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SPECIAL REPORT

Accounting and Reporting for Business Combinations

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Mergers, acquisitions and other types of business combinations are a common strategy among companies that wish to grow their businesses or diversify their risk. Entering into business combinations can help companies reach new geographic markets, expand product offerings or achieve various synergies. Business combinations offer a number of benefits to the parties involved, but the initial accounting for the business combination can be complicated and often requires extensive time and effort.

The authoritative accounting and reporting guidance for business combinations under US GAAP is included in Topic 805, Business Combinations, of the FASB Accounting Standards Codification. Topic 805 interacts with other various technical areas of the Codification, such as the guidance on consolidation (the concept of control), fair value measurements, income taxes and share-based payments. Thus, a reporting entity must be familiar with not only Topic 805, but also these other technical areas. In addition, SEC registrants must comply with an additional set of rules and regulations for SEC reporting purposes, such as the pro forma disclosures requirements in Rule 3-05 of Regulation S-X.

One of the challenges that a reporting entity might face in accounting for a business combination is determining if it has acquired a business or a group of assets. The accounting treatment is very different based on the result of that determination. Another challenge is identifying all of the assets that were acquired and all of the liabilities that were assumed (including intangible assets and contingencies that the acquired company may not have recorded). Other challenging areas involve measuring the assets acquired and liabilities assumed in the business combination at fair value and the resulting goodwill, accounting for adjustments to the initial amounts recorded and determining the tax implications of the acquisition. Many areas of the guidance require management to make judgments and assumptions. In addition, certain aspects of the accounting are changing, such as the definition of a business and rules for goodwill impairment testing. A reporting entity must stay informed about the ever-evolving guidance.

Background and Objectives

Each business combination is unique. Therefore, the accounting for each business combination may be different.

A reporting entity must ensure that the accounting and reporting for a business combination reflect the terms of the transaction at hand. Each business combination is unique. Even if a reporting entity has undergone a business combination before, there will be new or different facts and circumstances to analyze. For instance, some business combinations may involve items that require careful attention, such as intangible assets, contingencies, replacement awards or a previously-held equity interest, among others. In addition, the measurement of an item acquired or assumed in the business combination or transferred as consideration is based generally on fair value. These fair value estimates depend on market participants' assumptions about events that have occurred or exist as of the acquisition date.

A reporting entity must ensure that it allocates sufficient resources to understand and address all of the accounting and reporting requirements. Many elements of a business combination require significant management estimates and judgment. A reporting entity may wish to engage the assistance of various experts throughout the process, such as valuation specialists, tax practitioners and legal advisers. A reporting entity also must be able to articulate and support the basis for the judgments made and conclusions reached in performing the accounting.

Business combinations are often examined closely by regulators, investors and other users of financial statements. Users may raise questions to better understand the economic substance of the transaction and regulators may ask a reporting entity to prove that it has complied with the accounting and reporting requirements. A reporting entity must be prepared to field questions about its treatment of a business combination.

This special report focuses on the accounting required under US GAAP and is laid out in the following sections:

- Scope
- The Acquisition Method
  - Determine the acquirer
  - Determine the acquisition date
  - Recognize and measure the assets, liabilities and noncontrolling interest
  - Recognize and measure any goodwill or gain from a bargain purchase
- Presentation
- Disclosure

Scope

A business combination is a transaction in which an acquirer gains control over a business.

To determine if a business combination has happened, an acquirer must first evaluate whether it has acquired a business or a group of assets. The distinction is critical because the accounting treatment is very different based on the determination.

A transaction is not a business combination unless it involves the acquisition of a business. Therefore, understanding the FASB's definition of a business is important in order to determine if the transaction is a business combination.

ASU No. 2017-01 revises the definition of a business, which may change whether a transaction is a business combination.

A business is defined, under US GAAP, as a set of activities and assets that is both self-sustaining and managed to provide a return to investors. A business generally has three elements: inputs, processes and outputs, but a business does not have to include outputs. Also, there is no minimum number of inputs or processes required. A set of activities and assets is considered a business as long as market participants are capable of buying the set and continuing to produce outputs, such as incorporating the set with their own inputs and processes.

OBSERVATION:

The FASB definition of a business is not the same as the definition of a business under SEC regulations. Rule 11-01(d) of SEC Regulation S-X indicates that the term business:

> "should be evaluated in light of the facts and circumstances involved, and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary or a division is a business."

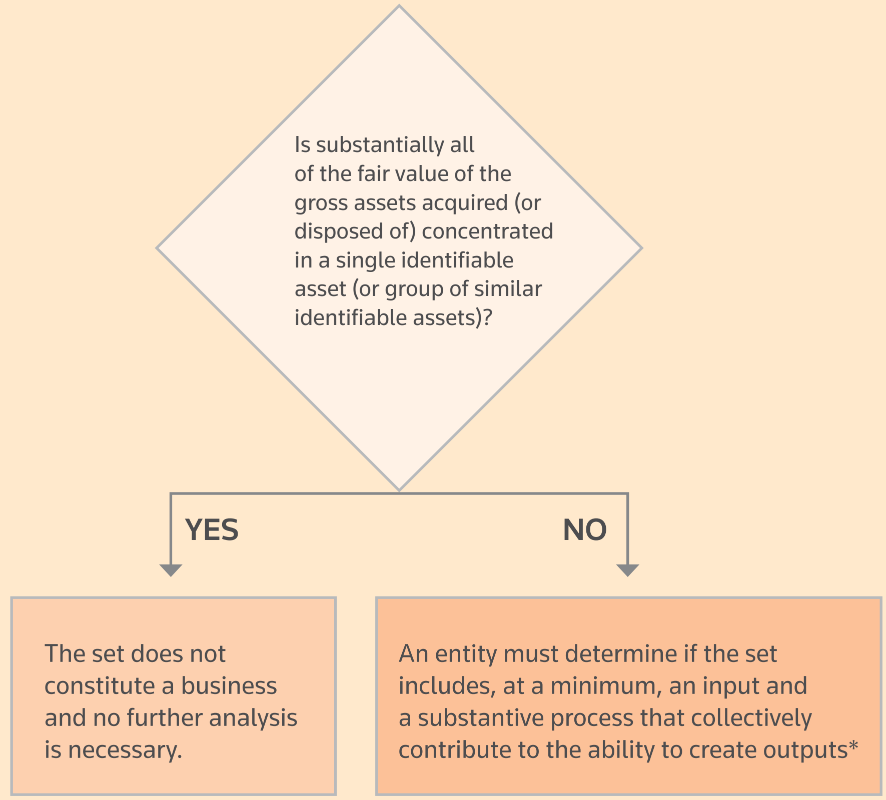
The SEC definition must be used to determine whether reporting under Item 2.01, Completion of Acquisition or Disposition of Assets, of Form 8-K is required for an acquisition transaction. In other words, a reporting entity might have to provide historical or pro forma financial information under Regulation S-X if an SEC registrant determines that a "significant" business acquisition has occurred or is probable, even if the transaction is not a business combination under US GAAP.

OBSERVATION:

In January 2017, the FASB issued Accounting Standards Update (ASU) No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. This ASU is effective for public business entities for annual periods beginning after December 15, 2017 (and interim periods therein) and for all other entities for annual periods beginning after December 15, 2018 (and interim periods after the year of adoption).

ASU No. 2017-01 revises the definition of a business under US GAAP by requiring a business to have, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. This ASU is intended to help entities distinguish between transactions that are business combinations and those that are asset acquisitions. In general, fewer sets of activities and assets will meet the revised definition of a business. Therefore, some of today's transactions may not qualify as a business combination under the new definition.

ASU No. 2017-01 provides an initial screen to evaluate if a set of activities and assets is a business. The following decision tree illustrates the initial screen.



*A market participant is not required to evaluate whether it could replace any missing elements.

ASU No. 2017-01 provides a framework to determine if a transaction includes an input and a substantive process. In addition, it gives a more narrow definition of the term "output" to better align with the guidance in Topic 606, Revenue from Contracts with Customers.

ASU No. 2017-01 must be applied prospectively. Early application is allowed for transactions that have not been reported in financial statements issued or made available for issuance. The following table gives an example of how ASU No. 2017-01 might change an entity's conclusion of whether a set of activities and assets is a business.

Facts	Prior to ASU No. 2017-01	Under ASU No. 2017-01
A real estate entity sells a building with existing leases. The sale involves the transfer of inputs, but not processes.	The transaction might meet the definition of a business under current GAAP because the buyer can take the input (the building) and combine the input with its own processes to produce outputs (lease income).	The transaction does not meet the definition of a business under ASU No. 2017-01 because there is no substantive process transferred.

If an entity acquires assets and liabilities that do not meet the definition of a business, the transaction is not a business combination. Instead, the entity accounts for the transaction as an asset acquisition under Subtopic 805-50, Business Combinations — Related Issues.

OBSERVATION:
Understanding the definition of a business is critical to ensure that an entity properly identifies transactions as either business combinations or asset acquisitions. Various differences exist between the accounting for business combinations and asset acquisitions. For instance, in a business combination, an entity recognizes goodwill; no goodwill is recognized for an asset acquisition. As another example, in a business combination, transaction costs are expensed as incurred. Transaction costs are capitalized for an asset acquisition. Due to these and other differences, distinguishing between business combinations and asset acquisitions is crucial to ensure that a transaction is accounted for properly. Confusing the two can result in material misstatements to the acquirer's financial statements and material errors in the subsequent measurement of the acquired assets and liabilities.

A business combination is accounted for using the acquisition method of accounting. The following transactions are often associated with a business combination, but are explicitly excluded from the scope of the acquisition method:

- Transactions between entities under common control (see Subtopic 805-50)
- The creation of a joint venture
- Acquisitions by not-for-profit entities (NFPs) occurring before December 15, 2009
- Mergers of NFPs
- Transactions between NFPs that do not require the consolidation of one NFP by the other (see FASB ASC 958-810-25-4)
- The consolidation of a variable interest entity that is a collateralized financing entity

The Acquisition Method

Under Topic 805, an acquirer accounts for a business combination using the acquisition method. The four basic steps in the acquisition method are as follows:

STEP 1 — Determine the acquirer.

STEP 2 — Determine the acquisition date.

STEP 3 — Recognize and measure the assets, liabilities and noncontrolling interest.

STEP 4 — Recognize and measure any goodwill or gain from a bargain purchase.

The acquisition method uses the same concept of control described in the consolidation guidance in Topic 810, Consolidation.

STEP 1 — Determine the acquirer

Step 1 of the acquisition method is to identify the acquirer. The acquirer is the entity that obtains control of the acquiree.

Factors that may help identify the acquirer include:

- Who pays cash or other assets as part of the acquisition transaction
- Who has more voting rights in the combined entity following the acquisition
- Who holds the largest minority voting interest in the combined entity
- Who is able to elect, appoint or remove members from the governing body of the combined entity
- Who takes the lead in managing the combined entity
- Who is larger (in terms of assets, revenues, earnings or some other measure)
- Who initiated the acquisition

OBSERVATION:

The Codification does not indicate how to weigh these various factors. At times, certain factors may point to one party as the acquirer, while others point to the counterparty. For instance, one party might initiate the acquisition, but the other party might have more voting rights and management responsibilities in the combined entity. A reporting entity must apply judgment and consider the facts and circumstances, not just individually, but also in the aggregate.

The acquirer often is the party that pays cash or other assets as part of the acquisition transaction. An acquirer might obtain control, however, without transferring any consideration. The following table provides examples:

Example	Description
Repurchase of shares	An acquiree repurchases a significant number of its own shares. If the number of shares is large enough, this can result in an existing investor (the acquirer) obtaining control of the acquiree.
Lapse of minority veto rights	An investor may hold a majority of the voting interest in an investee. If minority veto rights exist, however, these rights prevent the investor from having control of the investee. If the minority veto rights lapse, this can result in the investor (the acquirer) obtaining control of the investee.
Business combination by contract alone	Two parties may agree to enter into a contract to combine their businesses without transferring any consideration, such as a stapling arrangement or the formation of a dual-listed corporation.

In some cases, the acquirer identified for accounting purposes is different from the legal acquirer. This is called a reverse acquisition or reverse merger. For instance, a reverse acquisition might take place if a private company wants to become public without having to register its equity shares.

OBSERVATION:
Identifying the acquirer of a business combination often is relatively straight forward. It may, however, be more difficult in the case of a reverse acquisition or a business combination with no consideration.

STEP 2 — Determine the acquisition date

Step 2 of the acquisition method is to determine the acquisition date of the business combination. The acquisition date is the date on which the acquirer obtains control of the acquiree and the measurement date for recording the assets acquired and liabilities assumed in the transaction. An acquirer typically obtains control over an acquiree by exchanging consideration, such as:

- Transferring cash or other assets
- Incurring liabilities
- Issuing equity interests
- Performing a combination of these

In some cases, an acquirer can obtain control without exchanging any consideration. For example, an acquirer might gain control through a stapling arrangement or as a result of a lapse in minority veto rights.

If an acquirer obtains control of the acquiree over time, in stages, the business combination is referred to as a step acquisition. For instance, an entity might have a 10% interest in an investee, but no control, and then purchase an additional 50% interest in the investee, gaining control and resulting in a business combination.

OBSERVATION:
The acquisition date usually is the date at which the acquirer legally transfers consideration to the acquiree. The acquisition date also might be the closing date for the contract or another date. All pertinent facts and circumstances must be assessed to identify the acquisition date. An acquirer is encouraged to maintain documentation supporting its conclusion. Regulators or other users of financial statements sometimes ask how the acquisition date was identified.

Determining the acquisition date is key because it is the date at which the business combination is measured. It is also the date that starts the measurement period. During the measurement period, an acquirer may be allowed to adjust its initial accounting for the business combination, as described later in this special report. The measurement period exists to give an acquirer enough time to gather the information necessary to account for the business combination. The measurement period may extend for a maximum of one year from the acquisition date.

STEP 3 — Recognize and measure the assets, liabilities and noncontrolling interest

Step 3 of the acquisition method is to recognize and measure the assets acquired, liabilities assumed and any noncontrolling interest.

Examples of assets and liabilities that might be transferred in a business combination are:

Assets	Liabilities
Cash and cash equivalents	Accounts payable
Accounts receivable	Accrued liabilities
Derivative assets	Asset retirement obligations
Indemnification assets	Debt
Intangible assets(1)	Derivative liabilities
Inventory	Environmental obligations
Investments	Income taxes payable
Lease receivables	Lease obligations
Loan receivables	Liabilities for commitments or contingencies
Property, plant and equipment	Liabilities for employee benefits(2)
Reacquired rights	Liabilities for share-based payment awards
Contingent assets	Contingent liabilities
Deferred tax asset	Deferred tax liabilities

(1) Such as brands, trademarks, patents, customer lists or unrecorded intangible assets used in research and development activities
(2) Such as pension or other postretirement benefit plans

All assets acquired and liabilities assumed in a business combination must be recognized by the acquirer in its financial statements. This might result in the acquirer recognizing an asset or liability that was not previously recognized in the acquiree's financial statements, such as a brand name, patent, customer relationship or other intangible asset developed internally by the acquiree. The acquirer must recognize 100% of the acquiree's net assets, even when other parties retain a noncontrolling interest.

Various items require judgment to determine if they are part of the business combination. For instance, the acquirer and the acquiree may have a pre-existing arrangement or relationship in place prior to the acquisition; pre-existing arrangements are not part of the business combination and must be accounted for according to other relevant GAAP. An acquirer also must cautiously evaluate transactions to compensate employees (or former owners) of the acquiree for future services. The Implementation Guidance and Illustrations in Section 805-10-55 describes various factors to consider to determine whether a compensation arrangement is part of the business combination and gives related examples. The factors include the terms of the continuing employment — such as the duration and level of compensation — how the compensation relates to amounts paid to selling shareholders who do not become employees, the number of shares owned by the employees after the acquisition, how the amount of other consideration transferred in the business combination compares to the valuation of the acquiree, the formula used to determine the compensation, as well as other arrangements and issues.

OBSERVATION:
Identifying all of the assets and liabilities exchanged in a business combination requires careful attention. An acquirer is encouraged to consider the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, as part of its analysis. For areas requiring judgment, the acquirer is encouraged to document thoroughly the basis for its conclusions.

A common pitfall is to overlook one or more of the items exchanged, such as an intangible asset or a contingency. Failing to identify and measure one of the items exchanged results in the acquirer recording the wrong amount of goodwill. In addition, it results in improper accounting for the item in a future period. For example, if an acquirer overlooks an intangible asset and fails to record it separately, the intangible asset is recognized as part of goodwill. This results in improper accounting for the intangible asset in future periods because intangible assets must be amortized, and an overstatement of goodwill, where an overstated goodwill balance may not be assessed properly for impairment.

When identifying all of the assets and liabilities exchanged in a business combination, it is also important not to double count any assets or liabilities. For example, two distribution channels — that are acquired intangible assets — might use the same client list; the client list must only be counted once when measuring each identifiable intangible asset.

An acquirer might incur various transaction costs related to a business combination. Examples are finder's fees, professional or consulting fees (such as advisory, legal, accounting or valuation costs), general and administrative costs (such as those to run internal departments dedicated to acquisitions) and costs to register or issue debt and equity securities. These costs are collectively referred to in the Codification as "acquisition-related costs." Acquisition-related costs generally must be accounted for separately from the business combination and expensed as incurred. In other words, they are not capitalized as part of the business combination transaction. An exception applies to the costs to issue debt or equity securities; these costs must be treated in accordance with applicable GAAP and the acquirer must disclose its accounting for these costs in the notes to its financial statements.

Private companies have two accounting alternatives related to business combinations: one for the recognition of intangible assets, and a second for the measurement of goodwill.

Topic 805 provides an accounting alternative that private companies can elect for the recognition of certain intangible assets acquired in a business combination. If a private company elects this accounting alternative, it generally does not recognize the following intangible assets separately from goodwill:

- Customer-related assets
- Non-compete agreements

If, however, a customer-related asset can be licensed or sold separately from other assets of the business, a private company must recognize this customer-related asset separately from goodwill, even if it uses the accounting alternative.

OBSERVATION:
A private company that uses this accounting alternative will recognize fewer intangible assets than it otherwise would. Measuring intangible assets often is costly and complicated. Therefore, this accounting alternative simplifies the accounting for private companies.

A private company that elects the accounting alternative for the recognition of intangible assets is also required to elect the accounting alternative for the subsequent measurement of goodwill (discussed later in this special report).

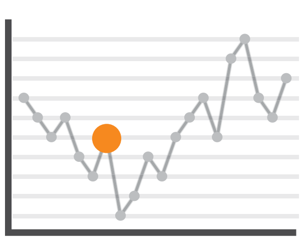
As of the acquisition date, an acquirer must classify and designate the assets acquired and liabilities assumed as appropriate. For instance, investment securities are classified as trading, available for sale or held-to-maturity under Topic 320, Investments — Debt and Equity Securities. As another example, the acquirer must decide whether to designate any derivatives acquired as hedging instruments under Topic 815, Derivatives and Hedging. To make decisions about classification, the acquirer generally must consider the contract terms and other factors as they exist as of the acquisition date. An exception applies for leases and contracts within the scope of Subtopic 944-10, Financial Services — Insurance — Overall; for these arrangements, the acquirer considers the contract terms and other factors as of the inception of the agreements.

The acquirer also must determine the tax implications of the acquisition, such as the recognition of deferred tax assets and liabilities because of differences in the book and tax bases of the acquired assets and assumed liabilities. In general, an acquirer must follow Topic 740, Income Taxes, to account for the tax effects of a business combination. Topic 805, however, provides supplemental guidance, including specific rules on how to determine the tax implications for goodwill and replacement awards classified as equity.

OBSERVATION:
Tax law varies by jurisdiction. An acquirer is encouraged to utilize tax professionals to ensure that it understands and complies with the relevant tax law. For example, goodwill is only taxable in certain jurisdictions. Therefore, an acquirer must know the applicable tax law to determine if goodwill results in deferred taxes.

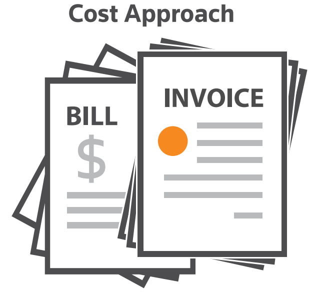
The general measurement principle for business combinations is that all assets acquired and liabilities assumed must be measured at fair value as of the acquisition date. Fair value is the price an entity would receive to sell an asset — or pay to transfer a liability — in a transaction that is orderly, takes place between market participants and occurs at the acquisition date. Topic 820, Fair Value Measurement, discusses three approaches to measure fair value, as shown in the following figure.

Market Approach



Income Approach

Cost Approach



An acquirer can use one or a combination of these approaches to measure fair value. In practice, entities often use a market approach, such as a quoted market price, or an income approach, such as a present value technique. Regardless of the approach selected, an acquirer must maximize the use of observable inputs and minimize the use of unobservable inputs. Also, an acquirer must be careful to use assumptions consistent with those that a market participant would use.

OBSERVATION:
An acquirer may not intend to use certain assets acquired in the business combination. For instance, an acquirer might buy its competitor for the sole purpose of acquiring and retiring the competitor's brand. In this case, an acquirer may be tempted to assign a low or zero value to the competitor's brand. The acquirer, however, must determine the fair value of the brand using assumptions consistent with those that a market participant would use. This may result in the acquirer assigning a relatively high value to the brand, and then having to recognize an impairment loss in a later period when the brand is retired.

OBSERVATION:
Determining the fair value of certain assets as of the acquisition date may be difficult. For example, intangible assets and contingencies may be hard to measure because management must use judgment and make assumptions about the future. An acquirer often uses valuation experts to assist in the valuation of assets acquired and liabilities assumed in a business combination. Ultimately, however, the acquirer is responsible for the valuation approach and assumptions used.

OBSERVATION:
The valuation of a business combination is often highly scrutinized by regulators and users of the financial statements. An acquirer that thoroughly documents the bases for its conclusions will be better prepared to address questions from users as they arise.

An acquirer does not record valuation allowances at the acquisition date for assets deemed uncollectible, such as loans or receivables. This is because the assets are measured at fair value as of the acquisition date. A fair value measurement already reflects expectations about uncollectible balances.

Exceptions exist to the general measurement principle for indemnification assets, income taxes, employee benefits, reacquired rights, share-based payment awards, assets held for sale and certain assets and liabilities related to contingencies. These items are measured according to the specific rules provided in Topic 805, which may result in some items being recorded at amounts other than fair value as of the acquisition date. For instance, Topic 805 requires an indemnification asset to be measured on the same basis as the indemnified item. If the indemnified item is not measured at fair value, it might be necessary to establish a valuation allowance for the indemnification asset.

OBSERVATION:

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The ASU changes the guidance on lease accounting and most notably requires lessees to recognize operating leases on the balance sheet. The ASU also amends Topic 805 to add leases as an exception to the general measurement principle, and include language on how to treat leases in a business combination.

ASU No. 2016-02 is effective for public entities for annual periods beginning after December 15, 2018, including interim periods within these annual periods. The ASU is effective for all other entities for annual periods beginning after December 15, 2019 and interim periods within annual periods beginning after December 15, 2020. Early application is permitted.

Once an acquirer has identified all of the assets acquired and liabilities assumed in the business combination, the acquirer also must determine if a noncontrolling interest exists.

The noncontrolling interest represents the portion of net assets not attributable to the acquirer. In other words, the portion attributable to other investors. The acquirer must measure the noncontrolling interest at fair value as of the acquisition date. The fair value of the noncontrolling interest often is determined based on the number of shares held by the noncontrolling interest and the quoted market price of a share. If the quoted market price of a share is not available, the acquirer must use another valuation technique. Often, the per-share valuation of the acquirer's interest and the noncontrolling interest differ. This is generally because the per-share valuation of the acquirer's interest includes a control premium. The control premium reflects the fact that market participants typically are willing to pay more per share for the ability to have control over an investee.

OBSERVATION:

It is not uncommon for an acquirer to pay a control premium between 10–20% of the fair value of the individual shares. The amount of the control premium can be affected by a number of factors and may depend, in part, on the particular industry or market.

Acquirers must carefully apply guidance on the measurement period; missapplication of this guidance occurs frequently.

The accounting for a business combination requires substantial effort and resources. The initial accounting often is incomplete at the end of the reporting period in which the business combination happens. This is because the acquirer has been unable to obtain all pertinent information necessary to evaluate the conditions that existed as of the acquisition date. As a result, the acquirer may have to record provisional amounts for certain assets or liabilities — for instance, independent valuations for intangible assets may not yet be finalized. The acquirer can record adjustments to these provisional estimates during the measurement period, subject to certain conditions. For example, the acquirer must provide disclosures that clearly denote the provisional items outstanding during the measurement period.

The measurement period is intended to allow an acquirer sufficient time to obtain the information necessary to evaluate the conditions that existed as of the acquisition date. When the acquirer receives the necessary information, adjustments may be necessary either:

- To revise the amounts recorded for assets and liabilities recognized at the time of the acquisition
- To recognize new assets and liabilities that would have been recognized at the time of the acquisition if all facts and circumstances had been known at that time

When an acquirer makes a measurement period adjustment, the acquirer usually records a corresponding debit or credit to goodwill.

An acquirer must not record a measurement period adjustment for either of the following:

- The correction of an error. An acquirer must account for the correction of an error according to Topic 250, Accounting Changes and Error Corrections. For example, an acquirer might record the wrong amount in its general ledger for an asset acquired due to a typo. The adjustment made to record the proper amount is accounted for as the correction of an error under Topic 250.
- Events that happened after the acquisition date. These events must be accounted for in the periods in which they occur following relevant guidance in the Codification. For instance, the impairment of an available-for-sale debt security occurring after the acquisition date is accounted for under Topic 320, Investments — Debt and Equity Securities.

OBSERVATION:
Improper application of the guidance on the measurement period is a common cause of errors and misstatements in an acquirer's financial statements. Some frequent pitfalls in applying this guidance are:

- Presuming that the measurement period lasts for a full twelve months. Twelve months is the maximum time that the measurement period can remain open. The measurement period ends when the acquirer obtains the information necessary to evaluate the conditions that existed as of the acquisition date.
- Failing to provide the required disclosures indicating the provisional items outstanding. If this happens, an acquirer cannot record an adjustment to goodwill. Instead, the adjustment is recognized through earnings.
- Recording corrections of errors or events happening after the acquisition date as measurement period adjustments.

ILLUSTRATION: The following illustration includes three scenarios. The scenarios show how slight changes in facts and circumstances might lead to a different conclusion about whether an adjustment to an environmental liability is a measurement period adjustment, the correction of an error or an event happening after the acquisition date.
In all three scenarios, assume the following:

- On March 20, 20X1, an acquirer buys a small energy infrastructure company (the acquiree) in a business combination. The acquiree owns and operates pipelines and terminals that transport and store natural gas, petroleum products and crude oil.
- In the days leading up to the business combination, one of the acquiree's crude oil tanks experiences a small leak that is suspected of causing low levels of contamination to nearby soil and groundwater. The acquirer assumes the acquiree's environmental liability to clean up the damage.
- For the March 31, 20X1 financial statements, the acquirer records an initial estimate of the environmental liability, but is awaiting additional information to finalize the estimate — such as the results of soil and groundwater testing and independent evaluations by professionals specializing in the remediation of environmental contamination.

Scenario 1	Scenario 2	Scenario 3
In its March 31, 20X1 financial statements, the acquirer discloses the business combination and provides all required disclosures about the measurement period. In particular, the disclosure indicates that the final valuation of the environmental liability is pending. In July 20X1, the acquirer receives the rest of the information necessary to finalize its estimate of the environmental liability. The acquirer records the adjustment to the environmental liability as a ***measurement period adjustment***.	In its March 31, 20X1 financial statements, the acquirer discloses the business combination. The acquirer, however, fails to provide the required disclosures about the measurement period. In July 20X1, the acquirer receives the rest of the information necessary to finalize its estimate of the environmental liability. The acquirer records the adjustment to the environmental liability as the ***correction of an error***.	After the acquisition date, a different crude oil tank on the site springs a small leak. The acquirer must increase its environmental liability for the cost to remediate the additional damage. The increase is reflected in current period activity because it was triggered by an ***event happening after the acquisition date***.

Once an acquirer finishes the initial accounting for a business combination, it generally must account for the assets acquired, liabilities assumed and noncontrolling interest according to relevant guidance in other areas of the Codification. Topic 805, however, provides specific rules for the subsequent measurement of several items, such as assets and liabilities from contingencies recorded as of the acquisition date, indemnification assets, reacquired rights and contingent consideration.

STEP 4 — Recognize and measure any goodwill or gain from a bargain purchase

Goodwill is defined as the future economic benefits arising from the other assets purchased in a business combination that are not identified and recognized separately. In essence, goodwill is an extra amount paid by the acquirer above the fair value of the net assets acquired. For instance, an acquirer might pay extra because of expected synergies or anticipated future growth of the combined businesses.

As a general rule, the amount of goodwill is determined using the fair value of the consideration transferred. The basic formula used to calculate goodwill is:

Goodwill = FV of the consideration transferred + Noncontrolling interest – FV of net assets acquired

ILLUSTRATION: In a business combination, an acquirer pays cash consideration of $400,500, acquires assets with a fair value of $813,400 and assumes liabilities with a fair value of $478,020. The acquirer does not hold any interest in the acquiree prior to the business combination. Assume that the fair value of the noncontrolling interest is $27,600.
The acquirer calculates the amount of goodwill as follows:

Goodwill = FV of the consideration transferred + Noncontrolling interest — FV of net assets acquired

= $400,500 + $27,600 – ($813,400 - $478,020)

= $92,720

The acquirer records the following journal entry to reflect the effects of the business combination:

Dr. Identifiable assets acquired	$813,400	
Dr. Goodwill	$92,720	
Cr. Cash		$400,500
Cr. Liabilities assumed		$478,020
Cr. Equity—noncontrolling interest		$27,600

For simplicity, this illustration shows a single general ledger account for identifiable assets acquired and liabilities assumed. In practice, however, an acquirer must reflect the effects of the transaction in the relevant general ledger accounts for each asset acquired and liability assumed.

OBSERVATION:
After calculating the amount of goodwill, an acquirer is encouraged to compare the amount of goodwill to the overall purchase price for the acquisition. If the goodwill balance is high relative to the overall purchase price, this typically indicates that the acquirer neglected to identify one or more of the assets acquired or liabilities assumed in the business combination. For instance, acquirers frequently fail to identify intangible assets that were not previously recognized by the acquiree, such as internally-developed brands or patents. A large goodwill balance may also suggest that the measurement of the consideration transferred, noncontrolling interest, net assets or a combination of these items is incorrect.

Fair value of the consideration transferred

Calculating goodwill requires measuring the fair value of the consideration transferred. This section addresses this issue specifically.

The consideration transferred in a business combination may be in various forms, such as cash, other assets, shares of stock, options, warrants, a business of the acquirer, replacement awards granted to employees of the acquiree or other instruments. Thus, an acquirer must take care to identify all items that constitute consideration.

Identifying and measuring some forms of consideration, such as cash, is relatively straight forward. Others, however, may pose challenges. The following table provides more information on two of the more complicated forms of consideration: replacement awards and contingent consideration.

Type of Consideration	Accounting
Replacement awards	Replacement awards are awards granted by the acquirer to the employees of the acquiree in exchange for their existing (acquiree) awards. If an acquirer grants replacement awards, the exchange is accounted for as a modification to the awards under Topic 718, Compensation — Stock Compensation. In addition, the acquirer must determine if it has an obligation to provide the replacement awards. For instance, the acquirer might have this obligation due to the provisions of the acquisition agreement, the terms of the acquiree's awards or relevant laws and regulations. If the acquirer has an obligation to provide the replacement awards, the replacement awards (or a portion of the awards) are part of the consideration transferred in the business combination. To determine the portion of replacement awards that must be included in the consideration transferred in the business combination, the acquirer must: • Distinguish whether the replacement awards relate either entirely to the employee's past services before the acquisition (referred to as precombination services) or partially to the employee's future services after the acquisition (referred to as postcombination services) • Measure the fair value of the replacement awards under Topic 718 • Allocate the fair value of the replacement awards between precombination services and postcombination services in accordance with Topic 805 • Include the fair value attributed to precombination services in the consideration transferred in the business combination The allocation of replacement awards between precombination and postcombination services can be complicated. Topic 805 provides specific rules on how to perform the allocation, as well as examples in the Implementation Guidance and Illustrations in Section 805-30-55.

Type of Consideration	Accounting
Contingent consideration	Contingent consideration exists if the consideration transferred in the business combination is contingent upon the occurrence of specific future events or changes in circumstances. For instance, an acquirer might pay additional cash to the acquiree (or receive a future reimbursement) depending on the profits generated by the acquiree's business or the achievement of a designated share price after the acquisition date. Contingent consideration must be included as part of the consideration transferred in the business combination. The contingent consideration is measured at its fair value as of the acquisition date. An acquirer must determine whether it is appropriate to recognize contingent consideration as an asset, liability or equity. If the acquirer has a right to a future reimbursement of consideration already paid, the acquirer records an asset. If the acquirer has an obligation to pay additional consideration to the acquiree, the consideration must be classified as a liability or equity according to applicable GAAP (such as Subtopic 480-10, Distinguishing Liabilities from Equity — Overall). The accounting for contingent consideration after the acquisition depends on whether a change in the fair value of the contingent consideration is due to either: • Additional information obtained about facts that existed at the acquisition date. This change generally is a measurement period adjustment, assuming that the acquirer has complied with the guidance for the measurement period or • An event after the acquisition date, such as reaching a milestone or meeting an earnings target. In this case: o Contingent consideration classified as an asset or liability is remeasured to fair value each period, with changes in the fair value generally recorded in earnings o Contingent consideration classified as equity is not remeasured to fair value each period

OBSERVATION:
Measuring the fair value of contingent consideration can be difficult. In practice, an acquirer often uses an income approach that can factor in the uncertainty associated with the amount and timing of the contingent consideration.

For instance, an acquirer might use a discounted cash flow methodology. This might be suitable for contingent consideration that will be paid in cash. In this case, selecting an appropriate discount rate is critical to the valuation. The discount rate must reflect the risks associated with the arrangement, such as credit risk and the risk that the contingent event will not occur. An acquirer might apply the discount rate to its best estimate of the contingent payout. Alternatively, an acquirer might apply the discount rate to a probability-weighted payout. A probability-weighted payout can be derived by listing the potential payouts, assigning each one a probability, and then calculating the probability-weighted payout. For example, assume that an acquirer might pay either $50,000, $25,000 or $0 of additional consideration. The acquirer determines that the likelihood of paying $50,000 is 55%, $25,000 is 30%, and $0 is 15%. The probability-weighted payout is computed as follows:

Payout (A)	Probability (B)	(A) * (B)
$50,000	55%	$27,500
$25,000	30%	$7,500
$0	15%	$0
Probability-weighted payout		$35,000

An acquirer then applies the discount rate to calculate the present value of the probability-weighted payout.

An acquirer also might use an option pricing model, such as a lattice model, to measure the fair value of contingent consideration. An option pricing model generally is appropriate for contingent consideration that will be paid in stock options or shares. Various assumptions typically are necessary to use an option pricing model, such as a stock option's exercise price, the expected volatility of the share price, expected dividends and the risk-free interest rate. The expected volatility often is the most difficult to estimate. Determining the appropriate assumptions requires significant judgment and an acquirer may wish to engage actuarial valuation specialists to assist in the valuation.

OBSERVATION:

Complexities can arise in a business combination if the owners of the acquiree will be employees of the combined entity. In this case, it may be difficult to determine whether amounts paid to the owners are consideration for the business, included in the fair value of consideration transferred in the business combination, or compensation for future service (accounted for separately from the business combination).

For example, assume the owners of the acquiree will serve as officers of the combined entity. In addition, they are entitled to stock options based on the future performance of the acquiree's business. The acquirer must evaluate whether the stock options are part of the consideration for the business combination or compensation for future service.

It is important to appropriately identify and measure the consideration transferred in the business combination. This exercise ultimately affects the amount of goodwill calculated.

The basic formula to calculate goodwill is adjusted if a business combination has no consideration or if the business combination is achieved in stages. Specifically:

- For business combinations with no consideration, the fair value of the acquirer's interest in the acquiree is used instead of the fair value of consideration transferred, as follows:

  Goodwill = FV of the acquirer's interest in the acquiree + Noncontrolling interest – FV of net assets acquired

- For business combinations achieved in stages, the fair value of the acquirer's previously-held equity interest in the acquiree is added to the total before subtracting the fair value of net assets acquired, as follows:

  Goodwill = FV of the consideration transferred + Noncontrolling interest + FV of the acquirer's previously-held equity interest – FV of net assets acquired

OBSERVATION:

The Codification does not address how to remeasure the fair value of a previously-held equity interest. In the past, constituents have asked whether the fair value measurement is supposed to include a control premium.

For example, assume that an entity holds a 6% interest in an investee and subsequently purchases an additional 55% interest. The entity (acquirer) must remeasure the fair value of the 6% interest previously held. To do so, the acquirer might either:

- Remeasure the fair value of the 6% interest immediately before acquiring the additional 55% interest. This approach excludes a control premium; or
- Remeasure the fair value of the 6% interest immediately after acquiring the additional 55% interest. This approach includes a control premium.

This issue was discussed at a meeting held by the FASB's Valuation Resource Group on September 23, 2008 (see Issue No. 2008-18 "Fair Value of Noncontrolling Interest and a Previously Held Equity Interest"). Members of the Valuation Resource Group had mixed views on whether to include a control premium. One observer at the meeting, however, had participated in the joint project team between the FASB and IASB to develop the guidance on business combinations. This observer expressed the opinion that the FASB intended to exclude any control premium from the fair value measurement.

Thus, it is common practice to exclude a control premium when remeasuring the fair value of the previously-held equity interest.

If the calculation of goodwill results in a negative balance, the transaction might be a bargain purchase. In a bargain purchase, the acquirer essentially buys the net assets of the acquiree at a discount. Bargain purchases are rare. They do, however, arise occasionally. For instance, a bargain purchase might happen if the acquiree is under financial distress and must sell its business to survive.

Before concluding that a bargain purchase has occurred, an acquirer is required to revisit steps 3 and 4 of the acquisition method. Specifically, the acquirer must reassess:

- Whether it properly identified all assets acquired and liabilities assumed in the business combination
- Whether these assets and liabilities were measured appropriately
- Whether the other amounts used to compute goodwill, such as the fair value of the consideration transferred and noncontrolling interest, were determined correctly

If, after this reassessment, the acquirer concludes that a bargain purchase has taken place, the acquirer recognizes a gain on the bargain purchase.

The subsequent measurement of goodwill must comply with Topic 350 — Intangibles — Goodwill and Other. Goodwill generally must be tested for impairment and must not be amortized. The impairment test must be performed at the reporting unit level and currently involves a two-step process consisting of the following steps:

- Step 1 — Identify potential impairment by comparing the fair value of the reporting unit to its carrying amount, including goodwill.
- Step 2 — Measure the amount of the impairment loss by comparing the implied fair value of the goodwill to its carrying amount.

Before proceeding to step 1, an entity is allowed to consider qualitative factors to determine if steps 1 and 2 are necessary. If qualitative factors indicate that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, steps 1 and 2 are not necessary. Goodwill must be tested for impairment at least annually and any time a triggering event occurs.

OBSERVATION:

In January 2017, the FASB issued ASU No. 2017-04, Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The ASU simplifies the subsequent measurement of goodwill for all entities.

ASU No. 2017-04 eliminates step 2 of the current goodwill impairment test. Instead, under the ASU, an entity measures the amount of a goodwill impairment loss as the amount by which the carrying value of the reporting unit exceeds its fair value. This impairment, however, cannot exceed the carrying value of the goodwill allocated to the reporting unit. In addition, the entity must consider the income tax effects of the impairment loss on the carrying amount of the reporting unit.

As a result of the ASU, entities will no longer have to calculate the implied fair value of goodwill. Historically, this calculation was complex and time consuming. Therefore, the ASU is intended to save time and effort.

The FASB has acknowledged that the ASU may result in a less precise measurement of the goodwill impairment loss. Users of financial statements, however, indicated that it is most helpful to know that an impairment loss is necessary, not the precise amount of the loss.

The ASU is effective for annual and interim impairment tests performed for periods starting after:

- December 15, 2019, for public business entities that are SEC filers;
- December 15, 2020, for public business entities that are not SEC filers; and
- December 15, 2021, for all other entities

Early adoption is allowed for goodwill impairment tests performed after January 1, 2017. Entities must apply the ASU on a prospective basis.

Topic 350 provides an accounting alternative for the subsequent measurement of goodwill by private companies. Under the accounting alternative, goodwill is amortized over 10 years, or a shorter period if deemed appropriate. An impairment test is performed at either the reporting unit level or the entity level and must be conducted if a triggering event occurs. This simplifies the impairment test for private companies. The accounting alternative is intended to reduce the costs and complexity for private companies by making it easier to account for goodwill in subsequent periods.

Presentation

Topic 805 is relatively silent regarding the presentation of an acquirer's financial statements. In most cases, the acquirer must follow the presentation rules under other relevant GAAP for the item (such as Topic 470, Debt, for debt obligations or Topic 330, Inventory, for inventory).

Topic 805 does, however, include presentation guidance for reverse acquisitions and income tax-related matters. Topic 805 also provides presentation guidance for transactions that are often associated with, but are not, business combinations. In particular, Section 805-50-45, Business Combinations — Related Issues — Other Presentation Matters, discusses the presentation issues for transactions between entities under common control.

In addition, Subtopic 805-50 discusses the concept of pushdown accounting. Pushdown accounting is relevant for the acquiree. Essentially, when a business combination occurs, an acquiree has a choice regarding how to measure its assets, liabilities and equity instruments in its separate financial statements. The acquiree can choose either:

- To continue to measure these amounts using their historical bases or
- To measure these amounts using a new basis by applying pushdown accounting. Under pushdown accounting, the acquiree uses the same basis used by the acquirer to measure these amounts

Subsidiaries of the acquiree also can choose whether to apply pushdown accounting in their separate financial statements. An acquiree's decision to use pushdown accounting does not affect the acquirer's accounting for or presentation of the business combination.

OBSERVATION:

Topic 805 generally requires the acquirer to measure the assets, liabilities and equity instruments of the acquiree at fair value. Thus, if an acquiree elects pushdown accounting, these items generally are remeasured to fair value on the acquisition date. The acquisition date fair values tend to be higher than the historical bases in the acquiree's separate financial statements prior to the acquisition. Therefore, electing pushdown accounting generally results in an increase to the net assets recorded in the acquiree's separate financial statements. This increase in net assets generally has consequences on the income statement in periods following the acquisition, such as higher amortization expense, depreciation expense and possibly impairment. The exact effects on a particular acquiree, however, depend on the transaction and the composition of the acquiree's assets, liabilities and equity instruments.

Even if an acquiree uses pushdown accounting, there may be differences in how the acquiree and the acquirer measure the assets, liabilities and equity of the acquiree in subsequent periods. This is because the acquiree and the acquirer may have different accounting policies. For instance, the acquiree might use first-in first-out (FIFO) to measure inventory and the acquirer might use last-in first-out (LIFO).

An acquiree can elect to apply pushdown accounting before the financial statements for the period in which the business combination occurs are issued or available to be issued. If an acquiree elects to apply pushdown accounting:

- Pushdown accounting must be applied starting as of the acquisition date
- The election is irrevocable

Even if the acquiree does not elect to apply pushdown accounting in the period of the acquisition, it may do so in a subsequent period, as long as the business combination is the most recent change-in-control event. If the acquiree elects pushdown accounting in a subsequent period, it must account for the election on a prospective basis as a change in accounting principle under Topic 250, Accounting Changes and Error Corrections.

OBSERVATION:
If an acquiree elects to apply pushdown accounting in a subsequent period, the acquiree must be able to justify why the change in accounting principle is preferable. SEC registrants must file a preferability letter with the SEC as discussed in 17 CFR §210.10-01 of Regulation S-X.

When an acquiree elects pushdown accounting, questions often arise about how to treat goodwill or a gain from a bargain purchase, acquisition-related costs and acquisition-related liabilities. The following table addresses these items.

Area of Interest	Rules Under Pushdown Accounting
Goodwill or gain from bargain purchase	If a business combination results in goodwill, the acquiree recognizes the goodwill in its separate financial statements. If a business combination is a bargain purchase, the acquiree must not record a gain from the bargain purchase in its income statement. Instead, the acquiree must adjust additional paid-in capital for the gain recognized by the acquirer. If the acquiree is a not-for-profit entity, this adjustment is made to net assets instead of additional paid-in capital.
Acquisition-related costs	By definition, acquisition-related costs are costs incurred by the acquirer in the business combination. They are not costs of the acquiree and are not expected to be pushed down to the acquiree.
Acquisition-related liabilities	The acquirer in a business combination may incur an acquisition-related liability. The acquiree does not recognize this liability in its separate financial statements unless the liability is considered an obligation of the acquiree, such as if the acquiree is jointly and severally liable for the obligation.

OBSERVATION:
The guidance for pushdown accounting does not address how to account for certain items, such as indemnification assets, contingent consideration, noncompete agreements, change-in-control bonuses and the presentation of predecessor and successor financial statements. Therefore, diversity in practice may exist regarding how to apply pushdown accounting for these items.

Disclosure

Each business combination is unique, and therefore, a reporting entity's overall objective is to provide disclosures about the nature and financial effects of business combinations. Disclosures are required for business combinations that happen both during the reporting period and after the end of the reporting period, but before the financial statements are issued or available to be issued. All material business combinations must be disclosed separately. If business combinations are immaterial on an individual basis, but material on a collective basis, disclosures may be provided in the aggregate. An acquirer also must provide disclosures about adjustments recognized during the period that relate to business combinations that happened either in the current or prior reporting period, such as measurement period adjustments.

OBSERVATION:

SEC registrants also must comply with SEC presentation and disclosure requirements. In particular, Rule 3-05 of Regulation S-X requires pro forma disclosures for any material business combination happening during the current fiscal year. This includes disclosing the results of operations as though the acquisition occurred at the beginning of the current reporting period. At a minimum, the pro forma information must include revenue, income before extraordinary items and the cumulative effect of accounting changes (both an amount and per share), net income (both an amount and per share) and net income attributable to the acquirer.

An acquirer must determine when to begin providing pro forma disclosures, as well as the extent to which they are required. Obtaining the information necessary to provide the disclosures may be challenging because an acquirer often cannot access the information until it officially obtains control over the acquiree.

OBSERVATION:
Providing inadequate disclosures about business combinations may result in restatements or questions from regulators or other users of an acquirer's financial statements. For instance, the SEC may provide comment letters requesting information about how the acquirer applied the provisions in Topic 805 to account for the transaction, including:

- The analysis performed to determine if the transaction is a business combination or an asset acquisition
- How the acquirer identified the acquisition date
- The methods and assumptions used to determine the fair values of the assets acquired, liabilities assumed, noncontrolling interest, considered transferred or previously-held equity interest
- Whether the measurement period remains open, including the reasons why and the financial statement line items affected
- The nature and amount of any measurement period adjustments recorded during the period
- The reasons for goodwill generated from the business combination or a gain from a bargain purchase
- The analysis performed to reevaluate whether recognizing a gain from a bargain purchase is justified
- The analysis performed to test the goodwill for impairment
- The intangible assets acquired, including support for the asset's useful life used to calculate amortization
- Contingent consideration arrangements, including the events that would trigger the acquirer to pay additional consideration, or result in a partial reimbursement by the acquiree
- Pro forma disclosures related to the business combination

Entities entering into mergers, acquisitions and other types of business combinations must gain an in-depth knowledge of the accounting and reporting requirements for business combinations under US GAAP. Although this special report provides an overview of the basic requirements, understanding the detail is critical to apply the guidance appropriately. Notable differences exist between the accounting for business combinations under US GAAP (Topic 805) and IFRS 3, Business Combinations. Multinational companies engaged in business combinations may be subject to both US GAAP and IFRS, and therefore, must be aware of the differences. These companies also may have complex foreign currency matters to be addressed. Entities also are encouraged to look more closely at the income tax implications and SEC rules related to a business combination. These and other matters pertinent to the accounting and reporting for business combinations are covered in a title of Checkpoint Catalyst: US GAAP.

Checkpoint® Related Guidance

Checkpoint Catalyst: US GAAP

Checkpoint Catalyst: US GAAP is the next generation of online research that gives practical insight and expertise on accounting topics that are complex, undergoing changes or challenging to apply — including business combinations, revenue recognition and leasing. Research is approached from a fresh, new perspective where content is always delivered in context along with powerful insight into related issues, so you'll never miss an important detail.

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