracts for measurement and accounting purposes (ASC 944-805-25-1). We interpret this to mean that for contracts for which the coverage period of the underlying contracts has ended, there is no reassessment by the acquirer of the acquiree's initial determination of insurance versus deposit. However, from the acquirer's perspective, it should account for the newly acquired contracts, and specifically any ceded reinsurance contracts, as prospective, even though the coverage relates to past events. Similarly, if the acquirer enters into a retrocession concurrently with the acquisition, the retrocession should also be accounted for as prospective ceded reinsurance. IFRS 4 does not distinguish between prospective and retroactive coverage; IFRS 4 acknowledges that for insurance events that have already occurred, the insurance event is the discovery of those ultimate claims. As IFRS 4 does not differentiate between prospective and retroactive coverage, there is no requirement under IFRS to treat any acquired contracts as prospective.

Incurred claim liability

In the past, the SEC staff expressed a view that the undiscounted cash flows relating to a non-life short-duration claim liability established in acquisition accounting should usually be the acquiree's recorded claim liability value just before the acquisition. That is, the best estimate of the claim liability made by the acquiree should be the best estimate that the acquirer uses, unless the acquirer will settle the liability in a manner demonstrably different from the manner in which the acquiree had planned to do so.

The SEC staff was concerned about increases in liabilities made by acquirers only to be released in earnings in subsequent reporting periods. The staff generally expressed a view that the acquired entity has the best information for establishing a best-estimate projection of cash flows with a presumption that, barring an error by the acquired entity, the amounts should be the same for the acquirer. A complete understanding of the facts and circumstances and the exercise of professional judgment is required in circumstances where the acquirer seeks to increase the value of the undiscounted claims liability of the acquired entity as compared to the undiscounted amount reported by the acquired entity prior to the acquisition.

The SEC's historical position referred to above was based on an analogy to the guidance for loan loss reserves contained in SAB Topic 2.A.5, "Adjustments to Allowances for Loan Losses in Connection with Business Combinations." SAB 112 removes Topic 2.A.5. because of the guidance in ASC 944-805, which requires an entity to record acquired receivables, including loans, at fair value and precludes an acquirer from recognizing a separate valuation allowance as of the acquisition date (because the effects of uncertainty about cash flows are already included in the fair value measure). The removal of Topic 2.A.5 does not necessarily indicate that the SEC's view regarding insurance loss reserve consistency has changed, because unlike loans, insurance liabilities are still presented gross, using the best estimate of the claim liability as one component and the insurance contract intangible asset as another component of the fair value of the contract.

Liability for unexpired portion of coverage

The Standards require that the liability relating to the acquired insurance contracts be measured based on the acquirer's accounting for insurance contracts that it issues or holds. Consistent with this concept, and consistent with prior practice for business combinations involving non-life short-duration contracts, US GAAP companies should record an unearned premium revenue liability for the unexpired portion of acquired insurance contracts and then recognize that revenue over the remaining coverage period, consistent with the policy for business that it issues or holds.

Based on the guidance in ASC 944-805-30-1, we believe there is more than one acceptable presentation approach for the liability relating to the unexpired portion of coverage. We believe that one acceptable approach would be to establish an unearned premium revenue liability based on the unexpired portion of premium that the acquiree had received from the policyholder. Under this approach, an insurance contract intangible asset would be recognized for the difference between the unearned premium revenue liability and the fair value of that obligation (essentially the difference between the gross premium and the fair value of expected future claim costs and expenses on the unexpired portion of the contract). The intangible would be amortized over the remaining coverage period of the contract.

The example provided in ASC 944-805-30-1 describes establishing "a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts," which we believe could also support an alternative approach of establishing a liability equal to the fair value of expected future contract claims and claims expenses (including a risk margin) on the unexpired portion of the acquired contracts (i.e., a net premium rather than a gross premium approach). Such an approach would not result in the recording of an insurance contract intangible asset for the unearned premium revenue liability. In addition, the exclusion of a portion of the "loading" (the cost of previously performed selling effort) from the liability under this method would result in certain premium-based industry ratios commonly used to assess company performance (e.g., loss, expense, and combined ratios) being less comparable between companies and between periods for the same company and thus less relevant to financial statement users.

While we believe both approaches are acceptable, we believe presenting the gross unearned premium liability and reflecting an insurance contract intangible asset is more consistent with the gross presentation required by ASC 805 (and optional presentation under IFRS).

11.2.4.2 Insurance contract intangible asset and liabilities related to acquired long-duration insurance contracts under US GAAP

For long-duration life insurance benefit liabilities, US GAAP companies have applied various approaches for establishing the recorded contract liability component, depending on the type of contract (e.g., traditional whole-life contract, limited pay contract, universal life contract, or payout annuity). For example, the liability measurement for a traditional whole-life contract is a function of the premium. For an existing traditional whole-life contract that is part way through the premium-collection period, determining the liability using the traditional net level premium method presents some practical challenges. Several methods are used in practice, including the defined initial reserve method and the defined valuation premium method. The defined initial reserve method carries forward the existing acquiree liability and computes a new net benefit premium ratio at the acquisition date to be used prospectively. The defined valuation premium method recomputes the liability at the acquisition date. For a universal life contract, the recorded liability would typically be its account balance. All methods for establishing long-duration life insurance benefit liabilities in postcombination accounting generally use current market data and updated insurance assumptions (e.g., mortality, expense, and lapse assumptions) at the acquisition date.

A question has arisen in practice whether the recognition of the fair value of an insurance contract between the two components noted previously is applicable to contracts that are classified for US GAAP purposes as investment contracts rather than insurance contracts. That is, should a contract such as a deferred annuity be recorded at its account balance, with the remaining difference between that balance and its fair value recorded as an intangible asset (or other liability), in accordance with the Standard for insurance contracts, or should the entire fair value be recorded as a liability, in accordance with financial instrument accounting? The intangible asset (or other liability) typically represents the difference between current market rates and contractual crediting rates of the instrument.

Prior to the adoption of the Standard, US GAAP addressed the accounting for the intangible asset recognized upon acquisition as representing the "present value of future profits" (PVFP) embedded in acquired insurance contracts. That guidance was applicable to life insurance contracts or "other long-duration contracts" covered by insurance accounting guidance. In practice, PVFP was typically established for all long duration contracts, including investment contracts.

Our understanding is that the Standard was not intended to change practice in the insurance industry. In addition, there are other areas of insurance accounting under US GAAP where the guidance for insurance contracts is followed for investment contracts as well, including the accounting for deferred acquisition costs. As a result, we believe it is acceptable for an acquirer to allocate the fair value of an investment contract into two components, consistent with the guidance for insurance contracts. However, the Standard explicitly refers to "insurance contracts," and as a result, we believe it would be an acceptable alternative to conclude that insurance contract requirements should not be required for investment contracts. Companies should make a policy election and apply that policy consistently. If PVFP is presented as an asset for investment contracts, it would generally not be subject to a premium deficiency test or separate asset recoverability test, given that PVFP is essentially a form of debt discount or premium associated with the investment contract liability.

Where a company chooses to record the entire fair value as a liability at the business combination date, that fair value liability may be less than the investment contract "account balance" that is payable on demand. If the subsequent accounting for the investment contract is amortized cost (i.e., the fair value option is not elected), it would be appropriate to amortize to earnings [profit or loss] the difference between the acquisition date fair value and the account balance in a systematic and rational manner. This approach is consistent with the subsequent accounting for liabilities arising from contingencies and with the accounting for the insurance contract intangible asset (or liability) discussed in BCG 11.2.1 and 11.2.4.1.

An issue that may arise for either an insurance contract or an investment contract is whether there are any embedded derivatives (which would be accounted for under the guidance of ASC 815) to be separated from the host contract upon a business acquisition. This analysis becomes particularly significant in lower interest rate environments. Embedded derivatives can exist due to minimum interest rate guarantees in acquired contracts. They can also exist for contracts that effectively have a substantial discount or premium; for example, due to having been originally issued to policyholders in a higher interest rate environment than currently exists. The embedded derivative related to the ability of the counterparty to lapse the contract or effectively put the contract must be assessed.

11.2.4.3 Insurance contract intangible asset and liabilities related to acquired insurance contracts under IFRS

The current practice for measuring recorded insurance liabilities under IFRS can differ across IFRS reporting entities because of the ability to continue measuring insurance liabilities using the entity's pre-existing accounting policies. Practices vary depending on the accounting frameworks that have been used to develop the entity's pre-IFRS 4 accounting policies. For IFRS reporting entities that have developed their accounting policies with reference to US GAAP, the approaches described above for contracts meeting the definition of insurance contracts under IFRS are appropriate alternatives.

However, contracts that are classified for IFRS purposes as investment contracts rather than insurance contracts are not within the scope of IFRS 4, and other relevant IFRS guidance should be followed. For example, a unit-linked investment contract acquired in a business combination is required to be recorded at fair value. In addition, these contracts will also have a customer contractual relationship intangible asset that represents the future profit margins to be earned on the investment management services under the contract. Subsequent to the business combination, the unit-linked investment contract liability will be accounted for under IAS 39, and the customer contractual relationship will be recognized and amortized as an intangible asset under IAS 38.

11.2.4.4 Postcombination accounting for insurance contract intangible asset and liabilities related to insurance contracts acquired in a business combination

Under the insurance standards, after a business combination, the insurance contract intangible asset (or, as noted for US GAAP, this would occasionally be an additional liability) is required to be measured on a basis consistent with the related insurance or reinsurance liability under ASC 944-805-35-1 and IFRS 4.31(b).

For example, for many property/casualty short-duration contracts, companies typically amortize any insurance contract intangible asset relating to the unearned premium component consistent with the amortization of the related unearned premium liability. ASC 944-805-35-2 suggests that amortization of the insurance contract intangible asset associated with undiscounted claim liabilities using the interest method (because the intangible asset includes the fair value adjustment for the time value of money) may be an appropriate method. In practice, amortization methods vary. Some companies unlock the pattern and/or term of amortization if reliable updated information is available indicating that actual results differ from original estimates; while others establish an amortization pattern and term, and do not unlock unless there is a significant change in the expected life. When unlocking is done, some companies use a retrospective method, while others use a prospective method. Other companies may use the effective yield method for amortizing the pure discount/time value of the money element and a separate amortization schedule for the risk margin component, if separately determinable, under the premise that expiration of risk is not consistent with an effective yield approach.

For long-duration life insurance contracts, the insurance contract intangible asset is typically amortized in a manner similar to the amortization of deferred acquisition costs for similar products. For example, for US GAAP companies with traditional whole-life insurance contracts subject to ASC 944, amortization of the insurance contract intangible asset is based on premium revenue. For US GAAP companies with universal life insurance contracts subject to ASC 944, amortization of the insurance contract intangible asset is generally based on estimated gross profits. Under the Standards, acquired contracts are considered newly purchased contracts. As a result, amortization of the insurance contract intangible asset is based on premiums or expected gross profit (or expected gross margins) from the acquisition date forward and not from the original policyholder contract inception date.

11.2.5 Other intangible assets recognized in a business combination

Other intangible assets must be identified, recognized, and measured at fair value. Business combinations involving insurance companies typically include the acquisition of various types of intangible assets, including:

- Customer relationships, such as renewal rights on short-duration insurance contracts, cross-selling opportunities, and customer/member lists
- Distribution channels (including the ability to generate new business from new customers)
- Brand names and trademarks
- Insurance licenses
- Service contracts and healthcare provider contracts
- Computer software

Issues involved in accounting for such intangibles, recorded in conjunction with a business combination or as stand-alone purchases, include identification, valuation, and postcombination accounting. Two major challenges include avoiding use of overlapping cash flows when determining the fair value for more than one intangible asset (e.g., customer relationships and distribution channels) and ensuring that all significant intangibles are identified. In terms of determining fair value, the most common methods used are the discounted cash flow method and the market approach (i.e., market transaction multiple method). Estimating intangible assets relating to customer relationships can be an especially challenging valuation area, given that such estimates are based on customer behavior, which is often difficult to predict. Valuation specialists, including actuaries, will typically be required for this exercise. See BCG 4 and FV 7 for further information on the recognition and valuation of intangible assets.

Accounting issues in the postcombination period include the selection of an amortization pattern and term for finite-lived intangibles. The method of amortization for finite-lived intangibles should reflect the pattern in which the economic benefits of the asset are consumed. The assigned useful lives can vary considerably based on the type of intangible, the type of business, and the specifics of the acquired portfolios. Judgment is needed in selecting an appropriate useful life and pattern of amortization based on the nature of the intangible asset and the benefits derived from that asset.

In the postcombination period, both finite- and indefinite-lived assets are subject to impairment testing. Indefinite-lived assets are subject to impairment testing at least annually, while finite-lived assets are subject to impairment testing only upon a "triggering" event. Issues surrounding the impairment of indefinite-lived intangible assets, finite lived intangibles are discussed in PPE 4 for US GAAP and BCG 10 for IFRS (e.g., certain insurance licenses that can be maintained indefinitely without substantial cost), are discussed in BCG 8 for US GAAP and BCG 10 for IFRS.

11.2.6 *Contingent commissions and sellers' claim liability guarantees*

Contingent commissions and sellers' claim liability guarantees for insurance contracts do not fall under the insurance contract guidance in the Standards. Contingencies other than claim liability guarantees, such as contingent commissions paid to agents, are not part of the insurance or reinsurance contract; and, therefore, are required to be accounted for under the Standards in the same manner as other noninsurance contingencies (e.g., as contingencies for contingent commissions arising from distribution agreements) in accordance with ASC 944-805-25-4. See BCG 2.5.13 for information on initial and subsequent recognition and measurement of noninsurance contingencies.

Indemnification agreements relating to the adequacy of acquired claim liabilities, which may be in the form of reinsurance contracts, are accounted for on the acquisition date consistent with other indemnification assets in accordance with ASC 805-20-25-27 through 28 (per ASC 944-805-25-5) and paragraphs 27 and 28 of IFRS 3. The guidance in ASC 944-805 on indemnification agreements has been carried forward from previous guidance, which provided examples of both a direct seller indemnification and a seller indemnification achieved through negotiation of a reinsurance contract with a third party reinsurer contemporaneous with, and in contemplation of, the business combination. We believe both of those indemnifications would continue to be accounted for under ASC 805-20-25-27 through 25-28.

In subsequent accounting periods, any asset relating to an indemnification agreement existing at the acquisition date would be measured on the same basis as the indemnified item to which it relates, subject to any contractual limitations on its amount and an assessment of collectibility under ASC 805-20-35-4 and IFRS 3.57. For example, for an indemnification of acquired claim liabilities that are classified as insurance contracts, the measurement of the indemnification asset would be consistent with that of the claim liability.

ASC 944-805-S99 notes that any receivable from the seller relating to an indemnification agreement should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or disclosures in SEC Industry Guide 6 (SEC 6940), *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property Casualty Insurance Underwriters*. The SEC staff indicated that although it is preferable to present the effects of the loss guarantee on a gross rather than net basis, it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information. In addition, the SEC staff believes the effects of such an arrangement on operations and cash flows should be clearly disclosed in management's discussion and analysis.

From the perspective of the seller, an indemnification agreement relating to the adequacy of acquired claim liabilities falls within the scope of ASC 460. Therefore, the seller would recognize and measure the fair value of the guarantee and record a liability for the obligation. The offsetting entry would likely affect the gain or loss on the transaction as a whole. In addition, the seller would be required to comply with disclosure requirements of ASC 460-10-50-4- through 50-6. Under IFRS, there is no specific guidance on the seller's accounting for an indemnification agreement relating to acquired claim liabilities. Entities will need to develop an appropriate accounting policy which could be based upon IAS 37 or IFRS 4.

11.3 Pushdown accounting

An acquirer of a business initially recognizes most of the acquired assets and liabilities at fair value. 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 under US GAAP. 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 US GAAP and is not addressed under IFRS.

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.

Figure 11-1

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	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 costs of goods sold

11.3.1 Scope

A company (that is a businesses or not-for-profit entity) has the option to apply pushdown accounting when they are acquired by another party (a change-in-control event). The election is available to the acquired company, as well as to any direct or indirect subsidiaries of the acquired company. Each acquired company or any of its subsidiaries can make its own election independently. Even, when a subsidiary elects not 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. See BCG 6 for further information.

11.3.2 Identifying the acquirer is the first step

The pushdown election is available for an acquired company's separate financial statements under US GAAP but not for an acquirer's consolidated financial statements under either US GAAP or IFRS, since the acquirer must apply business combination 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 reporting entity in a business combination. The acquirer is not always clearly evident; in some cases, the legal acquirer may not be the same as the accounting acquirer, e.g., when a "merger of equals" results in a reverse acquisition or when a new entity (Newco) is created to effect a transaction. The guidance on consolidations in ASC 810 and IFRS 10 and business combinations in ASC 805 and IFRS 3 should be followed to identify the acquirer.

EXAMPLE 11-1

Identifying the accounting acquirer

Parent Company acquires 100% of Target from Seller. In order to effect the transaction, a substantive Newco is formed by Parent Company, which is used to acquire all of the shares of Target. Target will continue as a wholly-owned subsidiary of Newco and Newco will be a reporting entity.

Is Newco the accounting acquirer?

Analysis

In this example, Newco is the accounting acquirer and would be required to apply business combination accounting for the acquisition of Target. The pushdown accounting election would only be available to Target and its subsidiaries (in their separate financial statements) under US GAAP.

Refer to BCG 2.3 for further guidance on identifying the accounting acquirer.

11.3.3 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–and those needs may vary. 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 often 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 business combination 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").

11.3.4 Change-in-control events

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, 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 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 business combination 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 business combination accounting under ASC 805.

11.3.5 When to make the pushdown accounting election

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.

Once applied, pushdown accounting is irrevocable. However, if an entity has not applied pushdown accounting for a change-in-control event, it may elect to do so in a subsequent period as a change in accounting principle, if preferable, and retrospectively adjust its reporting basis as of the date of the most recent change-in-control event, even when that event preceded the issuance of the new Standard.

A company might elect to apply pushdown accounting as a change in accounting principle to align the reporting basis of a subsidiary with that of its parent. This would require the use of the parent's business combination accounting as of the most recent change-in-control event. It would also require a roll-forward of that accounting (e.g., depreciation and amortization of stepped-up values, and potential impairments). Sometimes, the parent may not have applied business combination 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. 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, which can be difficult and costly.

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.

11.3.6 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. Goodwill should be calculated and recognized by the acquired company consistent with business combination accounting. 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.

The Standard provides a general principle but does not provide guidance for recognizing and measuring specific items in a company's separate financial statements when pushdown accounting is elected. Items such as contingent consideration, indemnifications, and transaction costs should be assessed for pushdown depending on the specific facts and circumstances. For example, a contingent consideration liability would generally not be recognized in the acquired company's separate financial statements unless the acquired company is the legal obligor. Transaction costs should generally be recognized as expense by the acquirer, and not pushed down to the acquired company. It is not always apparent whether certain assets and liabilities should be pushed down to the acquired company. Goodwill recorded by the acquirer related to the acquisition must be recognized in the acquiree's separate financial statements. However, regardless of what specific items are pushed down, goodwill recognized by the acquired company should generally equal goodwill recognized by the acquirer on the acquisition date.

EXAMPLE 11-2

Goodwill recognized by the acquired company – pushdown elected

Parent acquires Target 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 the 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 subsequent to its acquisition.

How much goodwill should be reflected in the post-acquisition separate financial statements of Target?

Analysis

The separate financial statements of Target should reflect goodwill of $100. This is equal to the goodwill recognized by Parent on the date of acquisition.

Debt (including acquisition related-debt) and any other liabilities of the acquirer should be recognized by the acquired company only if they represent an obligation of the acquired company pursuant to other applicable guidance in US GAAP. Prior to the revision of the pushdown guidance, SEC staff guidance required the acquisition-related debt of the acquirer to be recognized by an acquired company if certain specified conditions were met.

In contrast to the pushdown of parent company debt, to the extent joint and several obligations exist among multiple subsidiaries and/or the parent, a determination should be made as to whether these obligations fall within the scope of ASU 2013-04, *Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date*. To the extent obligations fall within the scope of this guidance, they 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.

11.3.7 Other considerations

This section highlights other considerations relating to pushdown accounting.

11.3.7.1 Expenses incurred on behalf of a subsidiary

A parent company may incur certain expenses (including employee compensation) on behalf of its subsidiary. In these cases, subsidiaries should continue to follow other guidance in US GAAP, which may require the related costs to be "pushed down" to the operating subsidiary. Specifically, 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. The new pushdown accounting standard does not change this or other similar guidance in US GAAP (e.g., accounting for share-based payments under ASC 718-10-15-4), 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 under the new Standard.

11.3.7.2 Foreign currency translation

Business combination 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. Refer to BCG 9.4.5 for further guidance on this topic.

11.3.7.3 Tax bases

If an acquired company elects not to apply pushdown accounting, but the transaction is accounted for as a purchase of assets for tax purposes, there is most likely 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. Refer to TX 14.6 for further guidance on this topic.

Appendices

Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification) and standards issued by the IASB. They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative US GAAP and IFRS.

US GAAP

The Codification is the primary source of authoritative US GAAP for nongovernmental reporting entities (hereinafter referred to as "reporting entities"). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB's standard-setting processes are communicated through *Accounting Standards Updates* (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a *FASB Accounting Standards Codification Quick Reference Guide,* which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance will be released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification's "Topics" and "Sections" and a list of frequently-referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative US GAAP (i.e., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative US GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board
- Transition Resource Group papers and minutes
- Pronouncements of other professional associations or regulatory agencies

- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- PwC accounting and financial reporting guides
- Accounting textbooks, guides, handbooks, and articles
- Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB's Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretative releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC staff when addressing matters related to public reporting entities.

IFRS

IFRS is a single set of accounting standards currently used in whole or in part in approximately 140 jurisdictions worldwide.

IFRS are developed by the International Accounting Standards Board (IASB), an independent standard setting body. Members of the IASB are appointed by international trustees and are responsible for the development and publication of IFRS standards as well as approving interpretations of the IFRS Interpretations Committee. The IFRS Interpretations Committee is responsible for evaluating the impact of implementing IFRS and other emerging issues that result from application of IFRS and undertaking projects to provide supplemental guidance or amend existing guidance.

The authoritative guidance issued by the IASB (and its predecessor organizations) are in the form of:

- IFRS Standards
- International Accounting Standards (IAS) Standards
- IFRIC Interpretations issued by the IFRS Interpretations Committee
- Standing Interpretation Committee of the IASC (SIC) interpretations

- The IFRS for SMEs Standard – restricted application by small and medium-sized entities as defined

The IASB has a variety of advisory organizations representing different constituents who provide insight into implementation issues for completed standards, feedback on draft standards, and suggestions on potential agenda items as examples. The IFRS Advisory Council and the Accounting Standards Advisory Forum are examples of such organizations.

IFRS standards may automatically apply upon publication in certain jurisdictions, while others require endorsement or undergo other modifications prior to application. For example, companies in the European Union may not apply a newly issued IFRS to their consolidated, public financial statements until the pronouncement was endorsed.

In addition to the authoritative guidance, PwC's Manual of Accounting is published annually, and may be used along with each of the PwC global accounting guides to assist in interpreting IFRS. While not authoritative guidance, the Manual of Accounting can be used as a practical guide in applying IFRS.

Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronyms used within this guide.

Technical references

AICPA Goodwill guide	AICPA Accounting and Valuation Guide – *Testing Goodwill for Impairment*
ASC 230	Accounting Standards Codification 230, *Statement of Cash Flows*
ASC 250	Accounting Standards Codification 250, *Accounting Changes and Error Corrections*
ASC 260	Accounting Standards Codification 260, *Earnings per Share*
ASC 270	Accounting Standards Codification 270, *Interim Reporting*
ASC 280	Accounting Standards Codification 280, *Segment Reporting*
ASC 310	Accounting Standards Codification 310, *Receivables*
ASC 320	Accounting Standards Codification 320, *Investments—Debt and Equity Securities*
ASC 323	Accounting Standards Codification 323, *Investments—Equity Method and Joint Ventures*
ASC 350	Accounting Standards Codification 350, *Intangibles—Goodwill and Other*
ASC 360	Accounting Standards Codification 360, *Property, Plant, and Equipment*
ASC 420	Accounting Standards Codification 420, *Exit or Disposal Cost Obligations*
ASC 450	Accounting Standards Codification 450, *Contingencies*
ASC 470	Accounting Standards Codification 470, *Debt*
ASC 480	Accounting Standards Codification 480, *Distinguishing Liabilities from Equity*

Technical references

ASC 505	Accounting Standards Codification 505, *Equity*
ASC 605–35	Accounting Standards Codification 605-35, *Construction—Type and Production Type Contracts*
ASC 606	Accounting Standards Codification 606, *Revenue from Contracts with Customers*
ASC 710	Accounting Standards Codification 710, *Compensation—General*
ASC 712	Accounting Standards Codification 712, *Compensation—Nonretirement Postemployment Benefits*
ASC 715	Accounting Standards Codification 715, *Compensation—Retirement Benefits*
ASC 718	Accounting Standards Codification 718, *Compensation—Stock Compensation*
ASC 730	Accounting Standards Codification 730, *Research and Development*
ASC 740	Accounting Standards Codification 740, *Income Taxes*
ASC 805	Accounting Standards Codification 805, *Business Combinations*
ASC 810	Accounting Standards Codification 810, *Consolidation*
ASC 815	Accounting Standards Codification 815, *Derivatives and Hedging*
ASC 820	Accounting Standards Codification 820, *Fair Value Measurements and Disclosures*
ASC 830	Accounting Standards Codification 830, *Foreign Currency Matters*
ASC 835	Accounting Standards Codification 835, *Interest*
ASC 840	Accounting Standards Codification 840, *Leases*
ASC 842	Accounting Standards Codification 842, Leases
ASC 845	Accounting Standards Codification 845, *Nonmonetary Transactions*
ASC 852	Accounting Standards Codification 852, *Reorganizations*

Technical references

ASC 860	Accounting Standards Codification 860, *Transfers and Servicing*
ASC 932	Accounting Standards Codification 932, *Extractive Activities—Oil and Gas*
ASC 944	Accounting Standards Codification 944, *Financial Services—Insurance*
ASC 946	Accounting Standards Codification 946, Financial Services – Investment Companies
ASC 958	Accounting Standards Codification 958, *Not-for-Profit Entities*
ASC 976	Accounting Standards Codification 976, *Real Estate—Retail Land*
ASC 985	Accounting Standards Codification 985, *Software*
IAS 1	International Accounting Standards 1, *Presentation of Financial Statements*
IAS 2	International Accounting Standards 2, *Inventories*
IAS 7	International Accounting Standards 7, *Statement of Cash Flows*
IAS 8	International Accounting Standards 8*, Accounting Policies, Changes in Accounting Estimates and Errors*
IAS 11	International Accounting Standards 11, *Construction Contracts*
IAS 12	International Accounting Standards 12, *Income Taxes*
IAS 16	International Accounting Standards 16, *Property, Plant and Equipment*
IAS 17	International Accounting Standards 17, *Leases*
IAS 18	International Accounting Standards 18, *Revenue*
IAS 19	International Accounting Standards 19*, Employee Benefits*
IAS 21	International Accounting Standards 21, *The Effects of Changes in Foreign Exchange Rates*
IAS 27	International Accounting Standards 27, *Consolidated and Separate Financial Statements*

Technical references

IAS 27 (2011)	International Accounting Standards 27 (Revised 2011), *Separate Financial Statements*
IAS 28 (2011)	International Accounting Standards 28 (Revised 2011), *Investments in Associates and Joint Ventures*
IAS 31	International Accounting Standards 31, *Interests in Joint Ventures*
IAS 32	International Accounting Standards 32, *Financial Instruments: Presentation*
IAS 33	International Accounting Standards 33, *Earnings Per Share*
IAS 36	International Accounting Standards 36, *Impairment of Assets*
IAS 37	International Accounting Standards 37, *Provisions, Contingent Liabilities and Contingent Assets*
IAS 38	International Accounting Standards 38, *Intangible Assets*
IAS 39	International Accounting Standards 39, *Financial Instruments: Recognition and Measurement*
IAS 40	International Accounting Standards 40, *Investment Property*
IAS 41	International Accounting Standards 41, *Agriculture*
IFRIC 17	International Financial Reporting Interpretations Committee 17, *Distributions of Non-cash Assets to Owners*
IFRS 2	International Financial Reporting Standard 2, *Share-Based Payment*
IFRS 3	International Financial Reporting Standard 3 (Revised 2008), *Business Combinations*
IFRS 4	International Financial Reporting Standard 4, *Insurance Contracts*
IFRS 5	International Financial Reporting Standard 5, *Non-current Assets Held for Sale and Discontinued Operations*
IFRS 7	International Financial Reporting Standard 7, *Financial Instruments: Disclosures*

Technical references

IFRS 8	International Financial Reporting Standard 8, *Operating Segments*
IFRS 9	International Financial Reporting Standard 9, *Financial Instruments*
IFRS 10	International Financial Reporting Standard 10, *Consolidated Financial Statements*
IFRS 11	International Financial Reporting Standard 11, *Joint Arrangements*
IFRS 12	International Financial Reporting Standard 12, *Disclosure of Interests in Other Entities*
IFRS 13	International Financial Reporting Standard 13, *Fair Value Measurement*
IFRS 15	International Financial Reporting Standard 15, *Revenue from Contracts with Customers*
IFRS 16	International Financial Reporting Standard 16, *Leases*
IPR&D guide	AICPA Accounting and Valuation Guide—*Assets Acquired to Be Used in Research and Development Activities*
SAB 54	Staff Accounting Bulletin No. 54, *Pushdown Basis of Accounting in Separate Financial Statements of Subsidiaries Acquired in Purchase Transactions*
SAB 73	Staff Accounting Bulletin No. 73, *Pushdown Basis of Accounting Required in Certain Limited Circumstances*
SAB 93	Staff Accounting Bulletin No. 93, *Accounting and Disclosures Relating to Discontinued Operations*
SAB 112	Staff Accounting Bulletin No. 112, *Amendments Resulting From FAS 141(R) and FAS 160*
SIC 12	Standing Interpretations Committee 12, *Consolidation—Special Purpose Entities*
EITF 95-3	EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
EITF 00-23	EITF Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 and FAS 160*

Technical references

EITF 02-5	EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141*

Other abbreviations

AICPA	American Institute of Certified Public Accountants
AOCI	Accumulated other comprehensive income
APB	Accounting Principles Board
APIC	Additional paid-in capital
ARB	Accounting Research Bulletin
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BEV	Business enterprise value
CDI	Core deposit intangibles
CEO	Chief executive officer
CGU	Cash generating unit
CODM	Chief operating decision maker
CON	Statements of Financial Accounting Concepts
CTA	Cumulative translation account
CU	Currency unit
DCF	Discounted cash flow
DTA	Deferred tax asset
DTL	Deferred tax liability
EBITDA	Earnings before interest, taxes, depreciation, and amortization
EITF	Emerging Issues Task Force
EPA	Environmental Protection Agency

Other abbreviations

EPS	Earnings per share
FAQ	Frequently asked questions
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FCC	Federal Communications Commission
FIN	FASB Interpretation
FSP	FASB Staff Position
FTB	FASB Technical Bulletin
FVLCOD	Fair value less costs of disposal
GAAP	Generally accepted accounting principles
HR	Human resources
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRIC	IFRS Interpretations Committee
IFRS	International Financial Reporting Standards
IPR&D	In-process research and development
IRR	Internal rate of return
IT	Information technology
LIFO	Last-in first-out
NCI	Noncontrolling interest
NOL	Net operating loss
OCI	Other comprehensive income
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PV	Present value

Other abbreviations

REIT	Real estate investment trust
RU	Reporting unit
R&D	Research and development
SAB	Staff Accounting Bulletin
SEC	United States Securities & Exchange Commission
SIC	Standing Interpretations Committee
SOP	Statement of Position
SPE	Special purpose entity
VIE	Variable interest entity
VIU	Value in use
WACC	Weighted average cost of capital

Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

Term	Definition
Acquired group	An acquired group of assets and related activities, referred to in the Standards as an integrated set of activities and assets.
Acquiree	The business or businesses that the acquirer obtains control of in a business combination [US GAAP only—This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.] [ASC 805-10-20; IFRS 3.A].
Acquirer	The entity that obtains control of the acquiree. [US GAAP only—However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity always is the acquirer.] [ASC 805-10-20; IFRS 3.A].
Acquisition date	The date on which the acquirer obtains control of the acquiree [ASC 805-10-20; IFRS 3.A].
Acquisition method	An entity shall account for each business combination by applying the acquisition method. The acquisition method requires all of the following steps [Applying the acquisition method requires]: 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; and d. Recognizing and measuring goodwill or a gain from a bargain purchase [ASC 805-10-05-4; IFRS 3.4-5].
Amortizable units of goodwill	Unit of accounting for assigning and amortizing goodwill for private companies that adopt the goodwill alternative.
Asset acquisition	An acquisition of an asset or group of assets that does not meet the definition of a business.

Term	Definition
Asset group (US GAAP only)	Unit of accounting for a long-lived asset(s) to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities [ASC 360-10-20 and ASC Glossary].
Associate (IFRS Only)	An entity over which the investor has significant influence [IAS 28R.3].
Book base	When determining deferred taxes by comparing the amount of the asset or liability recorded in the financial statements to the amount attributed to that asset or liability for tax purposes, the book base is the amount recorded in the financial statements.
Business (prior to adoption of ASU 2017-01)	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 [ASC 805-10-20; IFRS 3.A]. **New:** An integrated set of assets and activities that include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output [ASU 2017-01].
Business (upon adoption of ASU 2017-01)	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 [ASC 805-10-55-3A]
Business combination	A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as “true mergers” or “mergers of equals” are also business combinations [as that term is used in this IFRS] [ASC 805-10-20; IFRS 3.A].
Business combination achieved in stages	Also known as a step acquisition. When an acquirer obtains control of an acquiree in which it held an equity interest immediately before the acquisition date [ASC 805-10-25-9; IFRS 3.41].
Business enterprise value (BEV)	Often referred to as “Market Value of Invested Capital,” “Total Invested Capital,” or “Enterprise Value,” and represents the fair value of an entity’s interest-bearing debt and shareholders’ equity (e.g., the fair value of the entity as a whole).

Term	Definition
Call option	**US GAAP—**A contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period [ASC Glossary]. **IFRS—**A financial instrument that gives the holder the right to purchase ordinary shares [IAS 33.5].
Carryforward	A deduction or credit that cannot be utilized on the tax return during the current year but that may be used to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms *carryforward*, *operating loss carryforward*, and *tax credit carryforward* refer to the amounts of those items, if any, reported in the tax return for the current year [ASC Glossary]. (A similar concept exists in IFRS, IAS 12.)
Carrying amount	The amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon [IAS 36.6]. (A similar concept exists in US GAAP, ASC 350, and ASC 360).
Carryover basis	The carrying amounts of assets and liabilities in a contributing investor's financial statements (e.g., when being contributed to a joint venture). (A similar concept exists in IFRS, known as predecessor-values method.)
Cash-generating unit (CGU) (IFRS only)	The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets [IAS 36.6].

Term	Definition
Change in the reporting entity	A change that results in financial statements that, in effect, are those of a different reporting entity is limited mainly to the following: a. presenting consolidated or combined financial statements in place of financial statements of individual entities b. changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented c. changing the entities included in combined financial statements Neither a business combination accounted for by the acquisition method, nor the consolidation of a variable interest entity pursuant to ASC 810, is a change in reporting entity [ASC 250-10-20]. (A similar concept exists in IFRS.)
Combined financial statements	The financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic entity. The combined group does not include the parent [ASC Glossary].
Common control	While not defined in US GAAP or IFRS, 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. The extent of a noncontrolling interest is not relevant.
Component (US GAAP only)	A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management, as that term is defined in ASC 280-10-50-7, regularly reviews the operating results of that component [ASC 350-20-35-34].
Consideration transferred	The amount exchanged by the buyer (e.g., cash, other assets, liabilities assumed, contingent consideration, subsidiary or business of the buyer transferred to the seller, common or preferred equity securities, options, warrants and member interests of mutual entities to acquire a business) for the proportionate share of net assets acquired in a business combination.

Term	Definition
Consolidated financial statements	**US GAAP**—The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity [ASC Glossary]. **IFRS**—The financial statements of a group in which the assets, liabilities, equity, income, expenses, and cash flows of the parent and its subsidiaries are presented as those of a single economic entity [IAS 27R.4].
Consolidated group	A parent and all its subsidiaries [ASC Glossary; IFRS 10.A].
Contingent consideration	Usually is an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met [ASC 805-10-20; IFRS 3.A].
Contractual indemnity	Indemnity based on contractual agreement between the parties. The contractual terms can include a party agreeing to indemnify, defend and/or hold the other party harmless.
Contractual-legal criterion	See definition of *Identifiable*.
Control	**US GAAP**—Ownership of a majority voting interest and therefore, as a general rule, ownership by one reporting entity directly or indirectly, of over 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority owned subsidiary shall not be consolidated if control does not rest with the majority owner (for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the entity) [ASC 810-10-15-8 and ASC 810-10-15-10]. **IFRS**—An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee [IFRS 10.A].

Term	Definition
Control premium	A control premium generally represents the amount paid by a new controlling shareholder for the benefits resulting from synergies and other potential benefits derived from controlling the enterprise.
Controlling interest	The equity (residual interest) in a subsidiary attributable, directly or indirectly, to the parent and the parent's affiliates.
Corporate assets	Assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units [IAS 36.6]. (A similar concept exists in US GAAP, ASC 350.)
Cost approach	A valuation technique based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost) [ASC Glossary; IFRS 13.A].
Defensive intangible asset	An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset [ASC Glossary].
Deferred tax asset	**US GAAP**—The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized [ASC Glossary]. **IFRS**—The amounts of income taxes recoverable in future periods in respect of: a. deductible temporary differences; b. the carryforward of unused tax losses; and c. the carryforward of unused tax credits [IAS 12.5].
Deferred tax liability	**US GAAP**—The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law [ASC Glossary]. **IFRS**—The amounts of income taxes payable in future periods in respect of taxable temporary differences [IAS 12.5].

Term	Definition
Disposal group	**US GAAP**—A disposal group for a long-lived asset or assets to be disposed of, by sale or otherwise, represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction [ASC 360-10-20]. **IFRS**—A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of IAS 36 or if it is an operation within such a cash-generating unit [IFRS 5.A].
Entry price	The price paid to acquire an asset or received to assume a liability in an exchange transaction [ASC 820-10-20; IFRS 13.A].
Equity interest	Used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities [US GAAP only—and owner or member interests in the net assets of not-for-profit entities] [ASC 805-10-20; IFRS 3.A].
Equity-linked instrument	A hybrid instrument that contains an embedded component linked to the equity of the issuer. A convertible debt instrument is an example of an equity-linked instrument.
Exit price	The price that would be received to sell the asset or paid to transfer the liability [ASC 820-10-20; IFRS 13.A].
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date [ASC 805-10-20; IFRS 13.9].
Fair value less costs of disposal (FVLCOD)	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, less costs of disposal, which are incremental costs directly attributable to the disposal of an asset or cash generating unit, excluding finance costs and income tax expense. [IAS 36.6]. (A similar concept exists in US GAAP, ASC 360-10-35-38, and ASC 360-10-35-43.)

Term	Definition
Fair value method	In partial acquisitions in which control is obtained, the noncontrolling interest is recorded at its fair value. As a result, all of the acquiree's goodwill, including goodwill related to the controlling and noncontrolling interests, is recognized on the acquisition date. For US GAAP companies, this method is required. For IFRS companies, this method can be chosen on a transaction by transaction basis and is not a policy election (see also proportionate share method below).
Favorable contract	A contract that is favorable in terms of current market terms. Favorable contracts are recognized as assets and are measured at fair value including the impact of renewal provisions (except reacquired rights) [ASC 805-10-55-20 through 55-23; IFRS 3.B36].
Finite useful life	The foreseeable limit on the period of time over which an asset is expected to contribute directly or indirectly to future cash flows.
Goodwill	An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized [ASC Glossary; IFRS 3.A].
Goodwill alternative	A private company accounting alternative for goodwill which permits amortization of goodwill and provides an alternative model for assessing potential impairment (ASU 2014-02, *Accounting for Goodwill*).
Held-and-used	While not defined in US GAAP or IFRS, the term *held-and-used* is generally used to mean a long-lived asset that an entity: i. Uses in operations and does not plan to sell; ii. Plans to sell but has not yet satisfied the conditions in paragraph[s] ASC 360-10-45-9 [6-12 of IFRS 5] that must be met to classify the asset as held for sale; or iii. Plans to abandon, exchange for a similar productive long-lived asset, or distribute to owners in a spin-off.

Term	Definition
Held for sale	A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met: a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group). b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups). c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated. d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by ASC 360-10-45-11. e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset (disposal group) is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset (disposal group). A market price that is reasonable in relation to fair value indicates that the asset (disposal group) is available for immediate sale, whereas a market price in excess of fair value indicates that the asset (disposal group) is not available for immediate sale. f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn [ASC 360-10-45-9]. (A similar concept exists in IFRS, IFRS 5.6-8).
Host instrument	The non-derivative component of a hybrid instrument which “hosts” an embedded derivative feature.

Term	Definition
Identifiable	An asset is identifiable if it meets either of the following criteria: a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (separability criterion); [or] b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (contractual-legal criterion) [ASC 805-10-20; IFRS 3.A].
Impairment [loss]	**US GAAP**—The condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value [ASC 360-10-20]. (A similar concept exists for indefinite lived intangible assets and goodwill in ASC 350.) **IFRS**—The amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount [IAS 36.6].
Income approach	Uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts [ASC Glossary; IFRS 13.A].
Indefinite useful life	**US GAAP**—If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term indefinite does not mean the same as infinite or indeterminate [ASC 350-30-35-4]. **IFRS**—When, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity [IAS 38.88].
Intangible assets	**US GAAP**—Assets (not including a financial asset) that lack physical substance. (The term *intangible assets* is used to refer to intangible assets other than goodwill.) [ASC 805-10-20] **IFRS**—An identifiable nonmonetary asset without physical substance [IFRS 3.A].

Term	Definition
Internal rate of return (IRR)	The rate of return that would make the present value of future cash flows plus the final market value of an investment or business opportunity equal the current market price of the investment or opportunity.
Joint arrangement (IFRS only)	An arrangement where two or more parties contractually agree to share control [IFRS 11.A].
Market approach	A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business) [ASC Glossary; IFRS 13.A].
Market participant	Buyers and sellers in the principal (or most advantageous) market who are independent, knowledgeable, and willing and able to transact for the asset or liability [ASC 820-10-20; IFRS 13.A].
Multiperiod excess earnings method	A variation of the income approach that is used for the valuation of intangible assets. Intangible assets are generally used in combination with other tangible and intangible assets to generate income. The other assets in the group are often referred to as "contributory assets," which contribute to the realization of the intangible asset's value. Under this method, an estimate of an intangible asset's fair value starts with an estimate of the expected net income of a particular asset group. "Contributory asset charges" or "economic rents" are then deducted from the total net after-tax cash flows projected for the combined group to obtain the residual or "excess earnings" attributable to the intangible asset. The fair value of the asset is the present value of the excess earnings attributable to the intangible asset over its economic life.
Mutual entity	An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants. Mutual insurance entities [companies], credit unions, and farm and rural electric cooperatives [cooperative entities] are examples of mutual entities [ASC 805-10-20; IFRS 3.A].
Net cash settlement	A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.
Net operating losses (for income taxes)	Excess tax deductions over gross income in a year that results in tax losses.

Term	Definition
Net share settlement	A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares with a current fair value equal to the gain.
Noncontrolling interest (NCI)	The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent [ASC 805-10-20; IFRS 3.A].
Nonrecourse debt	Debt that is *secured* by a pledge of *collateral*, typically real property. If the borrower *defaults*, the issuer can seize the collateral, but the lender's recovery is limited to the collateral.
Nontaxable transaction	A business combination that for tax purposes is treated as the purchase and sale of an entity's stock. The tax bases of the acquired assets and liabilities carry over and are not stepped up (or down) to fair value.
Not-for-profit entities (US GAAP only)	An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return b. Operating purposes other than to provide goods or services at a profit c. Absence of ownership interests like those of business entities Entities that clearly fall outside this definition include the following: a. All investor-owned entities b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans [ASC 958-10-20]
Onerous contract (Loss contract)	A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it [ASC 805-10-55-21; IAS 37.10].

Term	Definition
Owners	**US GAAP**—Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities [ASC 805-10-20]. **IFRS**—Used broadly to include holders of equity interests of investor-owned entities and owners, members of, or participants in, mutual entities. This definition of owners is only to be used for purposes of IFRS 3 [IFRS 3.A].
Parent	**US GAAP**—An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.) [ASC Glossary] **IFRS**—An entity that controls one or more entities [IFRS 10.A].
Partial acquisition	The acquisition of a controlling interest that is less than 100 percent of the equity interest of the acquiree in which the acquirer did not have a previously held equity interest immediately before the acquisition date.
Physical settlement	A form of settling a financial instrument under which (a) the party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller and (b) the seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.
Predecessor-values method (IFRS only)	Accounting method that can be adopted to account for business combinations between entities under common control. Financial statements under this method are required to be prepared using predecessor book values without any step up to fair value.
Preexisting relationship	A relationship that existed before the acquirer and acquiree contemplated a business combination. A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer, or licensor and licensee) or noncontractual (for example, plaintiff and defendant) [ASC 805-10-55-20; IFRS 3.B51].

Term	Definition
Preferred shares	An equity security that has preferential rights compared to common shares.
Previously held equity interest	The equity interest in a subsidiary that was held by the parent company immediately before the acquisition date when a step acquisition occurs.
Principal market	The market with the greatest volume and level of activity for the asset or liability, which is presumed to be the market in which the reporting entity normally transacts, unless there is evidence to the contrary.
Proportionate share method (IFRS only)	In partial acquisitions in which control is obtained, the noncontrolling interest is measured at its proportionate share of the identifiable net assets of the acquiree at the acquisition date. As a result, goodwill is not recognized for the noncontrolling interest. Chosen on a transaction by transaction basis, not a policy election [IFRS 3.19].
Prospective financial information	Financial forecasts or financial projections, including the summaries of significant assumptions.
Pushdown accounting (US GAAP only)	Use of the acquiring entity's basis of accounting in the preparation of the acquired entity's financial statements [ASC Glossary].
Put option	**US GAAP**—A contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period [ASC Glossary]. **IFRS**—Contracts that give the holder the right to sell ordinary shares at a specified price for a given period [IAS 33.5].
Reacquired right	The acquisition of a right that the acquirer had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets [ASC 805-20-25-14; IFRS 3.B35].
Recoverable amount (IFRS only)	The higher of the fair value less costs of disposal of an asset or CGU and its value in use [IAS 36.6].
Replacement award	An award of share-based compensation that is granted (or offered) concurrently with the cancellation of another award [ASC Glossary]. (A similar concept exists in IFRS).
Replacement cost new	The indicated value of current labor and materials necessary to construct or acquire an asset of similar utility to the asset being measured.

Term	Definition
Replacement cost new less depreciation	Replacement cost new adjusted to reflect any losses in value due to physical deterioration and/or functional obsolescence of the asset.
Reporting unit (US GAAP only)	The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component) [ASC Glossary].
Research and development activities	**US GAAP**—Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process. Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives; construction of prototypes; and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements; and it does not include market research or market testing activities [ASC Glossary and ASC 730-10-15-4]. **IFRS**—Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use [IAS 38.8].
Residual value	**US GAAP**—The estimated fair value of an intangible asset at the end of its useful life to an entity, less any disposal costs [ASC Glossary]. **IFRS**—The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life [IAS 38.8].

Term	Definition
Reverse acquisition	**US GAAP**—An acquisition in which an entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in ASC 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition [ASC 805-10-20]. **IFRS**—An acquisition where the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This might be the case when, for example, a private entity arranges to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing [IFRS 3.21].
Separability criterion	See definition of *Identifiable*.
Spinoff	The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor [ASC Glossary].
Split-off	A transaction in which a parent entity exchanges its stock in a subsidiary for parent entity stock held by its shareholders [ASC Glossary].
Step acquisition	Also known as a business combination achieved in stages. When an acquirer obtains control of an acquiree in which it held an equity interest immediately before the acquisition date [ASC 805-10-25-9; IFRS 3.41].
Subsidiary	**US GAAP**—An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) [ASC Glossary] **IFRS**—An entity that is controlled by another entity [IFRS 10.A].
Tax base	When determining deferred taxes by comparing the amount of the asset or liability recorded in the financial statements to the amount attributed to that asset or liability for tax purposes, the tax base is the amount attributable to the asset or liability recorded in the financial statements.

Term	Definition
Taxable transaction	A business combination that for tax purposes is an asset transaction (purchase and sale of assets) or a stock transaction treated as an asset transaction (an election to do this is agreed to by both the seller and acquirer) and that for financial reporting purposes is considered the acquisition of a business. The tax bases of the acquired assets and liabilities are stepped up (or down) to fair value.
Temporary difference	**US GAAP**—A difference between the tax basis of an asset or liability computed pursuant to the requirements in ASC 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively [ASC Glossary]. **IFRS**—Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either: i. taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or ii. deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled [IAS 12.5].
Total service period	The sum of the following amounts: a. the part of the requisite service period for the acquiree award that was completed before the acquisition date and b. the postcombination requisite service period, if any, for the replacement award. The requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of ASC 718) [ASC 805-30-55-8 through 55-9]. (A similar concept exists in IFRS.)

Term	Definition
Unfavorable contract	A contract that is unfavorable in terms of current market terms. Unfavorable contracts are recognized as liabilities and are measured at fair value including the impact of renewal provisions. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it [ASC 805-10-55-21; IFRS 3.B36].
Unit of account	That which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated) for recognition purposes [ASC 820-10-20; IFRS 13.A].
Unit of valuation	The level at which fair value of an asset is measured based on its use together with other assets as a group.
Useful life	**US GAAP**—The period over which an asset is expected to contribute directly or indirectly to future cash flows [ASC Glossary]. **IFRS**—Either (i) the period of time over which an asset is expected to be used by the entity; or (ii) the number of production or similar units expected to be obtained from the asset by the entity [IAS 36.6].
Value in use	**US GAAP**—The amount determined by discounting the future cash flows (including the ultimate proceeds of disposal) expected to be derived from the use of an asset at an appropriate rate that allows for the risk of the activities concerned [ASC Glossary]. **IFRS**—Present value of the future cash flows expected to be derived from an asset or cash generating unit [IAS 36.6].
Variable interest entity (US GAAP only)	A legal entity subject to consolidation according to the provisions of the Variable Interest guidance in ASC 810-10 [ASC 810-10-20 and ASC Glossary].
Vesting conditions	The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets, or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the counterparty to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity’s profit over a specified period of time). A performance condition might include a market condition [IFRS 2.A].

Term	Definition
Vesting period	The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied [IFRS 2.A].
Voting interest entity (US GAAP only)	An entity that is not a variable interest entity, but one in which the equity investment is deemed sufficient to absorb the expected losses of the entity, and the equity investment has all of the characteristics of a controlling financial interest.
Weighted average cost of capital (WACC)	An average representing the expected return on all of a company's securities. Each source of capital, such as stocks, bonds, and other debt, is weighted in the calculation according to its prominence in the company's capital structure.
With and without method	A variation of the income approach that is used for valuation of intangible assets. The fundamental concept underlying this method is that the value of the subject intangible asset is the difference between an established, on-going business and one where the subject intangible asset does not exist. Under the with and without method, the value of the subject intangible asset is calculated by taking the difference between the business value estimated under two sets of cash flow projections: □ The value of the business with all assets in place at the valuation date □ The value of the business with all assets in place except the subject intangible asset at the valuation date Also, a method of allocating goodwill to a reporting unit that is not assigned any of the assets from a business combination but is expected to benefit from synergies.

Appendix D: Summary of significant changes

This appendix includes a summary of the noteworthy revisions to the *Business Combinations and Noncontrolling Interests, global* guide since it was last fully updated in April 2014.

This PwC guide has been reorganized. Some guidance has been moved to other PwC guides. The reorganization has changed some numbering of sections within chapters, and has caused some of our chapter numbers to change.

The following lists the changes made to the chapters as they appeared in the 2014 edition of the guide.

Chapter 1: Scope

- **BCG 1.3** was added to provide guidance on the definition of a business subsequent to the adoption of ASU 2017-01

Chapter 2: Acquisition method

- **BCG 2.5.2** was updated to reflect the guidance under ASU 2016-13 in relation to asset valuation allowances

- **BCG 2.6.4.1** was updated to include a section on *Contingent consideration arrangements related to a partially-owned subsidiary*

- **BCG 2.7.6** was updated to include a section on *Transaction service arrangements*

Chapter 3: Employee compensation arrangements

- **BCG 3.1** was updated to reflect the guidance in ASU 2016-09.

- Former section **BCG 3.8** on accounting for the income tax effects of share-based payments under US GAAP, has been moved to the *Income taxes* guide

Chapter 4: Intangible assets acquired in a business combination

- **BCG 4.3.4.7** was updated to reflect the guidance on leases under ASC 842 and IFRS 16

Chapter 5: Income tax implications in business combinations

- This guidance has been moved to the *Income taxes* guide

Chapter 6: Partial acquisitions, step acquisitions, and accounting for changes in the noncontrolling interest

- This chapter has been renumbered to Chapter 5

Chapter 7: Valuation

- This chapter has been moved to the *Fair value measurements* guide

Chapter 8: Common control transactions

- This chapter has been renumbered to Chapter 6

Chapter 9: Asset acquisitions

- This chapter has been renumbered to Chapter 7

- The guidance on accounting for nonmonetary transactions under US GAAP formerly in **BCG 9.2.2.1** has been moved to the *Property, plant, equipment and other assets* guide

- **BCG 9.2.4 (new BCG 7.2.4)** has been updated to provide additional guidance on the potential differences in accounting for an asset acquisition versus a business combination (Figure 7-1)

Chapter 10: ***Accounting for tangible and intangible assets postacquisition—US GAAP***

- This chapter has been renumbered to Chapter 8

- The guidance in former Chapter 10 related to accounting for tangible assets postacquisition–US GAAP now resides in the *Property, plant, equipment and other assets* guide

Chapter 11: Accounting for goodwill postacquisition–US GAAP

- This chapter has been renumbered to Chapter 9

- New **Chapter 9** was updated to provide guidance on the goodwill impairment model subsequent to the adoption of ASU 2017-04

- The order of certain sections in new **Chapter 9** were rearranged

Chapter 12: Postacquisition accounting issues—IFRS

- This chapter has been renumbered to Chapter 10

Chapter 13: Other business combination considerations

- This chapter has been renumbered to Chapter 11

- Former **BCG 13.2** was removed as the discussion of disclosures under the SEC's accounting and reporting rules and regulations can be found in the PwC FSP guide

About PwC’s National Accounting Services Group

The Accounting Services Group (ASG) within the Firm’s National Quality Organization leads the development of Firm perspectives and points of view used to inform the capital markets, regulators, and policy makers. ASG assesses and communicates the implications of technical and professional developments on the profession, clients, investors, and policy makers. The team consults on complex accounting and financial reporting matters and works with clients to resolve issues raised in SEC comment letters. They work with the standard setting and regulatory processes through communications with the FASB, SEC, and others. The team provides market services such as quarterly technical webcasts and external technical trainings, including our alumni events. The team is also responsible for sharing their expert knowledge on topics through internal and external presentations and by authoring various PwC publications.

In addition to working with the US market, the ASG team has a large global team that is involved in the development of IFRS.

The team of experienced Partners, Directors, and Senior Managers helps develop talking points, perspectives, and presentations for when Senior Leadership interacts with the media, policy makers, academia, regulators, etc.

About PwC

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 158 countries with more than 236,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.