

A nighttime photograph of a city skyline. Several tall skyscrapers are illuminated with lights, and their reflections are visible in the water below. A bridge with a long, glowing light trail from traffic spans across the water in the foreground. The sky is dark blue.

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Accounting for Business Combinations, Goodwill, and Other Intangible Assets

*A Roadmap to Applying Statements
141 and 142*

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*A Roadmap to Applying Statements
141 and 142*

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Preface

Issued concurrently in June 2001, FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets* (collectively the “Statements”), represent the completion of the first phase of the Financial Accounting Standards Board’s (FASB or the “Board”) project on accounting for business combinations. Statement 141 carried forward without reconsideration certain provisions from APB Opinion No. 16, *Business Combinations*, some of which are being reconsidered in later stages of the Board’s project.

The authoritative guidance in the Statements has been the subject of extensive interpretive guidance, including, before the issuance of Statement 141, those provisions carried forward without reconsideration. Sources of interpretive guidance include consensuses of the EITF, FASB Staff Positions, SEC Staff Accounting Bulletins, and speeches or other public comments by SEC staff members. This publication, *Accounting for Business Combinations, Goodwill, and Other Intangible Assets — A Roadmap to Applying Statements 141 and 142*, constitutes a single source for both the requirements of the Statements and available interpretive guidance. Where appropriate, we have included our interpretive views based on our experience and understanding of the principles involved.

In addition, this publication compares Statement 141 to IFRS 3, *Business Combinations*, and to an Exposure Draft of a proposed Statement of Financial Accounting Standards issued in June 2005, intended to replace Statement 141 as part of the Board’s continuing project on accounting for business combinations.

Accounting for Business Combinations

Section 1 — Scope of Statement 141

Occurrence of a Business Combination

1.00 Paragraph 9 of FASB Statement No. 141, *Business Combinations*, indicates that a business combination occurs in either of the following situations:

- An entity acquires net assets that constitute a business (see **1.05**).
- An entity acquires equity interests of one or more other entities and obtains control (see **1.02**) over that entity or entities.

1.01 While not explicitly stated in paragraph 9 of Statement 141, for an acquisition of equity interests to be the occurrence of a business combination, the entity whose equity interests are acquired must be a business (see **1.05**). This requirement is, therefore, the same as that provided in paragraph 9 of Statement 141 for an acquisition of net assets.

1.02 Footnote 5 of Statement 141 provides that “[c]ontrol is generally indicated by ‘ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company’ (ARB No. 51, *Consolidated Financial Statements*, paragraph 2, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*), although control may exist in other circumstances.” In addition, paragraph B23 of Statement 141 states, in part:

The Board affirmed the decision it made in developing the 1999 Exposure Draft that this Statement would not address transactions, events, or circumstances that result in one entity obtaining control over another entity through means other than the acquisition of net assets or equity interests. Therefore, this Statement does not change current accounting practice with respect to those transactions. For example, if a previously unconsolidated majority-owned entity is consolidated as a result of control being obtained by the lapse or elimination of participating veto rights that were held by minority stockholders, a new basis for the investment’s total carrying amount is not recognized under current practice. Instead, only the display of the majority-owned investment in the consolidated financial statements is changed. The majority-owned entity is consolidated rather than reported as a single investment accounted for by the equity method.

Section 1

Accounting for Business Combinations

1.03 Paragraph B23 of Statement 141 also indicates:

[T]his Statement does not change the consensus reached in EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements." The Board intends to consider the accounting for transactions in which control of an entity is obtained through means other than the acquisition of net assets or equity interests in another project.

Issue 2 ("Possibility of a Business Combination") of Issue 97-2 addresses "[w]hether there are circumstances in which a transaction between a PPM [physician practice management entity] and a physician practice in which the PPM executes a management agreement with the physician practice should be considered a business combination and thus accounted for under Opinion 16." Issue 2 of Issue 97-2 indicates:

The Task Force reached a consensus that a transaction between a PPM and a physician practice in which the PPM executes a management agreement with the physician practice is considered to be a business combination to be accounted for under Opinion 16 if (1) based on the terms of the management agreement the PPM is required to consolidate the physician practice and (2) the physician practice is a business.

If either criterion 1 or criterion 2 above is not met, the Task Force observed that the PPM would account for the management agreement as a service contract. The Task Force also observed that any other coincident transactions between the physician practice and the PPM, such as purchasing some or all of the physician practice assets and hiring physician practice employees, would be accounted for separately under their respective generally accepted accounting principles.

With respect to criterion 2 above, whether a physician practice is considered to be a business depends on the facts and circumstances. For example, a dentist who has recently graduated from dental school and who has incorporated but has done essentially nothing else is not considered to be a business.

The scope of Issue 97-2 provides that "[a]bsent unique industry characteristics, the SEC Observer stated that the conclusions reached in this Issue may be applicable to similar arrangements in other industries and that the SEC staff will consider this guidance when assessing the appropriate accounting for those arrangements. Similar arrangements would include those circumstances where one entity had a controlling financial interest in another through either a nominee structure or other contractual arrangement."

Variable Interest Entities

1.04 The initial measurement of variable interest entities subject to consolidation according to the provisions of FASB Interpretation No. 46(R), *Consolidation of Variable*

Interest Entities, is not within the scope of Statement 141, which, in paragraph 9, provides that the Statement “does not address transactions in which control is obtained through means other than an acquisition of net assets or equity interests.” Although such transactions are not within the scope of Statement 141, the FASB decided (as discussed in paragraphs D50–D52 of Interpretation 46(R)) that many of the initial measurement requirements of Statement 141 are appropriate for variable interest entities, including the recognition of goodwill, if applicable, when the variable interest entity is a business as defined in Appendix C of Interpretation 46(R).

Determining Whether an Asset Group Constitutes a Business

1.05 In a business combination, the net assets acquired (if an acquisition of net assets) or the entity over which control is obtained (if an acquisition of equity interests) must constitute a business (see **1.00**). Footnote 4 of Statement 141 indicates that “EITF Issue No. 98-3, ‘Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,’ provides guidance on determining whether an asset group constitutes a business.” Issue 98-3 states, in part:

The Task Force reached a consensus that the guidance below should be used to evaluate whether a business has been received in a nonmonetary exchange transaction.

A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing its outputs to customers.

The elements necessary for a transferred set to continue to conduct normal operations will vary by industry and by the operating strategies of the transferred set. An evaluation of the necessary elements should consider:

Inputs

- a. Long-lived assets, including intangible assets, or rights to the use of long-lived assets.
- b. Intellectual property.
- c. The ability to obtain access to necessary materials or rights.
- d. Employees.

Processes

- e. The existence of systems, standards, protocols, conventions, and rules that act to define the processes necessary for normal, self-sustaining operations, such as (i) strategic management processes, (ii) operational processes, and (iii) resource management processes.

Outputs

- f. The ability to obtain access to the customers that purchase the outputs of the transferred set.

A transferred set of activities and assets fails the definition of a business if it excludes one or more of the above items such that it is not possible for the set to continue normal operations and sustain a revenue stream by providing its products and/or services to customers. However, if the excluded item or items are only minor (based on the degree of difficulty and the level of investment necessary to obtain access to or to acquire the missing item(s)), then the transferred set is capable of continuing normal operations and is a business. The assessment of whether excluded items are only minor should be made without regard to the attributes of the transferee and should consider such factors as the uniqueness or scarcity of the missing element, the time frame, the level of effort, and the cost required to obtain the missing element. If goodwill is present in a transferred set of activities and assets, it should be presumed that the excluded items are minor and that the transferred set is a business.

The assessment of whether a transferred set is a business should be made without regard to how the transferee intends to use the transferred set. In other words, it is not relevant to the evaluation of whether the transferred set is a business whether the transferee will actually operate the set on a standalone basis or intends to continue using the transferred set in the same manner as the transferor.

If all but a *de minimis* (say, 3 percent) amount of the fair value of the transferred set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being received.

The level of working capital or the adequacy of financing necessary to conduct normal operations in the transferred set is not an indicator either way as to whether the set meets the definition of a business. Likewise, if the planned principal operations of the transferred set have commenced, the presence and/or expectation of continued operating losses while the set seeks to achieve the level of market share necessary to attain profitability is not an indicator of whether or not the set is a business. However, if the transferred set is in the development stage and has not commenced planned principal operations, the set is presumed not to be a business.

The determination of whether a transferred set of assets and activities is or is not a business is a three-step process. First, one must identify the elements included in the transferred set. Second, one must compare the identified elements in the transferred set to the complete set of elements necessary for the transferred set to conduct normal operations in order to identify any missing elements. Third, if there are missing elements, one must make an assessment as to whether the missing elements cause one to conclude that the transferred set is not a business. That assessment is based on the degree of difficulty or the level of investment (relative to the fair value of the transferred set) necessary to obtain access to or to acquire the missing elements. If the degree of difficulty and level of investment necessary to obtain access to or to acquire the missing elements are not significant, then the missing elements are considered

minor and their absence would not cause one to conclude that the transferred set is not a business. The determination of the degree of difficulty or level of investment necessary to obtain access to or to acquire the missing elements requires significant judgment and is dependent on the particular facts and circumstances.

1.06 Exhibit 98-3A of Issue 98-3 provides examples illustrating the application of the definition of a business.

1.07 When an acquisition of net assets or equity interests is not deemed the occurrence of a business combination (see **1.00**), the accounting to be applied to the acquisition differs from that applied to the occurrence of a business combination in certain respects. These differences include the following:

Recognition of Intangible Assets

Business Combination	Acquisition of an Asset Group Determined Not to Be a Business
<p>Paragraph 39 of Statement 141 provides that “[a]n intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). For purposes of this Statement, however, an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability. For purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill.” (See 6.00.)</p>	<p>Footnote 7 of FASB Statement No. 142, <i>Goodwill and Other Intangible Assets</i>, provides that the recognition criteria for intangible assets apart from goodwill contained in Statement 141 (see 6.00) “do not apply to intangible assets acquired in transactions other than business combinations.” Paragraph B37 of Statement 142 provides that “[t]he Board observed that intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination also may meet the asset recognition criteria in Concepts Statement 5 even though they do not meet either the contractual-legal criterion or separability criterion (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). . . . Thus, those assets should be recognized as intangible assets.” (See 6.03–6.06 for discussion of intangible assets that are not recognized apart from goodwill in a business combination, but may exist and require recognition in an acquisition of an asset group determined not to be a business.)</p>

Section 1

Accounting for Business Combinations

Allocating the Cost of the Acquisition to Assets Acquired and Liabilities Assumed

Business Combination	Acquisition of an Asset Group Determined Not to Be a Business
Paragraph 35 of Statement 141 provides that “an acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition.” Paragraph 37 of Statement 141 provides general guidance for assigning amounts to assets acquired and liabilities assumed, with paragraph B100 of Statement 141 stating that “some of that guidance may be inconsistent with the term <i>fair value</i> as defined in this Statement.” Paragraph 43 of Statement 141 provides that “[t]he excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill.”	Paragraph 9 of Statement 142 provides that “[t]he cost of a group of assets acquired in a transaction other than a business combination shall be allocated to the individual assets acquired based on their <i>relative</i> fair values and shall not give rise to goodwill.” [Emphasis added, footnote omitted]

1.08 Regarding allocation of the cost of an asset group acquired in a transaction other than a business combination on the basis of *relative* fair values, questions arise when there is a difference between the total cost and the initial total of the measurements of fair value. If, upon review of the initial measurements of fair value of the tangible and intangible assets acquired, that difference is not eliminated, it must be allocated. If the difference is an excess of cost, the difference should be allocated pro rata to increase the assets acquired, except for financial assets (other than investments accounted for by the equity method) and assets subject to fair value impairment testing, such as inventories and indefinite-lived intangible assets since increasing the value of such assets would most likely result in an impairment at the next testing date. The allocation of the difference to the assets acquired should include, if present, in-process research and development (R&D) assets to be charged to expense at the time of the acquisition. If, instead, the difference is an excess of net asset fair value, it should be allocated in a manner consistent with the allocation of negative goodwill under paragraph 44 of Statement 141, which provides for a pro rata reduction of the assets acquired (including R&D assets acquired and charged to expense in accordance with paragraph 5 of FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*), except for “(a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets.”

Example 1-1

Allocation of the Cost of Acquisition in a Transaction Other Than a Business Combination

For \$120, Company A acquires assets from Company B that are determined collectively not to constitute a business. Company A identifies, among the acquired group of assets, in-process R&D assets to be expensed in the period of the acquisition. The following illustrates the allocation of the cost of the assets on the basis of *relative* fair values.

	Initial Fair Value Measurement	Allocation	Total
Assembled Workforce	\$ 10	\$ 2	\$ 12
Property, Plant, & Equipment	70	14	84
In-Process R&D	<u>20</u>	<u>4</u>	<u>24</u>
Total	<u>\$100</u>	<u>\$20</u>	<u>\$120</u>

The allocation increases from \$20 to \$24 the amount charged to expense in the period of the acquisition as acquired in-process R&D.

If the assets acquired were determined instead to constitute a business, the in-process R&D asset expensed in the period of acquisition would be \$20 and the assembled workforce intangible asset would not be recognized apart from goodwill. The \$30 excess of the cost of the acquired assets (\$120) over the amounts assigned to the identifiable assets (\$90) would be recognized as goodwill.

Identifying a Business When Assessing Reporting Requirements Under SEC Regulation S-X

1.09 SEC Regulation S-X, Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired,” provides reporting requirements for SEC registrants regarding financial statements of businesses acquired or to be acquired. Rule 3-05 (a)(2) states:

For purposes of determining whether the provisions of this rule apply, the determination of whether a “business” has been acquired should be made in accordance with the guidance set forth in § 210.11-01(d).

1.10 SEC Regulation S-X, Rule 11-01(d), states:

For purposes of this rule, the term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity’s operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in

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evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:

- (1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or
- (2) Whether any of the following attributes remain with the component after the transaction:
 - (i) Physical facilities,
 - (ii) Employee base,
 - (iii) Market distribution system,
 - (iv) Sales force,
 - (v) Customer base,
 - (vi) Operating rights,
 - (vii) Production techniques, or
 - (viii) Trade names.

1.11 Given that considerations in SEC Regulation S-X, Rule 11-01(d), differ from those in Issue 98-3 regarding identification of a business, SEC registrants must undertake a separate analysis using the considerations in Rule 11-01(d) when evaluating the reporting requirements under SEC Regulation S-X.

Additional Scope Considerations

1.12 Transactions involving the ownership interests of an entity take many forms. Questions may arise about whether the specific transaction form is within the scope of Statement 141, otherwise addressed within Statement 141, or addressed in other authoritative literature. The following is a listing of transaction forms involving the ownership interests of an entity, with reference numbers indicating paragraphs of this document that discuss related accounting considerations:

- Acquisition of a controlling interest but not 100 percent of an entity (see **1.13**).
- Acquisition of a noncontrolling interest of a subsidiary (see **1.14–1.15**).
- Basis in leveraged buyout transactions (see **1.16–1.21**).
- Roll-up or put-together transactions (see **1.22**).
- Acquisitions of certain financial institutions (see **1.23**).
- Combinations between two or more mutual enterprises (see **1.24–1.25**).
- Formation of a joint venture (see **1.26–1.27**).
- Recapitalizations (see **1.28**).
- Transactions between entities under common control (see **1.29–1.33**).
- Transactions between entities under common control — accounting for minority interests (see **1.34**).

- Transactions between entities with common ownership (see **1.35–1.36**).
- Combinations involving not-for-profit organizations (see **1.37–1.39**).

Acquisition of a Controlling Interest but Not 100 Percent of an Entity

1.13 Paragraph 9 of Statement 141 indicates that for an acquisition of equity interests to be a business combination, the entity acquiring the equity interests must obtain control. Control is generally indicated by ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company (see **1.00**). Accordingly, a business combination may occur when a portion of the equity interest of the acquired entity remains as a noncontrolling interest (often referred to as minority interest). In such a transaction, the acquiring entity will recognize in its consolidated financial statements the net assets acquired through the combination of fair value — to the extent acquired — and the historical cost for the minority interest.

Example 1-2

Acquisition of a Controlling Interest but Not 100 Percent of an Entity

Company A, with no prior owned interest in Company B, acquired 75 percent of the equity interest in Company B in a transaction determined to be the occurrence of a business combination. The cost of the acquisition is determined by Company A to be \$1,600. The book value of Company B's net assets at the acquisition date was \$1,000. The fair value of the identifiable net assets of Company B at the acquisition date was \$1,500.

In its consolidated financial statements, Company A will reflect the acquisition of the equity interest in Company B as follows:

Identifiable net assets	\$1,375	Calculated as $(\$1,500 \times 75\%) + (\$1,000 \times 25\%)$
Goodwill	475	Calculated as $(\$1,600 - \$1,500 \times 75\%)$
Minority interest	<u>(250)</u>	Calculated as $(\$1,000 \times 25\%)$
Cost of the acquisition/ investment in B	<u>\$ 1,600</u>	

Acquisition of a Noncontrolling Interest of a Subsidiary

1.14 Although paragraph 11 of Statement 141 provides that “[t]he acquisition of some or all of the noncontrolling interests in a subsidiary is not a business combination,” paragraph 14 of Statement 141 indicates that “[t]he acquisition of some or all of the noncontrolling interests in a subsidiary — whether acquired by the parent, the subsidiary itself, or another affiliate — shall be accounted for using the purchase method.” Paragraph A6 of Statement 141 indicates:

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Examples of the types of transactions that constitute the acquisition of a minority interest include the following: (a) a parent exchanges its common stock or assets or debt for common stock held by minority stockholders of its subsidiary, (b) the subsidiary buys as treasury stock the common stock held by minority stockholders, or (c) another subsidiary of the parent exchanges its common stock or assets or debt for common stock held by the minority stockholders of an affiliated subsidiary.

1.15 Paragraph A7 of Statement 141 states, in part:

Another type of transaction that constitutes the acquisition of a minority interest is a transaction in which a subsidiary exchanges its common stock for the outstanding voting common stock of its parent (usually referred to as a downstream merger). Those transactions shall be accounted for as if the parent had exchanged its common stock for common stock held by minority stockholders of its subsidiary. Whether a parent acquires the minority or a subsidiary acquires its parent, the result is a single stockholder group, including the former minority stockholders, owning the consolidated net assets. The same would be true if a new corporation exchanged its common stock for the common stock of the parent and the common stock of the subsidiary held by minority stockholders.

Basis in Leveraged Buyout Transactions

1.16 EITF Issue No. 88-16, “Basis in Leveraged Buyout Transactions,” describes a fact pattern in which “[a] holding company (NEWCO) with no substantive operations acquires an operating company (OLDCO) in a leveraged buyout (LBO) transaction.” Issue 88-16 indicates:

The issue is what basis should be used by NEWCO to value its interest in OLDCO; that is, whether the acquisition of shares of OLDCO establishes a new basis of accounting or whether predecessor basis, OLDCO book value, or some combination should be used. [Footnote 1]

Footnote 1 provides that “[i]ssues concerning recognizing a new basis in the financial statements of OLDCO or recording an owner’s basis in the financial statements of OLDCO are outside the scope of this Issue.”

See **Section 8 — Push-Down Basis of Accounting** for considerations regarding the recording of an owner’s basis in the financial statements of OLDCO.

1.17 Issue 88-16 describes specific accounting for LBO transactions, stating:

To distinguish an LBO transaction within the scope of this Issue from other business combinations, the LBO should be effected in a single highly leveraged transaction or a series of related and anticipated highly leveraged transactions that result in the acquisition by NEWCO of all previously outstanding common stock of OLDCO; that is, there can be no remaining minority interest. [Footnote omitted] This Issue excludes LBO transactions in which

existing majority stockholders utilize a holding company to acquire all of the shares of OLDSCO not previously owned. Step acquisition accounting continues to be appropriate in such transactions.

1.18 The guidance in Issue 88-16 is deemed applicable only to those transactions that possess the characteristics of an LBO transaction as described in Issue 88-16 (see **1.17**). For example, in prepared remarks at the 2005 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member (Pamela R. Schlosser) stated:

In another example in which a NEWCO was used and the transaction was in fact highly leveraged, the registrant argued that EITF 88-16 was applicable. However, the form of the transaction differed from the leveraged buy-out transaction described in that literature. In this particular deal, NEWCO did not acquire the stock of the operating company, but rather merged into the operating company as part of a series of related transactions. Thus, the staff objected to the application of EITF 88-16 since the deal's form did not meet the stringent scope requirements of that guidance.

1.19 Issue 88-16 does not define the term "highly leveraged." The SEC staff has, however, noted in part C, "LBO — Definition of 'Highly Leveraged' in the Context of EITF 88-16 (SEC Staff, 1992)," of *Excerpts From Speeches by the Staff of the Office of the Chief Accountant Through December 6, 2001*, the following:

One of the criteria for the application of EITF 88-16, "Basis in Leveraged Buyout Transactions", to a purchase transaction is that the acquisition be highly leveraged. The SEC staff believes that a 60 percent or greater debt financed transaction would meet the highly leveraged test. If the transaction is 50 percent or more debt financed it is probably highly leveraged. Acquisitions involving leverage of significantly less than 50 percent would not meet the criteria for following EITF Issue No. 88-16 accounting.

1.20 For transactions found to be within the scope of Issue No. 88-16, consideration should be given to EITF Issue No. 90-12, "Allocating Basis to Individual Assets and Liabilities for Transactions Within the Scope of Issue No. 88-16."

1.21 Transactions within the scope of Issue 88-16 are not considered business combinations within the scope of Statement 141 and, accordingly, further discussion of the accounting for such transactions is beyond the scope of this document. Given the complexities of Issue 88-16, consultation with specialists is recommended when evaluating its application.

Roll-Up or Put-Together Transactions

1.22 Paragraph B20 of Statement 141 indicates that paragraph 10 of Statement 141 "explicitly states that the provisions of this Statement also apply to business combinations in

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which none of the owners of the combining entities as a group retain or receive a majority of the voting rights of the combined entity." Such transactions are often referred to as "roll-up" or "put-together" transactions.

Acquisitions of Certain Financial Institutions

1.23 Paragraph 5 of FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, provides that "[t]he acquisition of all or part of a financial institution that meets the definition of a business combination shall be accounted for by the purchase method in accordance with FASB Statement No. 141, *Business Combinations*." Footnote 1 of Statement 147 defines the term "financial institution" as including "all or part of a commercial bank, a savings and loan association, a credit union, or other depository institution having assets and liabilities of the same types as those institutions." Paragraph 1 of Statement 147 excludes transactions between two or more mutual enterprises (see **1.24**) from its scope.

Combinations Between Two or More Mutual Enterprises

1.24 Appendix C of Statement 147 defines the term "mutual enterprise" as "[a]n entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Credit unions are an example of a mutual enterprise."

1.25 A combination between two or more mutual enterprises is within the scope of Statement 141. However, paragraph 60 of Statement 141 states:

For combinations between two or more mutual enterprises, this Statement shall not be effective until interpretative guidance related to the application of the purchase method to those transactions is issued. [Footnote 24]

Footnote 24 provides that "[t]he Board intends to consider issues related to the application of the purchase method to combinations between two or more mutual enterprises in a separate project."

Until the FASB issues further guidance, combinations between two or more mutual enterprises should be accounted for under the guidance in APB Opinion No. 16, *Business Combinations*.

Formation of a Joint Venture

1.26 Paragraph 9 of Statement 141 provides that "[f]or purposes of this Statement, the formation of a joint venture is not a business combination. [While footnote 6 of Statement 141 states that the Board plans to address the accounting for joint ventures in another project,

such a project is not currently under way.]” In response to suggestions that the Board define “joint venture,” paragraph B21 of Statement 141 states, in part:

The Board concluded that this Statement should not provide that definition. The Board noted that constituents consider the guidance in paragraph 3(d) of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, in assessing whether an entity is a joint venture, and it decided not to change that practice at this time.

Paragraph 3(d) of Opinion 18 defines the term “corporate joint venture”:

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

1.27 EITF Issue No. 98-4, “Accounting by a Joint Venture for Businesses Received at Its Formation,” states, in part:

The SEC Observer indicated that the SEC staff would object to a conclusion that did not result in the application of Opinion 16 [superseded by Statement 141] to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

Recapitalizations

1.28 Paragraph B24 of Statement 141 states, in part, that “[t]he Board acknowledged, as it did prior to issuing the 1999 Exposure Draft, that this Statement does not address many current practice issues, such as accounting for recapitalization transactions.” In a recapitalization transaction, a series of steps is generally undertaken involving the equity of an entity, which may result in the establishment of a new controlling shareholder. In a leveraged recapitalization, new debt is issued with the proceeds used to redeem shares from existing shareholders as part of a series of steps that also may result in the establishment of a new controlling shareholder. Questions are often raised about whether,

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in recapitalization transactions that result in a new controlling shareholder of the recapitalized entity, the accounting basis of the net assets of the recapitalized entity should be adjusted. Consultation with specialists is recommended when evaluating the potential accounting effects of recapitalization transactions.

Transactions Between Entities Under Common Control

1.29 Paragraph 11 of Statement 141 provides that “[t]he term business combination as used in this Statement also excludes transfers of net assets or exchanges of equity interests between entities under common control.” Paragraph D11 of Statement 141 provides the following examples of those types of transactions:

- a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.
- b. A parent company transfers the net assets of a wholly owned subsidiary into the parent company and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.
- c. A parent company transfers its interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.
- d. A parent company exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent’s partially owned subsidiary, thereby increasing the parent’s percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

1.30 Paragraph D12 of Statement 141 provides that “[w]hen accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.” EITF Issue No. 90-5, “Exchanges of Ownership Interests Between Entities Under Common Control,” identified the following issue:

A parent company transfers its ownership interest in subsidiary Sub B to its subsidiary Sub A in exchange for additional shares of Sub A. The parent company’s investment in Sub B differs from the book value of net assets in Sub B’s financial statements because push-down accounting under SAB 54 was appropriately not applied.

Interpretation 39 indicates that the transfer of net assets or an exchange of shares between entities under common control is excluded from Opinion 16 and should be accounted for in a manner similar to a pooling of interests.

The Task Force reached a consensus on this issue “that the consolidated financial statements of Sub A should reflect the assets and liabilities of Sub B at the historical cost in the consolidated financial statements of Sub A’s parent. Task Force members noted that the parent company is transferring its investment in Sub B to Sub A. Thus, the parent’s carrying amount is historical cost under Interpretation 39. Task Force members also noted that Sub A must be a substantive, operating entity.”

1.31 Paragraphs D14–D18 of Statement 141 provide procedural guidance on the accounting for transfers of net assets or exchanges of equity interests between entities under common control. When determining the period for which combined financial information should be presented, refer to the following SEC staff views provided in the minutes of the November 30, 1989, meeting of the AICPA SEC Regulations Committee:

The staff reaffirmed that when companies under common control are merged or otherwise put together, they expect the prior year financial statements to be presented in a manner similar to a pooling of interests for the period during which the entities are under common control.

Regarding preparation of the financial statements of the then combined entities for periods prior to common control, we understand that the SEC staff further believes that the entity to be presented as the historical/predecessor entity is generally the combining entity first owned by the controlling shareholder, regardless of the legal form of the common control combination. Presentation of the historical/predecessor entity for periods prior to common control as other than the first entity owned by the controlling shareholder is expected to be infrequent, such as when the first entity owned by the controlling shareholder is a nonoperating shell corporation.

Example 1-3

Transaction Between Entities Under Common Control

Investor A owns 100 percent of Company B and Company C, having acquired Company B on January 1, 2006, and Company C on January 1, 2001. Investor A applied push-down accounting to Company B and Company C at the time of their acquisition. On January 1, 2007, Investor A elects to combine Company B and Company C. This is accomplished by Company B’s issuing additional shares in exchange for the outstanding shares of Company C. Both Company B and Company C are operating businesses.

On the basis of the guidance in Statement 141 and the above-noted views of the SEC staff, when preparing financial statements for the combined Company B/Company C entity, despite the legal form of the combination, Company C, being the first entity of the combining entities controlled by Investor A, is presented as the historical reporting entity up to the date of common control by Investor A (January 1, 2006), after which combined financial information is presented.

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1.32 Statement 141 does not define “common control.” After the issuance of Statement 141, EITF Issue No. 02-5, “Definition of ‘Common Control’ in Relation to FASB Statement No. 141,” was added to the EITF agenda. Paragraph 3 of Issue 02-5 indicates:

The FASB staff understands that the SEC staff has indicated that common control exists between (or among) separate entities only in the following situations:

- a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.
- b. Immediate family members hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).
 - (1) Immediate family members include a married couple and their children, but not the married couple’s grandchildren.
 - (2) Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.
- c. A group of shareholders holds more than 50 percent of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists.

1.33 Paragraph 4 of Issue 02-5 provides that “[t]he issue is how to determine whether separate entities are under common control in the context of Statement 141 when common majority ownership exists by an individual, a family, or a group affiliated in some manner.” Paragraph 5 of Issue 02-5 states that “[t]he Task Force did not reach a consensus on the issue of how to determine whether common control of separate entities exists. The Task Force discussed the practice being followed by SEC registrants. Some Task Force members expressed uncertainty as to whether common control might exist in situations other than those described above [see **1.32**].” Paragraph 7 of Issue 02-5 provides that “[t]he SEC Observer stated that SEC registrants should continue to follow the guidance in paragraph 3, above [see **1.32**], when determining whether common control of separate entities exists.”

Transactions Between Entities Under Common Control — Accounting for Minority Interests

1.34 Question 2 of FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*, asks, “[h]ow should a parent company account for minority interest in an exchange of stock between two of its subsidiaries if one or both of the

subsidiaries are partially owned?" Paragraphs 6–7 of Technical Bulletin 85-5 provide the following response:

6. The accounting depends on whether the minority shareholders are party to the exchange of shares. If some or all of the shares owned by minority shareholders are exchanged for shares of ownership in another subsidiary of the parent (or a new subsidiary formed by combining two or more subsidiaries of the parent), then the transaction is recognized by the parent company as the acquisition of shares from the minority interest, which according to paragraph 14 of Statement 141 should be accounted for by the purchase method, that is, based on fair value. The original minority interest effectively is purchased, and a new minority interest in a different subsidiary is created. However, 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.
7. If, however, minority shareholders are not party to an exchange of shares between two subsidiaries of the same parent (a partially owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent), the minority interest in the issuing subsidiary remains outstanding, and the transaction is an exchange of stock between companies under common control. In contrast to the acquisition of a minority interest, this transaction leaves all of the issuing subsidiary's minority interest outstanding, although the minority stockholders' interest in the net assets has changed in each case. Paragraph D12 of Statement 141 indicates that the assets and liabilities transferred in such an exchange of shares should be accounted for at existing carrying amounts.

Transactions Between Entities With Common Ownership

1.35 In prepared remarks at the 1997 AICPA National Conference on Current SEC Developments, an SEC staff member (Donna L. Coallier) addressed transactions between entities with a high degree of common ownership, stating:

When there is a transaction between entities with a high degree of common ownership, but that are not under common control, the staff assesses the transaction to determine whether the transaction lacks substance. FTB 85-5 provides an example of a similar assessment in an exchange between a parent and a minority shareholder in one of the parent's partially owned subsidiaries. Paragraph 6 of FTB 85-5 states, in part:

...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.

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Similarly, in a transfer or exchange between entities with a high degree of common ownership, the staff compares the percentages owned by the shareholders in the combined company to the percentages owned in each of the combining companies before the transaction. When the percentages have changed or the owned interests are not in substance the same before and after the transaction, the staff believes a substantive transaction has occurred and has objected to historical cost accounting.

1.36 On the basis of the guidance in paragraph 6 of Technical Bulletin 85-5 and the prepared remarks of the SEC staff member noted in **1.35**, for a transaction between entities not under common control to be accounted for in a manner consistent with a common control transaction, identical owners of the entities prior to the transaction with ownership in very similar percentages would most likely be required to demonstrate that the transaction lacks substance. Such fact patterns are expected to be rare.

Example 1-4

Transaction Between Two Entities With Common Ownership

Prior to being combined, Company B and Company C were owned as follows:

	Company B	Company C
Owner 1	80%	5%
Owner 2	10	10
Owner 3	5	20
Owner 4	5	65

Company B is significantly larger than Company C such that after the combination the ownership is as follows:

	Combined B/C
Owner 1	60%
Owner 2	10
Owner 3	10
Owner 4	20

Although Company B and Company C had identical owners prior to the combination, given the resulting change in relative ownership, accounting for the combination in a manner consistent with a transaction between entities under common control is not appropriate.

Combinations Involving Not-for-Profit Organizations

1.37 Appendix F of Statement 141 defines the term “not-for-profit organization” as:

An entity that possesses the following characteristics that distinguish it from a business enterprise: (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, and (c) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying

degrees (Concepts Statement 4, paragraph 6). Entities that clearly fall outside this definition include all investor-owned entities and mutual enterprises.

1.38 Paragraph 12 of Statement 141 states:

This Statement does not apply to combinations between **not-for-profit organizations**, nor does it apply to the acquisition of a for-profit business entity by a not-for-profit organization. [Footnote 7]

Footnote 7 states, “The Board intends to address issues related to the accounting for combinations between not-for-profit organizations and issues related to the accounting for the acquisition of a for-profit business entity by a not-for-profit organization in another project.”

In October 2006, the FASB issued for comment two Exposure Drafts that the accompanying news release indicates are “intended to improve the accounting and disclosures for mergers and acquisitions (M&A) by not-for-profit organizations. The proposals reflect the Board’s commitment to meet the reporting needs of the not-for-profit community and to ensure that financial statement users have access to decision-useful information.” The news release further notes:

Specifically, today’s proposal, *Not-for-Profit Organizations: Mergers and Acquisitions*, would eliminate the use of the pooling-of-interests method of accounting by not-for-profit organizations, in which assets acquired and liabilities assumed are recorded at “carryover” amounts recorded on the books of acquired organizations. This proposal would instead require the application of the acquisition method to all mergers and acquisitions by a not-for-profit organization. In applying that method, the proposal generally would require that not-for-profit organizations:

1. Recognize the identifiable assets acquired and liabilities assumed that compose the business or nonprofit activity acquired in a merger or acquisition;
2. Measure those assets and liabilities at their fair values as of the acquisition date;
3. Recognize either goodwill of the acquired business or nonprofit activity or the contribution inherent in the merger or acquisition as a residual based on the value of the identifiable assets acquired, liabilities assumed, and the consideration transferred (if any); and
4. Disclose information to enable users of the financial statements to evaluate the nature and financial effects of the merger or acquisition.

Today’s other Exposure Draft, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, proposes accounting guidance for those intangible assets after a merger or acquisition. The proposed guidance is consistent with the accounting for all other acquired intangible assets — whether purchased or donated, or whether acquired individually or as part of a group.

Under this proposal, not-for-profit organizations would be required to provide:

- a. Consistent and comparable information about identifiable intangible assets acquired by not-for-profit organizations in a merger or acquisition; and
- b. More faithfully representative and relevant information about events resulting in impairments of goodwill that a not-for-profit organization has acquired.

Refer to the FASB's Web site at www.fasb.org for project updates.

1.39 The acquisition of a not-for-profit organization by a for-profit business entity is within the scope of Statement 141.

Section 2 — Identifying the Acquiring Entity

2.00 Paragraph 15 of Statement 141 provides that “[a]pplication of the purchase method requires the identification of the acquiring entity. All business combinations in the scope of this Statement shall be accounted for using the purchase method. Thus, the acquiring entity shall be identified in all business combinations.”

Business Combination Effected Solely Through the Distribution of Cash or Other Assets or by Incurring Liabilities

2.01 Paragraph 16 of Statement 141 provides that “[i]n a business combination effected solely through the distribution of cash or other assets or by incurring liabilities, the entity that distributes cash or other assets or incurs liabilities is generally the acquiring entity.”

Business Combination Effected Through an Exchange of Equity Interests

2.02 Paragraph 17 of Statement 141 states, in part:

In a business combination effected through an exchange of equity interests, the entity that issues the equity interests is generally the acquiring entity. In some business combinations (commonly referred to as reverse acquisitions), however, the acquired entity issues the equity interests. Commonly, the acquiring entity is the larger entity. However, the facts and circumstances surrounding a business combination sometimes indicate that a smaller entity acquires a larger one. In some business combinations, the combined entity assumes the name of the acquired entity.

2.03 Paragraph 17 of Statement 141 further indicates:

[I]n identifying the acquiring entity in a combination effected through an exchange of equity interests, all pertinent facts and circumstances shall be considered, in particular:

- a. The relative voting rights in the combined entity after the combination
[See **2.06–2.07.**]

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- b. The existence of a large minority voting interest in the combined entity when no other owner or organized group of owners has a significant voting interest [See **2.08–2.09.**]
- c. The composition of the governing body of the combined entity [See **2.10–2.11.**]
- d. The composition of the senior management of the combined entity [See **2.12–2.13.**]
- e. The terms of the exchange of equity securities [See **2.14–2.15.**]

2.04 Paragraph 48 of Statement 141 indicates that “[t]he date of acquisition (also referred to as the acquisition date) ordinarily is the date assets are received and other assets are given, liabilities are assumed or incurred, or equity interests are issued.” The acquiring entity can only be determined as of the acquisition date. If an initial assessment of the acquiring entity is made prior to the acquisition date, sufficient procedures must be performed as of the acquisition date to ensure that all pertinent facts and circumstances as of the acquisition date have been considered in the final determination. Changes in facts and circumstances occurring after the acquisition date do not affect the determination of the acquiring entity.

2.05 Statement 141 requires, in the identification of the acquiring entity in a business combination effected through an exchange of equity interests, that all pertinent facts and circumstances be considered, particularly those listed in paragraphs 17(a)–17(e) (see **2.03**). Additional facts and circumstances that may be pertinent include which entity issued the equity interests (see **2.02**) as well as the relative assets, revenues, and earnings of the combining entities (see **2.16**).

Consideration of the Relative Voting Rights in the Combined Entity After the Combination

2.06 Paragraph 17(a) of Statement 141 states:

[A]ll else being equal, the acquiring entity is the combining entity whose owners as a group retained or received the larger portion of the voting rights in the combined entity. In determining which group of owners retained or received the larger portion of the voting rights, consideration shall be given to the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.

2.07 The relative voting rights in the combined entity should be considered at the acquisition date on the basis of all securities with voting rights, not just voting common stock. Any unusual or special voting arrangements in place at the acquisition date must be considered, because such arrangements may serve to alter the outstanding voting

rights of the holders of voting securities. In addition, while some options, warrants, or convertible securities of the legal acquiree may be exchanged for voting securities at the acquisition date, other options, warrants, or convertible securities of the legal acquiree, as well as similar securities of the legal acquirer, may remain outstanding at the acquisition date. To the extent that options, warrants, or convertible securities outstanding at the acquisition date could result in the subsequent issuance of voting securities in the combined entity, the specific facts and circumstances surrounding such options, warrants, or convertible securities must be considered. For example, a nonvoting security that is held by a large minority owner, that is outstanding at the acquisition date, and that can be immediately converted into a voting security may be determined to be a pertinent fact or circumstance; on the other hand, options with varying terms that are held by employees of both combining entities and that will remain outstanding in the combined entity may not be a pertinent fact or circumstance.

Consideration of the Existence of a Large Minority Voting Interest in the Combined Entity When No Other Owner or Organized Group of Owners Has a Significant Voting Interest

2.08 Paragraph 17(b) of Statement 141 states:

[A]ll else being equal, [when no other owner or organized group of owners has a significant voting interest] the acquiring entity is the combining entity whose single owner or organized group of owners holds the large minority voting interest in the combined entity.

2.09 Consideration of the existence of a large minority voting interest may require judgment; paragraph 17(b) of Statement 141 does not define either the term “large” when discussing minority interest or the term “significant” when discussing a voting interest held by others.

Consideration of the Composition of the Governing Body of the Combined Entity

2.10 Paragraph 17(c) of Statement 141 states:

[A]ll else being equal, the acquiring entity is the combining entity whose owners or governing body has the ability to elect or appoint a voting majority of the governing body of the combined entity.

2.11 Consideration should be given to (1) the initial composition of the governing body of the combined entity and (2) the process in place at the acquisition date governing how subsequent members of the governing body are to be elected or

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appointed and the next date when such subsequent election or appointment may occur. A plan at the acquisition date to alter the initial composition of the governing body or a process in place at the acquisition date that could result in an alteration of the governing body should be evaluated to determine whether such a plan or process is a pertinent fact or circumstance.

Consideration of the Composition of the Senior Management of the Combined Entity

2.12 Paragraph 17(d) of Statement 141 states:

[A]ll else being equal, the acquiring entity is the combining entity whose senior management dominates that of the 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.

2.13 Consideration should be given to (1) the initial composition of the senior management of the combined entity and (2) any plan or intention at the acquisition date to make subsequent changes in the initial composition of the senior management after the acquisition date. A plan or intention at the acquisition date to alter the initial composition of the senior management, such as a planned retirement with a determined successor, should be evaluated to determine whether such a plan or intention is a pertinent fact or circumstance. The pertinence of a planned or intended change to the initial composition of the senior management of the combined entity will most likely be influenced by both the specific senior management position(s) affected and the expected timing of the change(s).

Consideration of the Terms of the Exchange of Equity Securities

2.14 Paragraph 17(e) of Statement 141 states:

[A]ll else being equal, the acquiring entity is the combining entity that pays a premium over the market value of the equity securities of the other combining entity or entities. [Footnote 9]

Footnote 9 states, "This criterion shall apply only if the equity securities exchanged in a business combination are traded in a public market on either (a) a stock exchange (domestic or foreign) or (b) in an over-the-counter market (including securities quoted only locally or regionally)."

2.15 While not stated in Statement 141, in an evaluation of the terms of the exchange of equity securities, the values of the equity securities used in an analysis of the premium paid, if any, should be as of the measurement date provided in EITF Issue

No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination."

Business Combinations Involving More Than Two Entities

2.16 Paragraph 18 of Statement 141 provides that "[s]ome business combinations involve more than two entities. In identifying the acquiring entity in those cases, consideration also shall be given to which combining entity initiated the combination and whether the assets, revenues, and earnings of one of the combining entities significantly exceed those of the others."

Identifying the Acquiring Entity Based on Consideration of All Pertinent Facts and Circumstances

2.17 Each of the facts and circumstances noted in paragraphs 17(a)–17(e) of Statement 141 (see **2.03**) may identify the acquiring entity if all else is equal. In some business combinations, however, the facts and circumstances may provide differing indications as to the acquiring entity. Analysis of such business combinations will require judgment, since Statement 141, as explained in paragraph B92, provides no hierarchical guidance on identifying the acquiring entity.

Use of a New Entity to Effect a Business Combination

2.18 Paragraph 19 of Statement 141 provides that "[i]f a new entity is formed to issue equity interests to effect a business combination, one of the existing combining entities shall be determined to be the acquiring entity on the basis of the evidence available. The guidance in paragraphs 16–18 shall be used in making that determination."

Example 2-1

New Entity Formed to Effect a Business Combination

Company B and Company C agree to combine in a transaction to be accounted for as a business combination using the purchase method. To effect the transaction, a new entity will be formed to issue equity interests to the shareholders of both Company B and Company C. In this transaction, either Company B or Company C will be determined to be the acquiring entity on the basis of the available evidence. The guidance in paragraphs 16–18 of Statement 141 (see **2.01–2.17**) should be used in determining the acquiring entity.

2.19 In addition to the guidance in paragraph 19 of Statement 141 (see **2.18**), when identifying the acquiring entity in a transaction involving a new entity (often referred to as a "Newco"), consideration should be given to correspondence to the FASB staff dated August 16, 2001, from then SEC Chief Accountant Lynn E. Turner, which states:

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Newco as Acquirer — Paragraph 19 of SFAS No. 141 includes a prohibition against identifying a Newco as being the acquirer in a business combination, consistent with paragraph 71 of APB Opinion No. 16. The staff continues to believe however, that when a Newco has any precombination activities that are deemed to be significant, the Newco cannot be viewed as a new corporation solely formed to issue stock to effect a business combination and therefore could be deemed the accounting acquirer.

2.20 In response to the item “Newco as Acquirer” included in the correspondence described in **2.19**, the FASB staff wrote that it “believes that the SEC’s analysis of this item is consistent with the intent of FAS 141.”

Reverse Acquisitions

2.21 Paragraph 17 of Statement 141 provides that “[i]n a business combination effected through an exchange of equity interests, the entity that issues the equity interests is generally the acquiring entity. In some business combinations (commonly referred to as reverse acquisitions), however, the acquired entity issues the equity interests.” While Statement 141 does not provide implementation guidance regarding the accounting for a business combination determined to be a reverse acquisition, paragraphs B1–B15 of IFRS 3, *Business Combinations*, contain guidance that may be useful in identifying and resolving implementation issues.

2.22 In EITF Issue No. 90-13, “Accounting for Simultaneous Common Control Mergers,” the Task Force addressed a fact pattern in which “[a]n entity (Parent) obtains control by ownership or otherwise of another entity (Target). Almost simultaneously, as part of an integrated planned transaction, Target issues additional shares to Parent in exchange for Parent’s interest in a subsidiary (Subsidiary). Parent, Target, and Subsidiary are substantive operating entities.” The Task Force considered a number of issues related to this fact pattern, including “[h]ow the transaction should be accounted for by Target.” On this issue, the Task Force reached a consensus that:

[T]he transaction should be accounted for in Target’s separate financial statements as a reverse acquisition of Target by Subsidiary in accordance with paragraph 70 of Opinion 16 [now paragraphs 15–19 of Statement 141]. In this situation, Target’s separate financial statements would reflect its assets and liabilities at fair value to the extent acquired. However, Subsidiary’s assets and liabilities should not be revalued. Task Force members noted that this treatment is consistent with the concept underlying reverse acquisition accounting (that is, Subsidiary has acquired an interest in Target) and reflects the lack of gain or loss recognition at the Target-Subsidiary level.

Subsequent to Issue 90-13, the SEC staff has indicated (for example, in Division of Corporation Finance, *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, dated March 31, 2001) that it “believes the ‘partial step-up’ methodology of EITF 90-13 applies only in the particular facts and circumstances specified in that consensus.”

Mergers of a Private Operating Company Into a Nonoperating Public Shell Corporation

2.23 In a reverse acquisition (see **2.21**), the legal acquirer generally continues in existence as the legal entity whose shares represent the outstanding common stock of the combined company. In some instances, the legal acquirer is a public company whose shares are listed on an exchange. By effecting a reverse acquisition, the accounting acquirer (if a private entity) can gain access to the public market without going through an initial public offering. The SEC’s Division of Corporation Finance, *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, dated March 31, 2001, states:

The merger of a private operating company into a non-operating public shell corporation with nominal net assets typically results in the owners and management of the private company having actual or effective operating control of the combined company after the transaction, with shareholders of the former public shell continuing only as passive investors. These transactions are considered by the staff to be capital transactions in substance, rather than business combinations. That is, the transaction is equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation, accompanied by a recapitalization. The accounting is identical to that resulting from a reverse acquisition, except that no goodwill or other intangible should be recorded.

Section 3 — Determining the Cost of the Acquired Entity

3.00 The sections below discuss how the cost of an entity acquired in a business combination is determined.

Consideration Distributed by the Acquiring Entity to Selling Shareholders

Consideration distributed by the acquiring entity to selling shareholders, including in the form of contingent consideration, represents a cost of the acquired entity unless such consideration is determined to represent compensation for services, use of property, or profit sharing, in which case those amounts are to be recognized as expense of the appropriate periods (see **3.01–3.42**).

Costs of the Business Combination

The cost of an entity acquired in a business includes the direct, but excludes the indirect, costs of the business combination incurred by the acquiring entity (see **3.43–3.50**).

Recognition of Liabilities in Connection With an Acquisition

If certain conditions are met, the cost of an entity acquired in a business combination includes liabilities recognized by the acquiring entity as a result of a plan to (1) exit an activity of the acquired company, (2) involuntarily terminate employees of the acquired company, or (3) relocate employees of the acquired company (see **3.51–3.60**).

Preexisting Relationships Between Parties to a Business Combination

The cost of an entity acquired in a business combination excludes amounts paid or received to settle preexisting relationships between parties to the business combination (see **3.61–3.62**).

Settlement of Disputes With the Former Owners Over a Business Combination

The cost of an entity acquired in a business combination excludes amounts subsequently paid or received to settle disputes with the former owners unless a “clear and direct link to the purchase price” is demonstrated (see **3.63–3.64**).

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Settlement of Disputes With the Shareholders of the Acquiring Entity Over a Business Combination

The cost of an entity acquired in a business combination excludes costs incurred, including any settlement amount if paid, related to disputes with the shareholders of the acquiring entity over the business combination (see **3.65**).

Consideration Distributed by the Acquiring Entity to Selling Shareholders

3.01 Paragraph 20 of Statement 141 provides, in part, that “[a] cash payment by an acquiring entity shall be used to measure the cost of an acquired entity. Similarly, the fair values of other assets distributed as consideration, such as marketable securities [see **3.02–3.17**] or properties, and the fair values of liabilities incurred by an acquiring entity shall be used to measure the cost of an acquired entity [reference omitted].”

Determination of the Measurement Date for the Market Price of Acquirer Securities Issued

3.02 Paragraph B98 of Statement 141 states:

The Board recognizes that this Statement carries forward from Opinion 16 contradictory guidance about the date that should be used to value equity interests issued to effect a business combination. Paragraph 74 of Opinion 16, carried forward in paragraph 22, states that the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued. However, paragraph 94 of Opinion 16, carried forward in paragraph 49, states that the cost of an acquired entity should be determined as of the date of acquisition. Paragraph 48 defines that date as the date that assets are received and other assets are given, liabilities are assumed or incurred, or equity interests are issued. The Board decided to defer resolution of that apparent contradiction to its project on issues related to the application of the purchase method. Therefore, this Statement does not change the status of the guidance in EITF Issue No. 99-12, “Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination” [see **3.03–3.13**], or EITF Topic No. D-87, “Determination of the Measurement Date for Consideration Given by the Acquirer in a Business Combination When That Consideration is Securities Other Than Those Issued by the Acquirer” [see **3.14**]. This Statement also does not change the status of the guidance of other EITF issues interpreting the provisions of Opinion 16 related to determining the cost of the acquired entity.

3.03 Paragraph 3 of Issue 99-12 cites the issues as follows:

Issue 1 — The date that should be used to value marketable equity securities of the acquirer issued to effect a business combination accounted for using the purchase method when the

number of the acquirer's shares or amount of other consideration is not subject to change pursuant to the existing terms of the acquisition agreement

Issue 2 — The date that should be used as the measurement date to value equity securities of the acquirer issued in a purchase business combination if the number of the acquirer's shares or amount of other consideration to be issued could change pursuant to a formula in the initial acquisition agreement.

3.04 Paragraph 4 of Issue 99-12 indicates:

[T]he Task Force reached a consensus on Issue 1 that the value of the acquirer's marketable equity securities issued to effect a purchase business combination should be determined, pursuant to the guidance in paragraph 74 of Opinion 16 [now paragraph 22 of Statement 141], based on the market price of the securities over a reasonable period of time before and after the terms of the acquisition are agreed to and announced. In other words, the date of measurement of the value of the acquirer's marketable equity securities should not be influenced by the need to obtain shareholder or regulatory approvals. Task Force members observed that the reasonable period of time referred to in paragraph 74 of Opinion 16 is intended to be very short, such as a few days before and after the acquisition is agreed to and announced. Task Force members also observed that in transactions involving a hostile tender offer, the measurement date for the value of the acquirer's marketable equity securities occurs when the proposed transaction is announced and sufficient shares have been tendered to make the offer binding or when the proposed acquisition becomes nonhostile, as evidenced by the target company's agreement to the purchase price.

3.05 In correspondence to the FASB staff dated August 16, 2001, then SEC Chief Accountant Lynn E. Turner notes the following:

Period for Determining Fair Value of Securities — The language in paragraph 74 of Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, was carried forward to paragraph 22 of SFAS No. 141 indicating that "The market price for a *reasonable period* before and after the date that the terms of the acquisition are agreed to and announced shall be *considered* in determining the fair value of securities issued" (emphasis added) to effect a business combination.

Based on past consideration of registrant matters, the staff has experienced diversity in the application of this guidance due in part to an undefined period of time (i.e., a "reasonable period" before and after) coupled with the language that such period should be *considered* (i.e., not required) in determining the fair value. The staff asks that the EITF provide more specific guidance as to the appropriate application of this guidance. In the intervening period, the staff will continue to presume that "reasonable period before and after" should be interpreted to require that registrants use a period of time beginning two days before and ending two days after the date that the terms of the acquisition are agreed to and announced in determining the fair value of the securities issued to effect the business combination.

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3.06 In response to the item “Period for Determining Fair Value of Securities” cited above, the FASB staff noted that “FAS 141 carries forward without reconsideration the guidance in paragraph 74 of APB 16. The FASB staff believes that the Board did not intend to change how the guidance is currently being applied in practice.”

Example 3-1

Determining a Reasonable Period of Time Before and After the Terms of an Acquisition Are Agreed to and Announced (Case A)

On May 14, 20X0, Company B and Company C announced their agreement to combine in a transaction to be accounted for as a business combination. Company B, determined to be the acquiring entity, will issue shares of its common stock for those of Company C. The number of Company B shares of common stock to be issued or the amount of other consideration is not subject to change pursuant to the existing terms of the acquisition agreement. The acquisition is not expected to close for several months. The market price of Company B common stock was as follows:

May 8, 20X0	\$55	May 13, 20X0	\$55	May 16, 20X0	\$58
May 9, 20X0	56	May 14, 20X0	59	May 19, 20X0	57
May 12, 20X0	57	May 15, 20X0	58	May 20, 20X0	60

Application of the guidance in Issue 99-12 (see **3.04**), as interpreted by the SEC staff (see **3.05**), results in a value of \$57.40, determined by using the date the acquisition was announced (May 14), the two days before (May 12 and 13), and the two days after (May 15 and 16).

3.07 Paragraph 5 of Issue 99-12 states:

The Task Force also reached a consensus that if the purchase price (the number of shares or the amount of other consideration) is subsequently changed as a result of further negotiations or a revised acquisition agreement, a new measurement date for valuing the acquirer’s marketable equity securities that will be issued to effect the combination is established as of the date of the change. The Task Force clarified at the January 19–20, 2000 meeting that if the change in the number of shares or other consideration is not substantive, a new measurement date does not result from the change.

The Task Force did not, however, offer guidance on how to evaluate whether a change in the number of shares or other consideration is substantive.

3.08 The application of the guidance in paragraph 5 of Issue 99-12 (see **3.07**) to a change in “mix” of consideration was addressed at the 2002 AICPA Conference on Current SEC Developments by an SEC staff member (Randolph P. Green). In

unpublished remarks, Mr. Green indicated that a new measurement date under Issue 99-12 is established if the change in “mix” of consideration is substantive and reflects a change in understanding. A change in mix of consideration need not include a change in the number of shares to result in a new measurement date under Issue 99-12.

Example 3-2

Application of Issue 99-12 to a Change in “Mix” of Consideration

On January 14, 20X0, Company B entered into an agreement with Company C to acquire Subsidiary S of Company C in a transaction to be accounted for as a business combination. As consideration, Company B agreed to transfer to Company C a combination of cash and marketable equity securities of Company B, and to assume certain liabilities of Subsidiary S. Company B has been determined to be the acquiring entity. Company B determined under Issue 99-12 that the measurement date for the marketable equity securities to be issued was January 14, 20X0. The acquisition was not scheduled to close for several months.

After January 14, 20X0, and before the acquisition date, Company B and Company C agreed to amend the terms of the acquisition agreement to increase the amount of cash consideration and reduce the amount of liabilities to be assumed by Company B. Provided that the change is determined to be substantive and reflects a change in understanding, a new measurement date would result under Issue 99-12 even though the number of shares of marketable equity securities to be issued by Company B is unchanged.

3.09 Paragraph 6 of Issue 99-12 provides that “the Task Force addressed the accounting for contingent consideration issued to effect a purchase business combination in Issue No. 97-8, ‘Accounting for Contingent Consideration Issued in a Purchase Business Combination.’ The measurement guidance in this Issue is to be applied to the acquirer’s equity securities issued to effect a business combination accounted for using the purchase method, including those instruments that meet the criteria in Issue 97-8 for recording as part of the cost of the business acquired.”

3.10 Paragraph 7 of Issue 99-12 states:

[T]he Task Force reached a consensus on Issue 2 [see **3.03**] that if the application of the formula [in the initial acquisition agreement] results in a change to the number of shares or the amount of other consideration to be issued in the purchase business combination, then the first date on which the number of acquirer shares and the amount of other consideration become fixed without subsequent revision is the measurement date. That is, the measurement date is the earliest date, from the date the terms of the acquisition are agreed to and announced to the date of final application of the formula pursuant to the acquisition agreement, on which subsequent applications of the formula do not result in a change in the

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number of shares or the amount of other consideration. For example, assume the terms of a purchase business combination are agreed to and announced on March 1, 1999. Also assume that the purchase agreement includes a formula arrangement that specifies that an adjustment will be made to the number of shares issued in the business combination if the average closing security price for the 10 days ending June 30, 1999, is less than \$16. If the 10-day average closing security price drops below \$16 for the first time on June 1, 1999, and does not subsequently recover to an amount equal to or greater than \$16 from June 1, 1999 through June 30, 1999, June 1, 1999 is the measurement date. However, if the originally announced number of shares or amount of other consideration does not change as a result of final application of the formula, then the initial date that the terms were agreed to and announced is the measurement date. The Task Force noted that a new measurement date does not occur as a result of the application of a nonsubstantive formula in the original agreement.

3.11 Paragraph 8 of Issue 99-12 provides another example of the consensus on Issue 2:

[A]ssume that the terms of the acquisition are agreed to and announced on March 31, 1999. The number of shares to be issued in the business combination is equal to \$20 million divided by the June 30, 1999 closing market price of the acquirer's common stock; however, if the June 30, 1999 closing market price of the acquirer's common stock is less than \$16 or greater than \$24, the exchange ratio is adjusted as follows: (a) if the closing market price is less than \$16, the acquirer will issue 1,250,000 shares of its common stock for the outstanding common shares of the target company, and (b) if the closing market price is greater than \$24, the acquirer will issue 833,000 shares of its common stock for the outstanding common shares of the target company. The variable exchange ratio represents a formula and, as a result, if the stock price changes during the period from March 31, 1999 through June 30, 1999, but remains within the \$16–\$24 range, the measurement date is June 30, 1999. However, if the acquirer's closing common stock price exceeds \$24 on June 1, 1999, and remains above \$24 through June 30, 1999, the number of shares to be issued in the transaction becomes fixed on June 1, 1999, and that date is the measurement date. Additional examples of the application of the consensus are included in Exhibit 99-12A.

3.12 Paragraph 9 of Issue 99-12 provides that “[t]he Task Force also reached a consensus that the securities should be valued based on market prices a few days before and after the measurement date determined in Issue 2 but that the measurement period would not include any dates after the date the business combination is consummated.”

Example 3-3

Determining a Reasonable Period of Time Before and After the Terms of the Acquisition Are Agreed to and Announced (Case B)

On May 14, 20X0, Company B and Company C announced their agreement to combine in a transaction to be accounted for as a business combination. Company B, determined to be the acquiring entity, will issue shares of its common stock for those of Company C. The acquisition was consummated on the date it was announced (May 14, 20X0). The market price of Company B common stock was as follows:

May 8, 20X0	\$55	May 13, 20X0	\$55	May 16, 20X0	\$58
May 9, 20X0	56	May 14, 20X0	59	May 19, 20X0	57
May 12, 20X0	57	May 15, 20X0	58	May 20, 20X0	60

On the basis of the guidance in Issue 99-12 (see **3.12**), as interpreted by the SEC staff (see **3.05**), a value of \$57 is determined using the date the acquisition was announced (May 14) and two days before (May 12 and 13), but no days after, the business combination was consummated.

Determining the Date the Terms of an Acquisition Are Agreed to and Announced

3.13 The consensus on Issue 1 of Issue 99-12 (see **3.04**) refers to “a reasonable period of time before and after the terms of the acquisition are agreed to and announced.” While not stated in Issue 99-12, the date the terms of an acquisition “are agreed to” is not expected to occur before a formal agreement between the combining companies; “announcement” is not expected to occur before public disclosure.

Determination of the Measurement Date for Consideration Given by the Acquiring Entity When That Consideration Is Securities Other Than Those Issued by the Acquiring Entity

3.14 EITF Topic D-87 provides that “[t]he FASB staff believes that securities transferred to shareholders of an acquired company as consideration in a purchase business combination, other than securities issued by the acquirer, should be measured on the date the business combination is consummated.”

Determining the Fair Value of Securities Traded in the Market Given as Consideration by the Acquiring Entity

3.15 Paragraph 22 of Statement 141 provides, in part, that “[t]he fair value of securities traded in the market is generally more clearly evident than the fair value of an acquired entity (paragraph 6). Thus, the quoted market price of an equity security issued to effect a business combination generally should be used to estimate the fair value of an acquired entity after recognizing possible effects of price fluctuations, quantities traded, issue costs, and the like.” Despite this guidance, deviations from the use of quoted market price as a measure of fair value for unrestricted equity securities issued to effect a business combination occur infrequently, since the SEC staff believes that the quoted market price for a security, when available, is the best measure of its fair value.

Determining the Fair Value of Preferred Shares Given as Consideration by the Acquiring Entity

3.16 Paragraph 21 of Statement 141 states:

The distinctive characteristics of preferred shares make some preferred share issues similar to debt securities, while others are similar to common shares, with many gradations in between. Those characteristics may affect the determination of the cost of an acquired entity. For example, the fair value of nonvoting, nonconvertible preferred shares that lack characteristics of common shares may be determined by comparing the specified dividend and redemption terms with those of comparable securities and by assessing market factors. Thus, although the principle of recording the fair value of consideration received for shares issued applies to all equity securities, senior as well as common shares, the cost of an entity acquired by issuing senior equity securities may be determined in practice on the same basis as for debt securities.

3.17 Determining the fair value of preferred shares given as consideration by the acquiring entity when a market price is available should be based on the same considerations as those discussed in **3.15**.

Exchange of Employee Stock Options or Awards

3.18 The amount to be included in the cost of an entity acquired in a business combination resulting from the exchange of stock options or awards held by employees of the acquired entity with stock options or awards of the acquiring entity is the fair value of the new (acquiring entity) stock options or awards net of the portion of the fair value attributable to future vesting requirements, if any. While the guidance in EITF Issue No. 00-23, “Issues Related to the Accounting for Stock Compensation Under Opinion No. 25 and FASB Interpretation No. 44,” has been nullified by the issuance of FASB

Statement No. 123(R), *Share-Based Payment*, the interpretive guidance contained in Issue 13 of Issue 00-23 on measuring fair values at the measurement date required by Issue 99-12 is considered in practice to remain applicable. To the extent that the fair value of the new (acquiring entity) stock options or awards exceeds the fair value of the exchanged stock options or awards (excess), the excess is recognized as compensation cost. To the extent that service is required subsequent to the acquisition date in order to vest in the replacement awards, an amount should be allocated to unearned compensation and recognized as compensation cost over the remaining future vesting (service) period. The amount allocated to unearned compensation cost should be based on the portion of the fair value at the acquisition date related to the future service (vesting) period regarding awards for which the requisite service is expected to be rendered (i.e., those awards that are expected to vest), on the basis of forfeiture estimates made using information available at the acquisition date. That amount shall be calculated as the fair value of the replacement awards at the acquisition date, for which requisite service is expected to be rendered, multiplied by the fraction that is the remaining future service (vesting) period, divided by the total service (vesting) period (the vesting period prior to the acquisition date, plus the remaining future period required to vest in the replacement award). Subsequent to the acquisition date, the effects of changes in estimated forfeitures adjust the amount of compensation cost recognized subsequent to the acquisition date and do not adjust the cost of the acquired entity.

Example 3-4

Exchange of Employee Stock Options or Awards

Company X acquired 100 percent of Company Y in a transaction accounted for as a business combination. The measurement date of the transaction is April 5, 20X5, and the acquisition date is October 1, 20X5. Company X exchanged all employee stock options held in Company Y with its own employee stock options.

Company Y had two employees (Employee A and Employee B) that continued to be employed by Company X. At the acquisition date, Employee A will hold 100 stock options, all of which will be fully vested, and Employee B will hold 200 unvested stock options. Employee B's unvested stock options will cliff vest on October 1, 20X6, as long as Employee B continues to be employed by Company X. All of Employee B's options were granted on October 1, 20X4, and, as of the acquisition date, are expected to vest.

Employee	Number of Stock Options
A	100
B	200

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Example 3-4

Exchange of Employee Stock Options or Awards

Summary of Company X's Stock Option Values (per Option) on Certain Dates**

	Amount
Fair value on April 1, 20X5	\$12
Fair value on October 1, 20X5	10

** Values for illustrative purposes only.

Question — What amount should Company X include in the cost of the acquired entity (Company Y) for the stock options issued to employees of Company Y in exchange for the outstanding stock options of Company Y?

Answer —The amount included in the cost of the acquired entity is determined as follows:

	Employee A	Employee B
Total stock options held	100	200
Fair value on measurement date	$\times \$ 12$	$\times \$ 12$
Total	<u>\$ 1,200</u>	<u>\$ 2,400</u>

Allocation to Unearned Compensation

Total stock options held by Employee B	200
Fair value on consummation date	$\times \$ 10$
	\$ 2,000
Remaining future vesting (service) period ratio*	$\times 50\%$
Total	<u>\$ 1,000</u>

* Ratio based on Employee B being halfway through the vesting period at the acquisition date.

The amount included in the cost of the acquired entity (Company Y) resulting from the exchange of employee stock options is the fair value of the Employee A stock options exchanged (\$1,200), plus the fair value of the Employee B stock options exchanged (\$2,400), minus the amount attributable to future vesting (\$1,000) — for a total of \$2,600.

Consideration Distributed to Selling Shareholders in the Form of Future Products or Services

3.19 In some transactions, the acquiring entity may agree to provide future products or services to the seller. This situation may arise, for example, when the acquired entity is a subsidiary of the seller and that subsidiary provided products or services to its parent that the parent wishes to continue to receive after the sale. An agreement for future products or services to be exchanged between the acquiring entity and the seller must be evaluated to determine whether such an agreement represents an adjustment of the purchase price. An analysis of any such agreement would necessarily involve a determination of whether the terms represented market.

Example 3-5

Agreement to Provide Products or Services to a Seller After the Acquisition

Company B enters into an agreement with Company C to acquire Subsidiary S from Company C. Subsidiary S supplies a specific raw material to Company C that Company C wants to continue to receive after the sale. As consideration for the acquisition, Company B agrees to pay cash and to provide a predetermined amount of raw materials to Company C for a fixed term at a fixed price. An evaluation of the raw material supply agreement indicates that the agreement is unfavorable to Company B.

In determining the cost of the acquisition, Company B should include the consideration transferred to Company C in the form of the unfavorable raw material supply agreement.

Gains or Losses on Assets Transferred as Consideration by the Acquiring Entity

3.20 Paragraph 20 of Statement 141 provides that “the fair values of other assets distributed as consideration, such as marketable securities or properties . . . shall be used to measure the cost of an acquired entity.” (See **3.01**.) While issuances of the acquirer’s equity securities will not result in a gain or loss, use of other assets as consideration, such as securities other than those issued by the acquiring entity and tangible assets of the acquiring entity, may result in a gain or loss at the acquisition date.

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Example 3-6

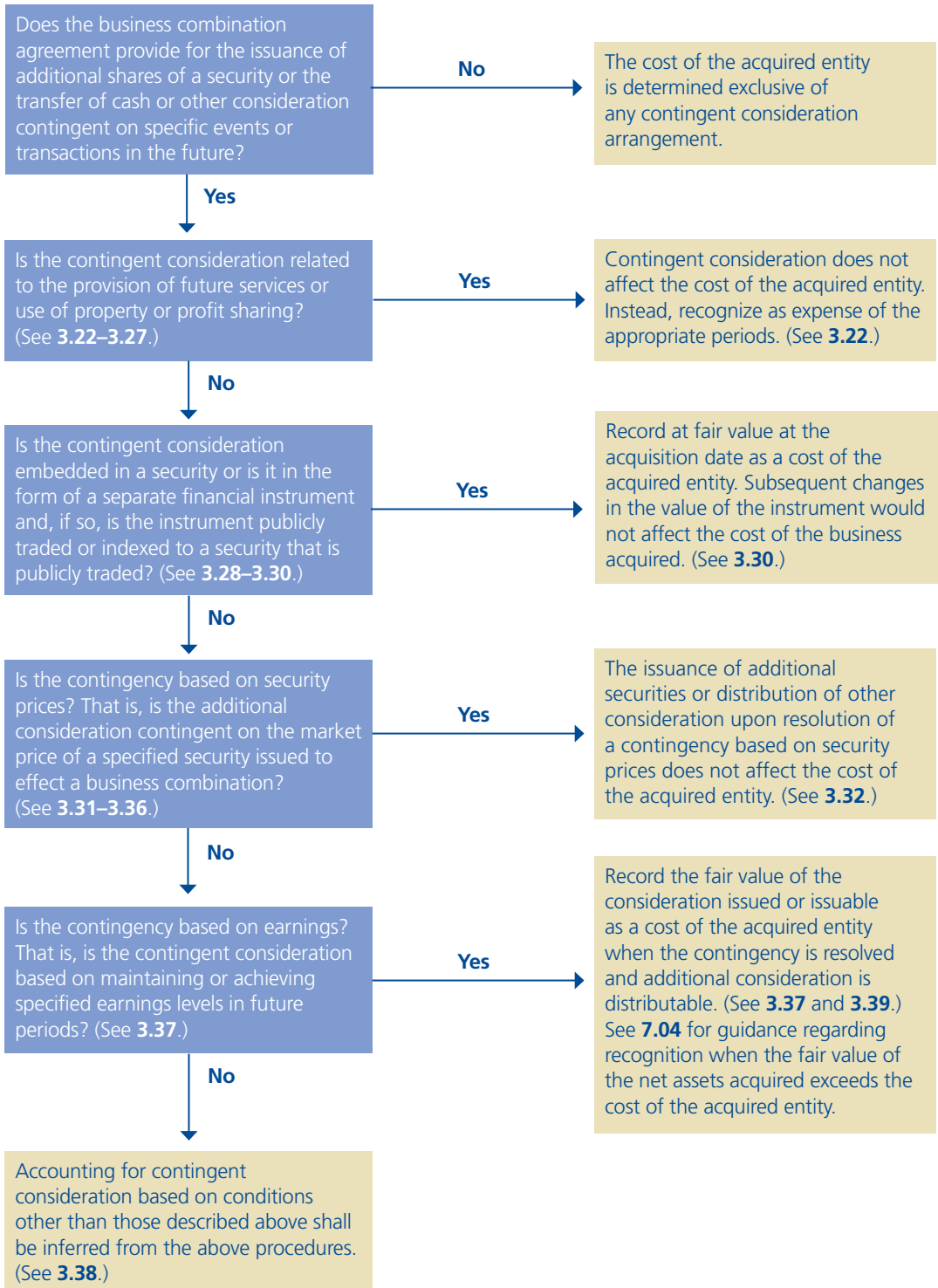
Gains or Losses on Assets Transferred as Consideration by the Acquiring Entity

Company B entered into an agreement with Company C to acquire Subsidiary S from Company C for consideration of cash and a building owned by Company B. Company B is the acquiring entity. The building to be transferred by Company B has a book value at the acquisition date of less than the building's measured fair value.

In determining the cost of the acquisition, Company B will include the fair value of the building transferred as consideration. As a result, Company B will recognize a gain on the disposal of the building at the acquisition date of Subsidiary S.

Contingent Consideration — Overview

3.21 Paragraph 25 of Statement 141 provides that “[a] business combination agreement may provide for the issuance of additional shares of a security or the transfer of cash or other consideration contingent on specified events or transactions in the future.” The accounting for contingent consideration arrangements is discussed in paragraphs 25–34 of Statement 141 as well as in additional guidance from the EITF. The following represents a framework for categorizing contingent consideration arrangements, summarizes the accounting for each category, and includes references to additional discussion herein:



Compensation in Contingent Arrangements

3.22 Paragraph 34 of Statement 141 requires that “[i]f the substance of the agreement for contingent consideration is to provide compensation for services or use of property or profit sharing, the additional consideration given shall be recognized as an expense of the appropriate periods.”

3.23 EITF Issue No. 95-8, “Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination,” states, in part:

The Task Force reached a consensus that the determination of whether contingent consideration based on earnings or other performance measures should be accounted for as an adjustment of the purchase price of the acquired enterprise or as compensation for services, use of property, or profit sharing is a matter of judgment that depends on the relevant facts and circumstances.

The Task Force also reached a consensus that the following factors or indicators should be considered in evaluating whether an arrangement for contingent consideration based on earnings or other performance measures is, in substance, additional purchase price of the acquired enterprise or compensation for services, use of property, or profit sharing.

Factors involving terms of continuing employment

1. *Linkage of continuing employment and contingent consideration:* The terms of continuing employment by 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, purchase agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional purchase price rather than compensation.
2. *Duration of continuing employment:* If the length of time 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.
3. *Level of compensation:* Situations in which employee compensation, other than the contingent payments, is at a reasonable level in comparison to that of other key employees in the combined enterprise may indicate that the contingent payments are additional purchase price rather than compensation.

Factors involving components of shareholder group

1. If selling shareholders who do not become employees receive lower contingent payments on a per share basis from what the selling shareholders who become employees of the

combined enterprise receive, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

2. The relative amount of stock 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 selling shareholders who owned substantially all of the stock in the acquired enterprise continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a minor amount of stock of the acquired enterprise 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 purchase price.
3. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, should also be considered.

Factors involving reasons for contingent payment provisions

1. Understanding the reasons why the acquisition agreement includes a provision for contingent payments may be helpful in assessing the substance of the arrangement. For example, if the initial consideration paid at the acquisition date is based on the low end of a range established in the valuation of the acquired enterprise and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional purchase price. 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.

Factors involving formula for determining contingent consideration

1. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, a contingent payment of five times earnings may suggest that the formula is intended to establish or verify the fair value of the acquired enterprise while a contingent payment of 10 percent of earnings may suggest a profit-sharing arrangement.

Factors involving other agreements and issues

1. 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 acquired enterprise. For example, if in connection with the acquisition the combined enterprise enters into a property lease arrangement with a significant selling shareholder with lease payments significantly below market value, that fact may indicate that some or all of the contingent payments are, in substance, for the use of the leased property rather than additional purchase price of the enterprise.

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3.24 Issue 95-8 provides that “[t]he Task Force also reached a consensus that an arrangement in which contingent payments are automatically forfeited if employment terminates as discussed in item 1 under ‘Factors Involving Terms of Continuing Employment,’ is a strong indicator that the arrangement is, in substance, compensation for postcombination services rather than additional purchase price. The Task Force observed that the list of factors or indicators above [see **3.23**] is not all-inclusive.”

3.25 After the issuance of Issue 95-8, some believed the only exception to compensation accounting when contingent payments were subject to forfeiture upon employment termination was the rare circumstance in which the requirement for continued employment was determined to be nonsubstantive (e.g., a very short period) and, thus, a means to immediately write off an amount that otherwise might result in additional goodwill. Accordingly, a continued employment requirement generally was viewed as a bright-line test and determinative of a compensation arrangement.

3.26 At the 2003 AICPA National Conference on Current SEC Developments, an SEC staff member (Chad A. Kokenge), in prepared remarks, indicated the following:

When an entity acquires a business, the purchase price is allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the date of acquisition. However, the fact that a business is acquired doesn’t obviate the need to evaluate whether portions of the arrangement need to be accounted for separately.

I’ll discuss an example that highlights this issue: contingent consideration that may be compensatory.

Determining whether contingent consideration in a business combination is additional purchase price or a period expense is judgmental. Generally, from a conceptual standpoint, contingency arrangements should be treated as additional purchase price when they serve to resolve differences in view between the buyer and the seller about the value of the business. However, when a selling shareholder becomes a continuing employee of the post-combination enterprise, it is often difficult to determine whether the contingency is truly a resolution of a business value disagreement, or simply compensation for post-acquisition services. EITF Issue 95-8 [endnote omitted] is helpful in this assessment as it provides guidance on factors to consider.

Issue 95-8 indicates that a contingent consideration arrangement in which the payments are subject to forfeiture if employment terminates is a strong indicator that the arrangement is compensation for post-combination services. Accordingly, when this indicator is present, we believe over-coming the compensation conclusion is very difficult.

With that said, this is not a bright line test, and we have, in rare situations, agreed with registrants who have suggested that a contingency arrangement that is tied to employment should, nonetheless, be treated as purchase price. I thought it would be useful to explain our thinking about some of the more pertinent considerations:

- If there are other selling shareholders who are subject to the exact same contingency formula on a per share basis but who do not continue or become employees, it would appear that the contingency is not solely based on employment. We would, however, want to understand why the continuing employees are asked to be subject to an employment contingency, in addition to the formula based on post-acquisition results;
- If the employees receive a level of compensation, including the contingent payments, that is significantly in excess of the amount that could conceivably be expected to be earned via employment, this would be an indicator that supports purchase price. However, the usefulness of this factor is often limited by the fact that many times the continuing employees perform services that are not comparable to the other employees of the merged entity, and the fact that executive management compensation often exceeds the compensation of other employees by a significant amount;
- If the contingent consideration formula is consistent with how the business valuation was established then this would also point toward purchase price. For example, by setting the fixed portion of the purchase price at the low end of a valuation range, with the contingency moving the price towards the high-end of the valuation range, based upon appropriate post-acquisition measures, the formula would at least be consistent with the business valuation. However, in these cases, we would, again, want to understand why an employment contingency was also added; and
- Lastly, understanding the basis of why the contingent consideration is included in the arrangement in the first place is important to the assessment. For example, if the contingency is only employment related, it is not clear to us how a case can really be made for purchase price.

We believe such evaluations are very fact specific. Accordingly, I recommend you carefully consider the factors relative to your particular arrangement.

Application of Issue 95-8 to Forfeitable Shares

3.27 At the 2000 AICPA National Conference on Current SEC Developments, an SEC staff member (R. Scott Blackley), in prepared remarks, addressed the application of Issue 95-8 to a forfeitable share arrangement in a purchase business combination, noting that the staff has been asked whether shares subject to vesting and forfeiture requirements should be included in the purchase price or accounted for as compensation arrangements. Mr. Blackley's remarks on this topic indicated:

For illustration, consider an example business combination where a company acquires another enterprise, XYZ Company, for cash and stock. All of the shareholders of XYZ Company are also employees. The acquiring company expects and desires to have the employee shareholders of XYZ Company continue as employees of the combined companies. Accordingly, of the shares issued to the shareholders of XYZ Company, a portion is held in an irrevocable trust, subject to a three-year vesting requirement ("forfeiture shares").

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The forfeiture provision requires that if, prior to vesting, a shareholder resigns from employment or is terminated for cause, the shares held in the trust allocable to the employee shareholder be forfeited. Additionally, any shares actually forfeited are reallocated to the remaining employee shareholders based on their remaining ownership interests such that all of the forfeiture shares in the trust will ultimately be issued.

Some have argued that the value of the forfeiture shares should be included as a component of the purchase price of XYZ Company. Those accountants argue that a fixed amount of consideration was issued in the merger since the forfeiture shares were issued at the consummation date and under no circumstances will be returned to the issuer. As such, they believe that the forfeiture shares do not represent contingent consideration. Therefore, the provisions APB 16 [superseded by Statement 141], which state that the substance of some agreements for contingent consideration is to provide compensation for services, are not applicable [footnote 4].

The staff believes that in the example transaction, the forfeiture shares must be accounted for as a compensation arrangement under the provisions of APB 25 [superseded by Statement 123R] [footnote 5]. The staff believes that APB 16 [superseded by Statement 141] emphasizes that arrangements entered into in connection with a business combination should not automatically be presumed to be a component of the purchase price, but rather that the substance of the arrangements should be the basis for the accounting. In that regard, the staff believes that the fact that the forfeiture shares were not returnable did not negate the need to assess the substance of the arrangement.

The staff looked to Issue 95-8 in evaluating whether the arrangement should be considered part of the purchase price or as compensation. In that Issue, the Task Force reached a consensus that an arrangement in which contingent payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is, in substance, compensation for post-combination services.

In considering the factors outlined in Issue 95-8, the staff placed significant weight on the fact that the shares vested based upon continued employment. In addition, the staff believes that such forfeiture provisions are included in arrangements in order to promote employee retention. The staff believes that these factors provided the greatest evidence as to the substance of the arrangement, and therefore the forfeiture shares should be accounted for as a compensatory arrangement.

The staff also considered what impact the use of the trust could have on the arrangement. The staff noted that APB 25 [footnote 6] contemplated the uses of a trust in a stock compensation arrangement, and as such, the introduction of a trust into such an arrangement did not change the conclusions that the transaction should be accounted for as a compensatory arrangement.

Footnote 4 refers to paragraph 86 of Opinion 16 (superseded by paragraph 34 of Statement 141).

Footnote 5 refers to an assumption that the accounting policy for employee stock compensation was to apply the intrinsic value method prescribed by Opinion 25.

Footnote 6 refers to paragraph 11(e) of Opinion 25.

Contingent Consideration Embedded in a Security or in the Form of a Separate Financial Instrument

3.28 EITF Issue No. 97-8, "Accounting for Contingent Consideration Issued in a Purchase Business Combination," states, in part:

In today's business environment, it is not uncommon for contingent consideration in a purchase business combination to be embedded in a security or to be in the form of a separate financial instrument, as opposed to the more traditional approach whereby the combination agreement contains a provision that the purchaser agrees to pay cash or some other form of consideration to the seller at a future date if certain future conditions are met. In some cases, the separate financial instrument trades in financial markets. For purposes of this Issue, it is assumed that the seller (who receives the contingent consideration embedded in a security or in the form of a separate financial instrument) has full transferability with regard to the security or instrument. In determining the cost of an acquired entity in a purchase business combination, paragraph 78 of Opinion 16 [now paragraph 26 of Statement 141] provides that securities issued unconditionally at the date of acquisition should be included in the cost of the acquisition and recorded at that date. Paragraph 79 of Opinion 16 [now paragraph 27 of Statement 141] states that contingent consideration should usually be recorded when the contingency is resolved and the consideration is issued or becomes issuable. It is unclear how the guidance of Opinion 16 [now Statement 141] should be applied to situations in which contingent consideration in a purchase business combination is embedded in a security or is a separate financial instrument that is issued by the purchaser at the acquisition date.

This Issue applies only to contingent consideration that is based on earnings or that is based on a guaranteed value of the securities issued to effect the combination.

3.29 Issue 97-8 indicates:

The issue is whether contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument should be recorded by the issuer at fair value at the acquisition date pursuant to paragraph 78 of Opinion 16 [now paragraph 26 of Statement 141] (as part of the cost of the business acquired) or recognized only when the contingency is resolved pursuant to paragraphs 79–83 of Opinion 16 [now paragraphs 27–31 of Statement 141].

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3.30 Issue 97-8 also indicates:

The Task Force reached a consensus that the security or separate financial instrument should be recorded by the issuer at fair value at the date of acquisition [footnote 1] pursuant to paragraph 78 of Opinion 16 [now paragraph 26 of Statement 141] (as part of the cost of the business acquired) if the instrument is publicly traded or indexed to a security that is publicly traded. Subsequent changes in the value of the instrument would not affect the cost of the business acquired. If the contingent consideration is not a financial instrument that is publicly traded or indexed to a security that is publicly traded, then the contingent consideration should be accounted for in accordance with paragraphs 79–83 of Opinion 16 [now paragraphs 27–31 of Statement 141].

Footnote 1 refers to EITF Issue No. 95-19, “Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination,” now Issue 99-12, for additional guidance on the date to be used.

Issue 97-8 also discusses subsequent accounting for the financial instruments recorded at fair value at the date of acquisition pursuant to the consensus.

Contingency Based on Security Prices — General

3.31 Paragraph 29 of Statement 141 states:

Additional consideration may be contingent on the market price of a specified security issued to effect a business combination. Unless the price of the security at least equals the specified amount on a specified date or dates, the acquiring entity is required to issue additional equity or debt securities or transfer cash or other assets sufficient to make the current value of the total consideration equal to the specified amount. The securities issued unconditionally at the date the combination is consummated shall be recorded at that date at the specified amount.

3.32 Paragraph 30 of Statement 141 states:

The issuance of additional securities or distribution of other consideration upon resolution of a contingency based on security prices shall not affect the cost of the acquired entity, regardless of whether the amount specified is a security price to be maintained or a higher security price to be achieved. When the contingency is resolved and additional consideration is distributable, the acquiring entity shall record the current fair value of the additional consideration issued or issuable. However, the amount previously recorded for securities issued at the date of acquisition shall be simultaneously reduced to the lower current value of those securities. Reducing the value of debt securities previously issued to their later fair value results in recording a discount on debt securities. That discount shall be amortized from the date the additional securities are issued.

Example 3-7**Contingency Based on Security Prices (Case A)**

Company A acquires Company B for 1 million shares of Company A common stock and an agreement to issue additional shares as consideration if the quoted market price of Company A common stock is below \$25 on the one-year anniversary of the acquisition date. The number of shares, if any, issued by Company A at the one-year anniversary of the acquisition date will be the amount necessary to guarantee the price of \$25 per share.

At the one-year anniversary of the acquisition date, the quoted market price of Company A common stock is \$20. Accordingly, Company A issues an additional 250,000 shares to the seller. The additional consideration will not alter the total cost of the acquisition. Company A will, however, need to adjust its equity accounts to reflect the additional shares issued and appropriately reclassify amounts from paid-in capital to common stock-par to reflect the issuance of the additional shares.

Example 3-8**Contingency Based on Security Prices (Case B)**

Company A acquires Company B for 1 million shares of Company A common stock and an agreement to issue cash consideration if the quoted market price of Company A common stock is below \$25 on the one-year anniversary of the acquisition date. The total cash, if any, issued by Company A at the one-year anniversary of the acquisition date will be the amount necessary to guarantee the \$25 per share price.

At the one-year anniversary of the acquisition date, the quoted market price of Company A common stock is \$20. Accordingly, Company A issues additional cash consideration of \$5 million to the seller. The additional consideration will not alter the total cost of the acquisition. Company A will, however, need to adjust its equity accounts to reduce paid-in capital equal to the consideration now paid in cash.

Below-Market Guarantee

3.33 EITF Issue No. 97-15, "Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination," indicates:

A purchase business combination agreement may contain a provision in which the purchaser agrees to pay cash or some other form of consideration to the seller at a future date if the securities issued to effect the combination are not worth a specified amount at some future date. In some situations, the purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller that guarantees a minimum value or security price at a future date that is less than the value or security price at the date such securities are issued (a "below-market guarantee"). The following example illustrates a below-market guarantee.

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Example 1: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees that if its share price is below \$8 one year after the combination, then Company A will issue additional shares to make up the deficiency below \$8 per share. In substance, Company A guarantees that the *total consideration* to be issued in the business combination will have a *minimum value* of \$800,000 in one year (which is less than the \$1,000,000 value of the consideration issued at the date of acquisition). [Emphasis added]

3.34 Issue 97-15 also indicates:

In the case of a below-market guarantee (whether that guaranteed minimum value is stated in or implied by the contingency arrangement), the consideration issued unconditionally at the date of the combination should be recorded at fair value at the date of acquisition. [Footnote 1] The payment or issuance of any additional consideration resulting from the guarantee would not change the recorded cost of the acquisition.

Footnote 1 refers to the subsequently issued Issue 99-12 for guidance on determining the measurement date to be used.

For the example in **3.33**, the consensus in Issue 97-15 provides that “the purchase price would be \$1,000,000 (100,000 shares issued unconditionally at \$10 per share).”

Contingency Based on Security Prices but Without a Guarantee of the Minimum Value of the Total Consideration

3.35 In addition to the below-market guarantee (see **3.33–3.34**), Issue 97-15 indicates:

[T]he purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller based on security prices at a future date in which the amount of additional consideration to be issued is limited so that the total value of all consideration to be issued is not determinable at the date of the acquisition. That is, the contingency arrangement is based on security prices and does not result in a guarantee of the minimum value of the total consideration, but, rather, provides for additional consideration to be issued should the value of the shares originally issued be less than a target value. The following examples illustrate these types of contingency arrangements.

Example 2: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees to issue 25,000 additional shares if the price of Company A stock is \$16 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 25,000 to zero as the share price increases from \$16 to \$20 per share. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$2,000,000 target value in 3 years.

Example 3: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees to issue 250,000 additional shares if the price of Company A stock is \$4 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 250,000 to zero as the share price increases from \$4 to \$20, with the total fair value of the additional shares to be issued limited to \$1,000,000 at the date issued. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$2,000,000 target value in 3 years.

Example 4: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees to issue 25,000 additional shares if the price of Company A stock is \$8 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 25,000 to zero as the stock price increases from \$8 to \$10. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$1,000,000 target value in 3 years.

3.36 Issue 97-15 also indicates:

In the case of a contingency arrangement based on security prices that does not result in a guarantee of the minimum value of the total consideration, the cost of the acquisition should be recorded at an amount equal to the maximum number of shares that could be issued multiplied by the fair value per share at the date of acquisition, [footnote 2] but should not exceed the target value (that is, the lowest total value at which additional consideration would not be required to be issued) of the consideration issued at the date of acquisition if that amount is limited (whether that target value is stated in or implied by the contingency arrangement). That is, the cost of the acquisition should be recorded at an amount equal to the lower of the target value and the maximum number of shares that could be issued multiplied by the fair value per share at the date of acquisition. The payment or issuance of any additional consideration resulting from the contingency would not change the recorded cost of the acquisition. In Example 2 [see **3.35**], the purchase price would be \$1,250,000 (the lower of 125,000 maximum shares that could be issued at \$10 per share and the target value of \$2,000,000). In Example 3 [see **3.35**], the purchase price would be \$2,000,000 (the lower of 350,000 maximum shares that could be issued at \$10 per share and the target value of \$2,000,000). In Example 4 [see **3.35**], the purchase price would be \$1,000,000 (the lower of 125,000 maximum shares that could be issued at \$10 per share and the target value of \$1,000,000).

Footnote 2 refers to the subsequently issued Issue 99-12 for guidance for determining the measurement date to be used.

Contingency Based on Earnings

3.37 Paragraph 28 of Statement 141 provides that “[a]dditional consideration may be contingent on maintaining or achieving specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring entity shall record the fair value of the consideration issued or issuable as an additional cost of the acquired entity [reference omitted; footnote omitted].”

Example 3-9

Contingency Based on Earnings

Company B acquires Company C for \$1 million cash paid at the acquisition date and an agreement to pay an additional \$250,000 if the earnings of Company C (to be operated after the acquisition as a separate subsidiary of Company B) equal or exceed a specified target for the 12-month period after the acquisition. If the earnings of Company C exceed the specified target, Company B will be required to pay the additional consideration, recognizing that amount as additional cost of the acquisition of Company C.

Contingency Based on Future Events Not Related to Security Prices, Payments for Services, Use of Property, or Profit Sharing

3.38 Paragraph 31 of Statement 141 states, in part:

Accounting for contingent consideration based on conditions other than those described shall be inferred from the procedures outlined. For example, if the consideration contingently issuable depends on both future earnings and future security prices, an additional cost of the acquired entity shall be recorded for the additional consideration contingent on earnings, and previously recorded consideration shall be reduced to the current value of the consideration contingent on security prices.

In addition to the example, other arrangements that require evaluation are those based on components of earnings, such as revenues or EBITDA (earnings before interest, taxes, depreciation, and amortization), and those based on a future event, such as FDA approval of a pharmaceutical product held by the acquired entity. If the arrangement is not related to security prices or does not provide compensation for services or use of property, or profit sharing, arrangements based on components of earnings or on other future events are typically inferred from the accounting for a contingency based on earnings (see **3.37**).

Impact of Contingency Based on Earnings or Another Similarly Accounted for Item on Allocation of the Cost of the Acquired Entity

3.39 Paragraph 31 of Statement 141 provides that “if the consideration contingently issuable depends on later settlement of a contingency, an increase in the cost of acquired

assets, if any, shall be amortized, if applicable, over the remaining useful lives of the assets [footnote 11].” (Footnote 11 refers to Statement 142 for guidance on accounting for goodwill and other intangible assets.) Since the allocation of the cost of the acquisition is based on information as of the date of the acquisition, the additional cost of the acquired entity resulting from the resolution of a contingency based on earnings or another similarly accounted for item is expected to be allocated to goodwill.

Consideration Held in Escrow Pending Resolution of Representation and Warranty Provisions

3.40 Paragraph 32 of Statement 141 states:

Amounts paid to an escrow agent representing interest and dividends on securities held in escrow shall be accounted for according to the accounting for the securities. That is, until the disposition of the securities in escrow is resolved, payments to the escrow agent shall not be recorded as interest expense or dividend distributions. An amount equal to interest and dividends later distributed by the escrow agent to the former shareholders shall be added to the cost of the acquired assets at the date distributed.

Paragraph 26 of Statement 141 requires that “[c]onsideration that is issued or issuable at the expiration of the contingency period or that is held in escrow pending the outcome of the contingency shall be disclosed but not recorded as a liability or shown as outstanding securities unless the outcome of the contingency is determinable beyond a reasonable doubt.”

3.41 In some transactions, at the request of the acquiring entity, a portion of the consideration is held in escrow pending resolution of representation and warranty provisions contained in the combination agreement. If the consideration held in an escrow account is shares or other securities, the arrangement typically provides that the risks and rewards of ownership are transferred to the sellers. Voting rights and any dividends related to the shares or other securities held in escrow are also generally conveyed to the sellers during the escrow period. In such arrangements, the escrowed shares or other securities are a means for an acquiring entity to gain further assurance that the representations and warranties provided in the combination agreement are accurate and, if not accurate, that a ready means to obtain restitution exists. Representation and warranty provisions generally lapse within a short period after the consummation date.

3.42 In the absence of evidence to the contrary, representation and warranties provided in the combination agreement are assumed to be accurate, and release of the consideration from escrow is therefore determined to be beyond a reasonable doubt.

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Accordingly, inclusion of amounts in escrow in the cost of the acquired entity as of the consummation date is generally considered appropriate. Each escrow arrangement must, however, be evaluated on the basis of its own facts and circumstances.

Costs of the Business Combination

3.43 Paragraph 24 of Statement 141 provides that “[t]he cost of an entity acquired in a business combination includes the direct costs of the business combination. Costs of registering and issuing equity securities shall be recognized as a reduction of the otherwise determinable fair value of the securities. However, indirect and general expenses related to business combinations shall be expensed as incurred.”

3.44 Paragraph A8 of Statement 141 provides implementation guidance on the direct costs of the business combination, stating:

Those direct costs include “out-of-pocket” or incremental costs directly related to a business combination such as a finder’s fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals. Internal costs associated with a business combination (whether one-time costs or recurring in nature) shall be expensed as incurred. In addition, costs related to unsuccessful negotiations also shall be expensed as incurred.

Costs of Registering and Issuing Equity Securities

3.45 Paragraph A9 of Statement 141 provides implementation guidance on the cost of registering and issuing equity securities, stating:

[C]osts of registering and issuing equity securities shall be recognized as a reduction of the otherwise determinable fair value of the securities. A publicly held company issuing *unregistered* equity securities in a business combination with an agreement for subsequent registration shall record those securities at the fair value of its registered securities less an estimate of the related registration costs. A liability shall be recognized at the date of acquisition in the amount of the present value of the estimated costs of registration. Any difference between the actual costs of registration and the recorded liability (including imputed interest) shall be recognized as an adjustment to the carrying amount of goodwill. If the securities issued in the business combination are to be included in the registration of a planned future offering of other securities (piggyback registration), only the incremental costs of registering the equity securities issued shall be recognized as a liability at the acquisition date.

Debt Issue Costs

3.46 SEC Staff Accounting Bulletin Topic 2.A.6, “Debt Issue Costs,” provides that “[f]ees 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 debt issue costs.” SAB Topic 2.A.6 further indicates that “debt issue costs are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the debt proceeds changes the nature of such costs. Accordingly, they should not be considered a direct cost of the acquisition.” SAB Topic 2.A.6 also addresses the amortization of debt issue costs related to interim “bridge financing,” stating that “[d]ebt issue costs should be amortized by the interest method over the life of the debt to which they relate. Debt issue costs related to the bridge financing should be recognized as interest cost during the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated period.”

Hedging Activities Related to a Planned Business Combination

3.47 Paragraph 21(c) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides that a firm commitment to enter into a business combination is not eligible for designation as a hedged item in a fair value hedge. In addition, paragraph 29(f) of Statement 133 indicates that a business combination subject to Statement 141 is not eligible for designation as a hedged transaction in a cash flow hedge. This guidance points out that the effect resulting from a financial instrument put in place to manage risk related to a planned business combination does not represent a direct cost of the acquired entity.

Acquisition Costs Incurred by the Acquired Entity

3.48 Acquisition costs incurred by the entity determined to be the acquired entity should be expensed as incurred. However, when there is a preexisting agreement between the acquiring entity and the acquired entity that authorizes the acquired entity to incur the costs and provides that the acquiring company will reimburse the costs when paid, recognition of a receivable by the acquired entity from the acquiring entity is appropriate. The reimbursement by the acquiring entity of the amounts paid represents to the acquiring entity an addition to the cost of the acquired entity.

Accounting for Direct Acquisition Costs When the Acquiring Entity Is Not Determined

3.49 Paragraph 24 of Statement 141 provides that “[t]he cost of an entity acquired in a business combination includes the direct costs of the business combination.” In certain anticipated combinations, the acquiring entity may not be readily determinable at the time both parties incur costs. In such cases, though expected to be infrequent, both parties

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should defer all direct acquisition costs until the acquiring entity has been determined. Consideration should be given by both entities to the need to disclose (1) the financial statement impact that would result from expensing the deferred amounts if the entity is determined not to be the acquiring entity or the business combination is determined to be unsuccessful (see **3.50**) and (2) the period in which such a charge may occur.

Accounting for Direct Acquisition Costs by the Acquiring Entity When Consummation of the Business Combination Is Uncertain

3.50 Since inclusion of direct costs incurred by the acquiring entity in the cost of the business combination is required under Statement 141, the direct costs deferred by the acquiring entity should not be expensed unless the business combination has been determined to be unsuccessful. In reporting periods prior to a determination that the business combination is unsuccessful, disclosure of uncertainties surrounding the completion of the business combination, along with amounts deferred and the financial statement impact (both amount and timing) that could result from expensing the deferred amounts, may be warranted.

Recognition of Liabilities in Connection with an Acquisition

3.51 EITF Issue No. 95-3, "Recognition of Liabilities in Connection With a Purchase Business Combination," states, in part:

The Task Force reached consensus...that the costs of a plan to (1) exit an activity of an acquired company, (2) involuntarily terminate employees of an acquired company, or (3) relocate employees of an acquired company should be recognized as liabilities assumed in a purchase business combination and included in the allocation of the acquisition cost in accordance with Opinion 16 [now Statement 141] if specified conditions are met.

Costs to Exit an Activity of an Acquired Entity

3.52 Issue 95-3 further indicates:

The Task Force reached a consensus that a plan to exit an activity of an acquired company exists if all of the following conditions are met:

1. As of the consummation date of the acquisition, management having the appropriate level of authority begins to assess and formulate a plan to exit an activity of the acquired company.
2. As soon as possible after the consummation date, management having the appropriate level of authority completes the assessment of which activities of the acquired company to exit and approves and commits the combined company to the

plan. Although the time required will vary with the circumstances, the finalization of the plan cannot occur beyond one year from the consummation date of the acquisition.

3. The plan specifically identifies all significant actions to be taken to complete the plan, activities of the acquired company that will not be continued, including the method of disposition and location of those activities, and the plan's expected date of completion.
4. Actions required by the plan will begin as soon as possible after the plan is finalized, and the period of time to complete the plan indicates that significant changes to the plan are not likely.

3.53 Issue 95-3 states, in part:

The Task Force reached a consensus that a cost resulting from a plan to exit an activity of an acquired company should be recognized as a liability assumed as of the consummation date of the acquisition only if the cost is not associated with or is not incurred to generate revenues of the combined entity after the consummation date and it meets either of the following criteria:

1. The cost has no future economic benefit to the combined company, is incremental to other costs incurred by either the acquired company or the acquiring company in the conduct of activities prior to the consummation date, and will be incurred as a direct result of the plan to exit an activity of the acquired company. The notion of incremental does not contemplate a diminished future economic benefit to be derived from the cost but, rather, the absence of the cost in either company's activities immediately prior to the consummation date.
2. The cost represents an amount to be incurred by the combined company under a contractual obligation of the acquired company that existed prior to the consummation date and will either continue after the plan is completed with no economic benefit to the combined company or be a penalty incurred by the combined company to cancel that contractual obligation.

Involuntary Employee Termination Benefits and Relocation Costs

3.54 Issue 95-3 states, in part:

The Task Force reached a consensus that a cost resulting from a plan to involuntarily terminate or relocate employees of an acquired company should be recognized as a liability assumed as of the consummation date of the purchase business combination and included in the allocation of the acquisition cost if all of the following criteria are met:

1. As of the consummation date of the acquisition, management having the appropriate level of authority begins to assess and formulate a plan to involuntarily terminate (relocate) employees of the acquired company.

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2. As soon as possible after the consummation date, management having the appropriate level of authority completes the assessment of which employees of the acquired company will be involuntarily terminated (relocated), approves and commits the combined company to the plan of termination (relocation), and communicates the termination (relocation) arrangement to the employees of the acquired company. The communication of the termination (relocation) arrangement should include sufficient detail to enable employees of the acquired company to determine the type and amount of benefits they will receive if they are terminated (relocated). Although the time required will vary with the circumstances, the finalization of the plan of termination (relocation) and the communication of the termination (relocation) arrangement cannot occur beyond one year from the consummation date of the acquisition.
3. The plan of termination (relocation) specifically identifies the number of employees of the acquired company to be terminated (relocated), their job classifications or functions, and their locations.
4. Actions required by the plan of termination (relocation) will begin as soon as possible after the plan is finalized, and the period of time to complete the plan indicates that significant changes to the plan are not likely.

Costs Related to Activities or Employees of the Acquired Company That Do Not Meet the Conditions Described in Issue 95-3

3.55 Issue 95-3 provides that “[t]he Task Force agreed that costs related to activities or employees of the acquired company that do not meet the conditions described above [see **3.51–3.54**] are indirect and general expenses related to the acquisition as discussed in paragraph 76 of Opinion 16 [now paragraph 24 of Statement 141].” Paragraph 24 of Statement 141 indicates that “indirect and general expenses related to business combinations shall be expensed as incurred.”

Costs Related to Exit Plans and Involuntary Employee Termination and Relocation Plans Initiated or Revised Based on Events Occurring After the Consummation Date

3.56 Issue 95-3 states, in part:

The Task Force also agreed that, with respect to exit plans and involuntary employee termination and relocation plans, initial or revised plan actions that result from events occurring after the consummation date do not result in an element of cost of the acquired company. The costs described above are not recorded as part of the purchased entity and should be either expensed or capitalized when incurred based on the nature of the expenditure and the capitalization policy of the combined company.

Costs Related to Activities or Employees of the Acquiring Entity

3.57 Issue 95-3 provides that “[t]he Task Force observed that costs related to activities or employees of the acquiring company are not considered in the purchase price allocation because the cost of the acquisition is not allocated to the assets and liabilities of the acquiring company as discussed in Technical Bulletin 85-5.” FASB Technical Bulletin No. 85-5, *Costs of Closing Duplicate Facilities of an Acquirer*, states:

Question 1

1. Are the costs incurred to close duplicate facilities of an acquiring company recognized as part of the cost of acquisition in a business combination?

Response

2. No. Only the direct costs of an acquisition should be included in the cost of a purchased company in a business combination. Indirect expenses of an acquiring company, including costs incurred when the acquiring company closes some of its facilities because they duplicate facilities acquired in a business combination, should be charged to expense in determining net income. Therefore, the disposition of the acquiring company’s assets do not affect the accounting for assets acquired and liabilities assumed of the acquired company, and any gain or loss on disposal or other cost associated with the disposition of an existing asset of the acquiring company should be charged to income.

Adjustments to Liabilities Recognized as a Result of a Plan to Exit an Activity, Involuntarily Terminate Employees, or Relocate Employees of an Acquired Company

3.58 Issue 95-3 provides:

The Task Force also reached a consensus that when the ultimate amount of a cost expended [to exit an activity, involuntarily terminate employees, or relocate employees of an acquired company] is less than the amount recorded as a liability assumed in a purchase business combination as a result of applying the above consensuses, the excess should reduce the cost of the acquired company. The amount of a cost exceeding the amount recorded as a liability assumed in a purchase business combination should result in an additional element of cost of the acquired company if an adjustment to an original estimate is determined within one year of the acquisition date and, thereafter, should be included in the determination of net income in the period in which the adjustment is determined. The Task Force observed that costs related to plans to exit activities and involuntarily terminate or relocate employees that are recorded as part of the purchased entity under this Issue are not preacquisition contingencies accounted for under Statement 38.

Disclosure Requirements Related to a Plan to Exit an Activity, Involuntarily Terminate Employees, or Relocate Employees of an Acquired Company

3.59 See **12.10** for discussion of disclosure requirements of a plan to exit an activity, involuntarily terminate employees, or relocate employees of an acquired company, as addressed in Issue 95-3.

Amounts Due to Employees of the Acquired Entity Upon a Change in Control

3.60 Arrangements may be in place at the acquired entity that provide for a payment to be made to one or more employees of the acquired entity upon a change in control for which the planned business combination will qualify. The arrangements may take many forms, including payments to some or all employees at the acquisition date and payments to an employee after the acquisition date if that employee voluntarily leaves employment of the combined entity within a predetermined period. While oftentimes not recognized as a liability on the books of the acquired entity, since payments are contingent upon a change in control, such arrangements may nevertheless represent an assumed liability to the acquiring entity and may, therefore, be included in the cost of the entity acquired. Each arrangement must, however, be evaluated on the basis of its own facts and circumstances. For example, if an arrangement assumed by the buyer were to require a minimum future service period beyond the acquisition date for a payment to be received, some or all of that payment may represent compensation expense to be recognized by the acquiring entity and not recognized as a part of the cost of the entity acquired.

Other

Preexisting Relationships Between Parties to a Business Combination

3.61 Preexisting relationships may exist between parties to a business combination in such forms as franchise or license arrangements, supply agreements (whether fixed or executory), and lawsuits or other disputes. EITF Issue No. 04-1, "Accounting for Preexisting Relationships Between the Parties to a Business Combination," provides guidance through the following issues considered and consensuses reached:

Issue 1 — Whether a business combination between two parties that have a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists, thus requiring accounting separate from the business combination.

Issue 2 — How the effective settlement of an executory contract in a business combination should be measured.

Issue 3 — Whether the acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets should be included in the measurement of the settlement amount or included as part of the business combination.

Issue 4 — Whether the acquirer should recognize, apart from goodwill, an acquired entity's intangible asset(s) that, before the business combination, arose solely from the acquired entity's contractual right to use the acquirer's recognized or unrecognized intangible asset(s).

Issue 5 — Whether it is appropriate for an acquirer to recognize a settlement gain in conjunction with the effective settlement of a lawsuit or an executory contract in a business combination.

The Task Force reached a consensus on Issue 1 that consummation of a business combination between parties with a preexisting relationship should be evaluated to determine if a settlement of a preexisting relationship exists. The Task Force determined that a business combination between two parties that have a preexisting relationship is a multiple-element transaction with one element being the business combination and the other element being the settlement of the preexisting relationship.

The Task Force reached a consensus on Issue 2 that the effective settlement of an executory contract in a business combination as a result of a preexisting relationship should be measured at the lesser of (a) the amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared to pricing for current market transactions for the same or similar items or (b) any stated settlement provisions in the contract available to the counterparty to which the contract is unfavorable. To the extent that a stated settlement amount is less than the off-market component of the contract, the difference should be included as part of the business combination. An unfavorable contract is not necessarily a loss contract for the acquirer. The Task Force observed that the amount recognized as a settlement gain or loss in the acquirer's consolidated statement of operations may differ from the amount measured in cases in which the acquirer had previously recognized an amount in its financial statements related to the preexisting relationship. For example, if an entity acquires a supplier for which it previously had recognized an \$8 liability on the supply contract (as a result of a previous business combination) and the measured loss on that contract is \$10 based on this consensus, the entity would recognize a \$2 loss (the \$10 measured loss on the contract less the \$8 loss previously recognized) in its statement of income.

The Task Force reached a consensus on Issue 3 that the acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets (for example, rights to the acquirer's trade name under a franchise agreement or rights to the acquirer's technology under a technology licensing agreement, hereinafter referred to as a "reacquired right") should be included as part of the business combination. The Task Force observed that if the contract giving rise to the reacquired right includes terms that are favorable or unfavorable when compared to pricing (for example, royalty rates) for current market transactions for the same or similar items, an entity should measure a settlement gain or loss as the lesser of (a) the amount by which the contract is favorable or unfavorable to market terms from the perspective of the acquirer or

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(b) the stated settlement provisions of the contract available to the counterparty to which the contract is unfavorable. Refer to the consensus in Issue 2 for additional guidance on the measurement of the settlement amount for the favorable or unfavorable terms or the settlement provisions of the contract.

The Task Force reached a consensus on Issue 4 that a reacquired right (which would exclude the amount recognized as a settlement gain or loss as a result of the application of the consensus in Issue 3) should be recognized as an intangible asset apart from goodwill. The Task Force observed that Statement 142 requires that the fair value of all identifiable intangibles, including trade name and technology assets, be separately valued when determining implied goodwill. For example, if an entity reacquires the right to its trade name in a certain geographic location, the entity should recognize the value of the reacquired trade name as either a separate intangible asset or a part of its recognized trade name. The entity is not required to allocate the cash flows associated with its trade name to separate assets that represent other geographic locations in Step 2 of the goodwill impairment test.

The Task Force reached a consensus on Issue 5 that a settlement gain or loss should be recognized in conjunction with the effective settlement of a lawsuit (including threatened litigation) or executory contract in a business combination, unless otherwise specified in existing authoritative literature. The Task Force observed that the amount recognized as a settlement gain or loss in the acquirer's consolidated statement of operations may differ from the amount measured in cases in which the acquirer had previously recognized an amount in its financial statements related to the preexisting relationship. The Task Force also observed that the effective settlement of a lawsuit in a business combination should be measured at fair value.

3.62 See **12.11** for discussion of disclosures required for business combinations between parties with a preexisting relationship as required by Issue 04-1.

Settlement of Disputes With the Former Owners Over a Business Combination

3.63 In a business combination, disputes may arise between the acquiring entity and the former owners, resulting in amounts transferred between the parties after the consummation. Questions arise about whether, in accounting for such subsequent payments, the acquiring entity should reflect the amount paid or received as an adjustment to the cost of the acquired entity or as an income statement item. At the 2003 AICPA National Conference on Current SEC Developments, an SEC staff member (Randolph P. Green), in prepared remarks, indicated that "we have generally concluded that legal claims between an acquirer and the former owners of an acquired business should be reflected in the income statement when settled." As support for this view, Mr. Green cited paragraph B177 of Statement 141, which provides that "contingencies

related to litigation over the acquisition” are not preacquisition contingencies. Mr. Green did, however, offer that treatment of such a payment by the acquirer as an adjustment to the cost of the acquisition may be warranted when there is a “clear and direct link to the purchase price.” Mr. Green gave the following example:

[A]ssume a purchase agreement explicitly sets forth the understanding that each “acquired customer” is worth \$1,000, that not less than one thousand customers will be transferred as of the consummation date, and subsequent litigation determines that the actual number of acquired customers was only nine hundred. The effects of the litigation should properly be reflected as part of the purchase price. In contrast, if the purchase agreement obligates the seller to affect its best efforts to retain customers through the consummation date and litigation subsequently determines that the seller failed to do so, the effects are not clearly and directly linked to the purchase price and, accordingly, should be reflected in the income statement.

Note: While not stated by Mr. Green in the above example, if the buyer had incurred legal costs to settle the dispute or if the settlement amount had included reimbursement to the sellers for legal costs or other damages, those amounts would not have had a “clear and direct link to the purchase price” and thus should have been reflected in the income statement.

3.64 As an alternative to the example cited in **3.63**, Mr. Green noted in prepared remarks that “claims that assert one party misled the other or that a provision of the agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the purchase price and, therefore, should be reflected in the income statement.”

Settlement Disputes With the Shareholders of the Acquiring Entity Over a Business Combination

3.65 In connection with a business combination, shareholders of the acquiring entity may bring a claim against the acquiring entity asserting any number of items, such as that the acquiring entity overpaid for the acquisition. Costs incurred for such disputes, including any settlement amount if paid, represent income statement items for the acquiring entity and not a cost of the acquired entity. This view is consistent with an additional statement from the prepared remarks cited above from SEC staff member Randolph P. Green (see **3.63–3.64**). Referring to settlements of litigation over purchase price, Mr. Green stated that “the cost of litigation brought by the acquirer’s shareholders should always be reflected in the income statement.”

Section 4 — Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed — General

4.00 Paragraph 35 of Statement 141 states, in part:

[A]n acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition (refer to paragraph 48). Prior to that allocation, the acquiring entity shall (a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20–23 and (b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity.

Date of Acquisition

4.01 Paragraph 48 of Statement 141 states:

The date of acquisition (also referred to as the acquisition date) ordinarily is the date assets are received and other assets are given, liabilities are assumed or incurred, or equity interests are issued. However, the parties may, for convenience, designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated. The designated date should ordinarily be the acquisition date for accounting purposes if a written agreement provides that effective control of the acquired entity is transferred to the acquiring entity on that date without restrictions except those required to protect the shareholders or other owners of the acquired entity, such as restrictions on significant changes in the operations, permission to pay dividends equal to those regularly paid before the effective date, and the like. Designating an effective date other than the date assets or equity interests are transferred or liabilities are assumed or incurred requires adjusting the cost of an acquired entity and net income otherwise reported to compensate for recognizing income before consideration is transferred. The cost of an acquired entity and net income shall therefore be reduced by imputed interest at an appropriate current rate on assets given, liabilities assumed or incurred, or preferred shares distributed as of the transfer date to acquire the entity.

4.02 Paragraph 49 of Statement 141 states the following requirement:

The cost of an acquired entity and the amounts assigned to the assets acquired and liabilities assumed shall be determined as of the date of acquisition. The statement of income of an

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acquiring entity for the period in which a business combination occurs shall include the income of the acquired entity after the date of acquisition by including the revenue and expenses of the acquired entity based on the cost to the acquiring entity.

Documentation at Date of Acquisition

4.03 Paragraph 50 of Statement 141 provides that “[t]he provisions of Statement 142 require that the assets acquired and liabilities assumed in a business combination that meet certain criteria, including goodwill, be assigned to a **reporting unit** as of the date of acquisition. For use in making those assignments, the basis for and method of determining the purchase price of an acquired entity and other related factors (such as the underlying reasons for the acquisition and management’s expectations related to dilution, synergies, and other financial measurements) shall be documented at the date of acquisition.”

Allocation Period

4.04 Appendix F of Statement 141 defines the term “allocation period” as:

The period that is required to identify and measure the fair value of the assets acquired and the liabilities assumed in a business combination. **The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable.** Thus, the existence of a preacquisition contingency for which an asset, a liability, or an impairment of an asset cannot be estimated does not, of itself, extend the allocation period. Although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination. [Emphasis added]

4.05 While the definition provides that “the allocation period should usually not exceed one year from the consummation of a business combination,” except for the items specifically addressed in Statement 141, adjustments to allocated amounts beyond a one-year period are expected to be rare.

4.06 As indicated in **4.00**, paragraph 35 of Statement 141 requires that “[a]n acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition.” Accordingly, the existence of an allocation period is not intended to result in the reflection of events occurring after the acquisition date in the allocation of the cost of the acquired entity. Instead, the effects of events occurring subsequent to the date of acquisition should be included in the determination of net income in the period in which the adjustment is determined.

Provisional Measurement of Assets Acquired and Liabilities Assumed

4.07 Because of the complexity of completing certain purchase price allocations, the proximity of the consummation date of the business combination to the acquiring entity's next reporting date, or both, the assignment of amounts to some assets acquired and liabilities assumed by the acquiring entity may not be complete by the acquiring entity's next reporting date, thus necessitating the reporting of provisional measurements. Under APB Opinion No. 16, *Business Combinations*, and APB Opinion No. 17, *Intangible Assets*, adjustments to provisional measurements generally represented movement from one amortizing asset to another (e.g., from fixed assets to goodwill, or vice versa). The financial statement impact caused by such adjustments was thus mitigated, especially in cases in which both of the assets adjusted had similar expected useful lives and similar methods of amortization. Because of the existence of nonamortizing goodwill and the potential for other nonamortizing intangible assets, the financial statement impact of adjustments to provisional measurements under Statement 141 and Statement 142 may be more significant. If financial statements are issued before the allocation of the purchase price is complete, general disclosure of the provisional nature of the allocation would need to be made along with the time when the allocation process is expected to be complete. In addition, specific disclosure would be expected regarding the item or items for which future adjustment to the provisional measurement may occur. If there is no disclosure to the contrary, the purchase price allocation may be presumed to be complete.

4.08 Statement 141 is silent as to how adjustments to provisional measurements are to be reported. Provided that the provisional measurement was appropriately prepared on the basis of all information then available, the adjustment is generally accounted for as a change in accounting estimate. Paragraph 19 of FASB Statement No. 154, *Accounting Changes and Error Corrections*, provides that "[a] change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods."

Fair Value Measurements — General

4.09 As noted in **5.00**, paragraph 37 of Statement 141 provides general guidance on assigning amounts to assets acquired and liabilities assumed, except goodwill. That guidance, as noted in paragraph B100 of Statement 141, was carried forward from

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Opinion 16 without reconsideration, with the Board recognizing “that some of that guidance may be inconsistent with the term *fair value* as defined in this Statement.” Paragraph B100 provides that “[t]he Board decided, however, that it would consider those inconsistencies in a separate project on issues related to the application of the purchase method.” (See **Section 14 — Comparison of Statement 141 to FASB Proposed Replacement.**)

4.10 Paragraph 1 of FASB Statement No. 157, *Fair Value Measurements*, provides that “[t]his Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this Statement simplifies and codifies related guidance within generally accepted accounting principles (GAAP).” The summary section of Statement 157 indicates:

Prior to this Statement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that required fair value measurements. Differences in that guidance created inconsistencies that added to the complexity in applying GAAP. In developing this Statement, the Board considered the need for increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements.

4.11 Paragraph 36 of Statement 157 provides that “[t]his Statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year.” The summary section of Statement 157 indicates that “this Statement does not require any new fair value measurements.” Thus, Statement 157 does not alter the guidance in Statement 141 (see **4.09**) that provides for the assignment of amounts in the allocation of the cost of an acquisition in a manner that differs from fair value.

4.12 The summary section of Statement 157 provides that “[t]he changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.” Although not effective until the dates noted in **4.11**, Statement 157’s provisions regarding valuation techniques offer useful guidance on the measurement of fair value in the interim. Specifically, paragraph 18 of Statement 157 provides that valuation techniques used to measure fair value should be consistent with the market approach, income approach, and cost approach. Key aspects of those approaches, as summarized in paragraph 18 of Statement 157, are as follows:

- a. Market approach.** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.
- b. Income approach.** The 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. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques [footnote omitted]; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets. [Footnote 10]
- c. Cost approach.** The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

Footnote 10 provides that the "use of the multiperiod excess earnings method to measure the fair value of in-process research and development is discussed in AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries.*"

Fair Value Measurements — Tax Amortization Benefits

4.13 Paragraphs 127–129 of FASB Statement No. 109, *Accounting for Income Taxes*, provide the following guidance:

- 127. Values are assigned to identified assets and liabilities when a business combination is accounted for as a purchase. The assigned values frequently will be different from the tax bases of those assets and liabilities. The Board concluded that a liability or asset should be recognized for the deferred tax consequences of differences between the

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assigned values and the tax bases of the assets and liabilities (other than nondeductible goodwill and leveraged leases) recognized in a purchase business combination.

128. The Board considered and rejected the approach that assigns net-of-tax values to those assets and liabilities. That approach mixes the normal amounts of expenses and revenues with their tax effects and thereby confuses the relationship between various items on the statement of earnings in subsequent years. For example, the relationship between sales and cost of sales is affected if cost of sales includes amounts that reflect the net-of-tax values assigned to acquired inventory or depreciable assets. Likewise, the relationship between pretax income from continuing operations and income tax expense is affected to the extent that pretax income from continuing operations includes any net-of-tax amounts.
129. Paragraph 89 of Opinion 16 stated that “. . . the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for income taxes.” The Board believes that the net result is the same whether amounts assigned to the individual assets acquired and liabilities assumed are pretax or net-of-tax. For example, assume (a) that the pretax market or appraisal value of depreciable assets acquired in a purchase business combination is \$1,000, (b) that the tax basis of those assets is zero, and (c) that the enacted tax rate is 40 percent for all years. If net-of-tax, the assigned value of those assets would be \$600. If pretax, the assigned value of those assets would be \$1,000, and there would be a \$400 deferred tax liability. Under either approach, the net result of allocating the purchase price is the same. The Board concluded that the amounts assigned to assets and liabilities in a purchase business combination should not be net of any related deferred tax liability or asset.

4.14 The appropriate treatment of tax amortization benefits in the measurement of fair value of an asset was addressed at the 2006 AICPA National Conference on Current SEC and PCAOB Developments; an SEC staff member (Cheryl Tjon-Hing), in prepared remarks, indicated the following:

Tax amortization benefits (TAB) represents, as its name implies, the cash flow generated to an owner of an asset as a result of being able to write-off the full fair value of that asset for tax purposes — generally, this benefit may impact a fair value conclusion, derived using an income approach, by as much as 20% to 30%. Now, it seems logical that the fair value of an asset should not change just because of the way a transaction is structured. So TABs should be taken into account, in determining asset fair values, no matter what the tax attributes of a transaction are. But for those requiring more specific guidance, FAS 109, paragraph A129 [footnote 2] implicitly states that TABs should be factored into an asset's fair value. To the extent that a portion of the step-up value is not deductible for tax purposes, that is what deferred tax liabilities are for. In fact, preparers of fair value measurements should be aware that if a TAB is not factored into the fair value of an asset, there may be a mismatch if any associated deferred tax liability is recorded, for accounting purposes, in an acquisition transaction. Now, despite the aforementioned accounting guidance, we often see that TABs are excluded from asset fair values measured for business combinations effected through a purchase of shares — usually, this is because preparers argue that any step-up in fair value over tax value is not deductible for tax purposes.

Footnote 2 refers to paragraph A129 of Statement 109.

4.15 Sections 5.3.97–.108 of the AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*, illustrate the requirements of paragraphs 127–129 of Statement 109 (see **4.13**) in the context of applying the multiperiod excess earnings method in estimating the fair value of intangible assets acquired for use in R&D activities, including specific in-process R&D projects, for purposes of allocating purchase price pursuant to Statement 141.

Fair Value Measurements in Business Combinations and Impairment Tests

4.16 The summary section of Statement 157 states, in part:

The definition of fair value retains the exchange price notion in earlier definitions of fair value. This Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

4.17 The summary section of Statement 157 further provides that “[t]his Statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability.”

4.18 On October 23, 2006, the FASB issued for comment proposed FASB Staff Position (FSP) No. FAS 141-b, 142-e, and 144-b, “Fair Value Measurements in Business Combinations and Impairment Tests.” Paragraph 2 of the proposed FSP stated, in part:

During the process of finalizing Statement 157, the Board became aware of diversity in practice about measurements of nonfinancial assets that are required to be measured at fair value in business combinations and impairment tests. This diversity primarily relates to the circumstances in which a reporting entity uses entity-specific assumptions, rather than the assumptions of market participants, in a fair value measurement. Diversity in practice also arose related to the appropriate measurement attribute for certain assets acquired and liabilities assumed in a business combination. The FASB staff identified certain wording in Statements 141, 142, and 144 that may have contributed to this diversity, which is described

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in the following paragraphs. As a result, this FSP is intended to serve as an interim measure to clarify the current requirements for fair value measurements under those Statements until Statement 157 is adopted by the reporting entity.

4.19 On December 13, 2006, the FASB met to decide whether to issue a final FSP. After analyzing comment letters received during the exposure period of the proposed FSP, the Board voted not to issue the proposed FSP and to remove this project from its agenda.

Use of the Residual Method to Value Assets Acquired Other Than Goodwill

4.20 EITF Topic No. D-108, "Use of the Residual Method to Value Acquired Assets Other Than Goodwill," states, in part:

The SEC staff is aware of instances in which registrants have asserted that certain intangible assets that arise from legal or contractual rights cannot be separately and directly valued (hereinafter referred to as a "direct value method") because the nature of the particular asset makes it fundamentally indistinguishable from goodwill in a business combination (for example, cellular/spectrum licenses, cable franchise agreements, and so forth). Accordingly, some have applied a policy of assigning purchase price to all other identifiable assets and liabilities as provided in Statement 141, with the remaining residual amount being allocated to the "indistinguishable" intangible asset. In those instances, there is either no goodwill recognized or the amount of goodwill recognized uses a technique other than the one specified in paragraph 43 of Statement 141 [such as an attempt to directly measure some components of goodwill]. These methods have been referred to as "the residual method" of valuing intangible assets and have been used in the telecommunications, broadcasting, and cable industries. Similar methods were used to allocate purchase price in acquisitions under APB Opinion No. 16, *Business Combinations*.

4.21 Topic D-108 also indicates:

The SEC staff believes that the residual method does not comply with the requirements of Statement 141. Paragraph 37(e) of Statement 141 requires intangible assets that meet the recognition criteria to be recorded at fair value. Paragraph 43 of Statement 141 states that "the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill." The SEC staff notes that a fundamental distinction between other recognized intangible assets and goodwill is that goodwill is both defined and measured as an excess or residual asset,

while other recognized intangible assets are required to be measured at fair value. The SEC staff does not believe that the application of the residual method to the valuation of intangible assets can be assumed to produce amounts representing the fair values of those assets. The SEC staff also notes that valuation difficulty does not provide relief from the requirements in paragraphs 37(e) and 39 of Statement 141 to separately recognize intangible assets at fair value apart from goodwill. Furthermore, the SEC staff notes that the same types of assets being valued using the residual method by some entities are being valued using a direct value method by other entities. Accordingly, the SEC staff believes the residual method should no longer be used to value intangible assets other than goodwill. Rather, a direct value method should be used to determine the fair value of all intangible assets required to be recognized under Statement 141. Impairment testing of intangible assets similarly should not rely on a residual method and should, instead, comply with the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

4.22 Furthermore, Topic D-108 provides:

Registrants should apply a direct value method to such assets acquired in business combinations completed after September 29, 2004. Further, registrants who have applied the residual method to the valuation of intangible assets for purposes of impairment testing shall perform an impairment test using a direct value method on all intangible assets that were previously valued using the residual method by no later than the beginning of their first fiscal year beginning after December 15, 2004. Impairments of intangible assets recognized upon application of a direct value method by entities previously applying the residual method should be reported as a cumulative effect of a change in accounting principle. Related deferred tax effects should also be reported as part of the cumulative effect of a change in accounting principle. Reclassification of recorded balances between goodwill and intangible assets immediately prior to adoption of this SEC staff announcement is prohibited. Early adoption of a direct value method is encouraged.

Use of a Third-Party Specialist to Assist in the Measurement of Fair Value

4.23 An important decision an entity must make when measuring the fair value of assets acquired and liabilities assumed is whether to use the assistance of a third-party specialist. Whether a fair value measurement is prepared entirely by the entity or with the assistance of a third-party specialist, the level of evidence needed to support that measurement is expected to be similar.

Section 5 — Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed (Other Than Intangible Assets)

5.00 Paragraph 37 of Statement 141 provides general guidance on assigning amounts to assets acquired and liabilities assumed, except goodwill. That guidance, as noted in paragraph B100 of Statement 141, was carried forward from Opinion 16 without reconsideration, with the Board recognizing that “some of that guidance may be inconsistent with the term *fair value* as defined in this Statement.” Paragraph B100 provides that “[t]he Board decided, however, that it would consider those inconsistencies in the separate project on issues related to the application of the purchase method.” (See **Section 14 — Comparison of Statement 141 to FASB Proposed Replacement.**)

Marketable Securities

5.01 Paragraph 37(a) of Statement 141 provides that marketable securities are to be assigned amounts “at fair values.”

5.02 The classification of debt and equity securities as held-to-maturity, trading, or available-for-sale is based on the intention of the acquiring entity without consideration of the classification by the acquired entity. Even if the acquiring entity’s classification of a particular security as available-for-sale is consistent with that of the acquired entity, no amount of unrealized holding gains or losses is reported as of the acquisition date.

Receivables

5.03 Paragraph 37(b) of Statement 141 provides that receivables are to be assigned amounts “at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.”

5.04 As indicated in the summary section of AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, the “SOP prohibits ‘carrying over’ or creation of valuation allowances in the initial accounting of all loans

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acquired in a transfer that are within the scope of this SOP. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination.” The scope of SOP 03-3, on the basis of how the term “loan” is defined in its glossary, appears to exclude receivables with terms of less than one year.

5.05 Although it specifically describes the combination of two banks, SEC Staff Accounting Bulletin Topic 2.A.5, “Adjustments to Allowances for Loan Losses in Connection With Business Combinations,” is considered to be broadly applicable. SAB Topic 2.A.5 gives the following example:

Facts: Bank A acquires Bank B in a business combination.

Question: Are there circumstances in which it is appropriate for Bank A, in assigning acquisition cost to the loan receivables acquired from Bank B, to adjust Bank B’s carrying value for those loans not only to reflect appropriate current interest rates, but also to reflect a different estimate of uncollectibility? [Footnote omitted]

Interpretive Response: Needed changes in allowances for loan losses are ordinarily to be made through provisions for loan losses rather than through purchase accounting adjustments. Except in the limited circumstances discussed below, where Bank A has plans for ultimate recovery of loans acquired from Bank B that are demonstrably different from plans that had served as the basis for Bank B’s estimate of loan losses, purchase accounting adjustments reflecting different estimates of uncollectibility may raise questions from the staff as to: (a) the reasonableness of the preacquisition allowance for loan losses recorded by Bank B, or (b) whether the adjustments will have a distortive effect on current or future period financial statements of Bank A. Similar questions may be raised by the staff regarding significant changes in allowances for loan losses that are recorded by a bank shortly before it is acquired.

Estimation of probable loan losses involves judgment, and Banks A and B may differ in their systematic approaches to such estimation. Nevertheless, assuming that appropriate methodology (i.e., giving due consideration to all relevant facts and circumstances affecting collectibility) is followed by each bank, the staff believes that each bank’s estimate of the uncollectible portion of Bank B’s loan portfolio should fall within a range of acceptability. That is, the staff believes that the uncollectible portion of Bank B’s loans as estimated separately by the two banks ordinarily should not be different by an amount that is material to the financial statements of Bank B and, therefore, an adjustment to the net carrying value of Bank B’s loan portfolio at the acquisition date to reflect a different estimate of uncollectibility ordinarily would be unnecessary and inappropriate.

However, a purchase accounting adjustment to reflect a different estimate of uncollectibility may be appropriate where Bank A has plans regarding ultimate recovery of certain acquired loans demonstrably different from the plans that had served as the basis

for Bank B's estimation of losses on those loans. [Footnote 2] In such circumstances, Bank B's estimate of uncollectibility for those certain loans may be largely or entirely irrelevant for purposes of determining the net carrying value at which those loans should be recorded by Bank A. For example, if Bank B had intended to hold certain loans to maturity but Bank A plans to sell them, the acquisition cost allocated to those loans should equal the value that currently could be obtained for them in a sale. [Footnote 3] In that case, Bank A would report those loans as assets held for sale rather than as part of its loan portfolio, and would report them in postacquisition periods at the lower of cost or market value until sold.

The staff does not intend to suggest that an acquiring bank should record acquired loans at an amount that reflects an unreasonable estimate of uncollectibility. If Bank B's financial statements as of the acquisition date are not fairly stated in accordance with generally accepted accounting principles because of an unreasonable allowance for loan losses, that allowance for loan losses should not serve as a basis for recording the acquired loans. Rather, Bank B's preacquisition financial statements should be restated to reflect an appropriate allowance, with the resultant adjustment being applied to the restated preacquisition income statement of Bank B for the period(s) in which the events or changes in conditions that gave rise to the needed change in the allowance occurred.

Footnote 2 states, "A bank's plans for recovering the net carrying value of certain individual loans or groups of loans may differ from its plans regarding other loans. The plan for recovering the net carrying value of a loan might be, for example, (a) holding the loan to maturity, (b) selling it, or (c) foreclosing on the collateral underlying the loan. The assigned value of loans" should be based on the plan for recovery."

Footnote 3 states, "It is not acceptable to recognize losses on loans that are due to concerns as to ultimate collectibility through a purchase accounting adjustment, nor is it acceptable to report such losses as 'loss on sale.' An excess of carrying value of Bank B's loans over their market value at the acquisition date that is due to concerns as to ultimate collectibility should have been recognized by Bank B through its provision for loan losses."

Inventories

5.06 When assigning amounts to inventory, the acquiring entity in future periods should recognize only profits associated with value added to the acquired inventory after the acquisition date. Paragraph 37(c) of Statement 141 provides the following general guidance on assigning amounts to inventory on the basis of its class:

- (1) Finished goods and merchandise at estimated selling prices less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiring entity

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- (2) Work in process at estimated selling prices of finished goods less the sum of (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit allowance for the completing and selling effort of the acquiring entity based on profit for similar finished goods
- (3) Raw materials at current replacement costs

5.07 Generally, it is not appropriate to assign the acquired entity's carrying value to the cost of acquired finished goods and merchandise and work-in-process inventories because the acquired entity's carrying value does not reflect the manufacturing profit. Manufacturing profit as of the acquisition date should be considered part of the value assigned to the inventory.

5.08 Raw materials should be valued at replacement cost as of the date of the acquisition because no value has been added to them through manufacturing or holding.

LIFO Inventories

5.09 Paragraph 37(c) of Statement 141 requires that fair value be assigned to the inventories on the basis of the nature of the inventory. This requirement applies to all inventories regardless of the method of accounting for inventories by the acquiring entity or the acquired entity. Accordingly, inventories accounted for under the last-in, first-out (LIFO) method by the acquired entity should be valued at the acquisition date in accordance with the provisions of Statement 141. Carryover of the acquired entity's LIFO-basis inventories for book purposes is not permitted.

Mining Assets

5.10 EITF Issue No. 04-3, "Mining Assets: Impairment and Business Combinations," provides that "[t]his Issue applies to mining entities. Mining entities include entities involved in finding and removing wasting natural resources — other than oil- and gas-producing entities that are within the scope of Statement 19." Issue 04-3 states, in part:

Economic value exists in a mining asset beyond the value attributable to *proven* and *probable* reserves. Industry Guide 7 defines proven and probable reserves [footnote omitted] as follows:

- (1) *Proven Reserves*. Reserves for which (a) quantity is computed from dimensions revealed in outcrops, trenches, workings or drill holes; grade and/or quality are computed from the results of detailed sampling and (b) the sites for inspection, sampling, and measurement are spaced so closely and the geologic character is so well defined that size, shape, depth, and mineral content of reserves are well-established.
- (2) *Probable Reserves*. Reserves for which quantity and grade and/or quality are computed from information similar to that used for proven reserves, but the sites for inspection,

sampling, and measurement are farther apart or are otherwise less adequately spaced. The degree of assurance, although lower than that for proven (measured) reserves, is high enough to assume continuity between points of observation.

As indicated in the above definitions, the distinction between categories of reserves relates to the level of geological evidence and, therefore, confidence in the reserve estimates. In addition to geological evidence, the SEC requires that an economic feasibility study be completed before mining assets are considered proven and probable reserves.

5.11 In Issue 04-3, the Task Force addressed and reached a consensus on the following issues related to the allocation of the purchase price of a business combination to mining assets:

Issue 1(a) — Whether VBPP [value beyond proven and probable reserves] should be considered when an entity allocates the purchase price of a business combination to mining assets

Issue 1(b) — Whether the effects of anticipated fluctuations in the future market price of minerals should be considered when an entity allocates the purchase price of a business combination to mining assets

The Task Force reached a consensus on Issue 1(a) that an entity should include VBPP in the value allocated to mining assets in a purchase price allocation to the extent that a market participant would include VBPP in determining the fair value of the asset.

On Issue 1(b), the Task Force reached a consensus that an entity should include the effects of anticipated fluctuations in the future market price of minerals in determining the fair value of mining assets in a purchase price allocation in a manner that is consistent with the expectations of marketplace participants. Generally, an entity should consider all available information including current prices, historical averages, and forward pricing curves. Those marketplace assumptions typically should be consistent with the acquiring enterprise's operating plans with respect to developing and producing minerals. The Task Force observed that it generally would be inappropriate for an entity to use a single factor, such as the current price or a historical average, as a surrogate for estimating future prices without considering other information that a market participant would consider.

Plant and Equipment

5.12 Paragraph 37(d) of Statement 141 provides the following general guidance on assigning amounts to plant and equipment:

- (1) To be used, at the current replacement cost for similar capacity [footnote 12] unless the expected future use of the assets indicates a lower value to the acquiring entity
- (2) To be sold, at fair value less cost to sell

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Footnote 12 states, "Replacement cost may be determined directly if a used-asset market exists for the assets acquired. Otherwise, the replacement cost should be estimated from the replacement cost new less estimated accumulated depreciation."

5.13 The amounts assigned to plant and equipment represent a new cost basis; therefore, accumulated depreciation should not be established at the date of the acquisition.

5.14 When evaluating whether an acquired long-lived asset should be classified for measurement purposes as "to be sold," one should consult paragraph 32 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which provides that "[a] long-lived asset (disposal group) that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 30(d) is met (except as permitted by paragraph 31) and any other criteria in paragraph 30 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months)." Paragraph 30 of Statement 144 states, in part:

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). [Reference to examples omitted]
- 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, [footnote 18] and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 31. [Reference to example omitted]
- e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- 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.

Footnote 18 states, "The term *probable* is used consistent with the meaning associated with it in paragraph 3(a) of FASB Statement No. 5, *Accounting for Contingencies*, and refers to a future sale that is 'likely to occur.'"

5.15 When determining the cost to sell for plant and equipment to be sold, one should refer to the following guidance from paragraph 35 of Statement 144:

Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is classified as held for sale. [Footnote omitted] If the sale is expected to occur beyond one year as permitted in limited situations by paragraph 31, the cost to sell shall be discounted.

Other Assets

5.16 Paragraph 37(f) of Statement 141 requires that other assets, including land, natural resources, and nonmarketable securities be assigned amounts “at appraised values.”

Debt

5.17 Paragraph 37(g) of Statement 141 requires that accounts and notes payable, long-term debt, and other claims payable be assigned amounts “at present values of amounts to be paid determined at appropriate current interest rates.”

5.18 Paragraph 2 of EITF Issue No. 98-1, “Valuation of Debt Assumed in a Purchase Business Combination,” states:

[P]rovisions of Opinion 16 [now Statement 141] have led to questions about whether the measurement objective for purposes of allocating a portion of the purchase price to debt assumed in a purchase business combination is fair value or some other value determined using a present value computation. Computing the present value of a liability's future cash flows can have objectives other than estimating the liability's fair value and, therefore, can result in amounts that differ significantly from fair value. For example, some debt obligations provide the issuer with a right to prepay the obligation before its stated maturity for a specified call premium. The fair value of that debt obligation would include the value of the issuer's prepayment option. However, some computations of present value would discount the contractual cash flows of the liability, ignoring the issuer's right to prepay.

5.19 Paragraph 3 of Issue 98-1 provides that “[t]he issue is whether the debt assumed in a purchase business combination should be assigned an amount equal to its fair value or some other value determined from the present value of contractual cash flows at the date of acquisition.” Paragraph 4 of Issue 98-1 states:

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The Task Force reached a consensus that the amount assigned to debt assumed in a purchase business combination should be its fair value. The Task Force noted that quoted market prices, if available, are the best evidence of the fair value of the debt. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of debt with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using the appropriate discount rate, [see footnote discussion in **5.20**] option pricing models, or matrix pricing models). Therefore, if a present value technique is used, the estimated future cash flows should not ignore relevant provisions of the debt agreement (for example, the right of the issuer to prepay).

5.20 Footnote 1 of Issue 98-1 states:

The appropriate discount rate [referred to in **5.19**] would be the current interest rate applicable to the credit standing of the acquiring (combined) entity. However, if the debt remains an obligation of the acquired entity only, and is not guaranteed or collateralized by the acquirer, then the rate would be the current interest rate applicable to the credit standing of the acquired entity alone.

Single-Employer Defined Benefit Pension Plan

5.21 Paragraph 37(h) of Statement 141 requires that “[a] liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation of a single-employer defined benefit pension plan, [be assigned] at amounts determined in accordance with paragraph 74 of FASB Statement No. 87, *Employers’ Accounting for Pensions*.”

5.22 Paragraph 74 of Statement 87 (as amended by FASB Statement No. 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans*) states:

When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit pension plan, the assignment of the purchase price to individual assets acquired and liabilities assumed shall include a liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation, thereby eliminating any previously existing net gain or loss, prior service cost or credit, or transition asset or obligation recognized in accumulated other comprehensive income. If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the projected benefit obligation.

5.23 See **5.37–5.38** for discussion of EITF Issue No. 96-5, “Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination.”

5.24 “Illustration 7 — Accounting for a Business Combination,” in paragraph 261 of

Statement 87, contains an example illustrating how the liability (or asset) recognized by the acquiring firm at the date of a business combination would be reduced in years after the date of the business combination.

5.25 While paragraph 74 of Statement 87 addresses the recognition of pension-related assets and liabilities in a business combination when the acquiring entity expects to terminate or curtail the plan of the acquired entity, Question 15 of FASB Staff Implementation Guide (Statement 87), “A Guide to Implementation of Statement 87 on Employers’ Accounting for Pensions: Questions and Answers,” addresses a fact pattern in which the acquired entity did not have a pension plan but in which the acquiring entity will grant the employees of the acquired entity credit for prior service in its pension plan. The accounting model provided in Question 15 is consistent with that in paragraph 87 of FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, with respect to evaluating the effects of improvements to the plan of the acquired entity (see **5.30**). Question 15, as amended by FASB Staff Position No. FAS 158-1, “Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides,” states:

Q — If the acquiring employer in a business combination accounted for in accordance with FASB Statement No. 141, *Business Combinations*, includes the employees of the acquired employer in its pension plan and grants them credit for prior service (the acquired employer did not have a pension plan), should the credit granted for prior service be treated as prior service cost and recognized in other comprehensive income or treated as part of the cost of the acquisition? [References omitted]

A — The answer to this question depends on an analysis of all the facts and circumstances surrounding the acquisition. If the acquiring employer’s granting of credit for prior service to the employees is required by the seller as part of the consummation of the acquisition, then it should be considered as part of the cost of the acquisition. Otherwise, the credit granted for prior service should be accounted for as a retroactive plan amendment.

If the credit granted for prior service is considered part of the cost of the acquisition, the debit offsetting the increase in the projected benefit obligation should be an adjustment of the goodwill otherwise determined for the acquisition. If the credit granted for prior service is accounted for as a retroactive plan amendment, the prior service cost is recognized in other comprehensive income and subject to amortization as specified in paragraphs 24–27. The effects of the alternatives on the balance sheet, income statement, and other comprehensive income could differ.

Multiemployer Pension Plans

5.26 Paragraph 67 of Statement 87 states, in part:

For purposes of this Statement, a **multiemployer plan** is a pension plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

5.27 Paragraph 70 of Statement 87 indicates:

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of FASB Statement No. 5, *Accounting for Contingencies*, shall apply.

5.28 Paragraph 253 of Statement 87 states:

The Board also decided to avoid possible ambiguity and future diversity in practice by clarifying how Opinion 16 should apply to a multiemployer plan situation. The Exposure Draft would have required recognition of a withdrawal liability when the employer is acquired in a business combination accounted for as a purchase. Based on respondents' comments, however, the Board concluded that no recognition of withdrawal liabilities should be required unless withdrawal under conditions that would result in a liability is probable. The Board was led to that conclusion by doubts about the reliability of the measure of the liability in other circumstances. The Board was not convinced that there is an obligation for future contributions to a multiemployer plan or that an estimated withdrawal liability would provide useful information about such an obligation, absent a probable withdrawal.

Single-Employer Defined Benefit Postretirement Plan

5.29 Paragraph 37(i) of Statement 141 provides that "[a] liability for the accumulated postretirement benefit obligation in excess of the fair value of plan assets or an asset for the fair value of the plan assets in excess of the accumulated postretirement benefit obligation of a single-employer defined benefit postretirement plan [be assigned] at amounts determined in accordance with paragraphs 86–88 of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*."

5.30 Paragraphs 86–88 of Statement 106 (as amended by Statement 158) state:

When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit postretirement plan, the assignment of the purchase price to

individual assets acquired and liabilities assumed shall include a liability for the accumulated postretirement benefit obligation in excess of the fair value of the plan assets or an asset for the fair value of the plan assets in excess of the accumulated postretirement benefit obligation. The accumulated postretirement benefit obligation assumed shall be measured based on the benefits attributed by the acquired entity to employee service prior to the date the business combination is consummated, adjusted to reflect (a) any changes in assumptions based on the purchaser's assessment of relevant future events (as discussed in paragraphs 23–42) and (b) the terms of the substantive plan (as discussed in paragraphs 23–28) to be provided by the purchaser to the extent they differ from the terms of the acquired entity's substantive plan.

If the postretirement benefit plan of the acquired entity is amended as a condition of the business combination (for example, if the change is required by the seller as part of the consummation of the acquisition), the effects of any improvements attributed to services rendered by the participants of the acquired entity's plan prior to the date of the business combination shall be accounted for as part of the accumulated postretirement benefit obligation of the acquired entity. Otherwise, if improvements to the postretirement benefit plan of the acquired entity are not a condition of the business combination, credit granted for prior service shall be recognized as a plan amendment as discussed in paragraphs 50–55. If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the accumulated postretirement benefit obligation. Otherwise, no future changes to the plan shall be anticipated.

As a result of applying the provisions of paragraphs 86 and 87, any previously existing net gain or loss, prior service cost or credit, or transition obligation or transition asset remaining in accumulated other comprehensive income is eliminated for the acquired employer's plan.

Multiemployer Postretirement Benefit Plans

5.31 Paragraph 79 of Statement 106 states:

For purposes of this Statement, a **multiemployer plan** is a postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

5.32 Paragraph 83 of Statement 106 states:

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of FASB Statement No. 5, *Accounting for Contingencies*.

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5.33 Paragraph 387 of Statement 106 states:

The Board concluded that no recognition of additional liabilities for multiemployer plans should be required under Opinion 16 unless conditions exist that make an additional liability probable. The Board was not convinced that there ordinarily is an obligation for future contributions to a multiemployer plan or that recognition of any contractual withdrawal liability would provide useful information about such an obligation, absent a probable withdrawal.

Liabilities and Accruals

5.34 Paragraph 37(j) of Statement 141 provides that “[l]iabilities and accruals — such as accruals for warranties, vacation pay, and deferred compensation” are to be assigned amounts “at present values of amounts to be paid determined at appropriate current interest rates.”

5.35 SEC Staff Accounting Bulletin Topic 2.A.9, “Liabilities Assumed in a Business Combination,” provides the following example illustrating the assignment by the acquiring entity of amounts to liabilities assumed and a discussion of the appropriate accounting when that process results in a determination that the financial statements of the acquired entity as of the acquisition date are not fairly stated in accordance with GAAP because of an improperly recorded liability:

Facts: Company A acquires Company Z in a business combination. Company Z has recorded liabilities for contingencies such as product warranties and environmental costs.

Question: Are there circumstances in which it is appropriate for Company A to adjust Company Z’s carrying value for these liabilities in the purchase price allocation?

Interpretive Response: Yes. Statement 141 requires that receivables, liabilities, and accruals be recorded in the purchase price allocation at their fair value, typically the present value of amounts to be received or paid, determined using appropriate current market interest rates. In some cases, fair value is readily determinable from contemporaneous arms-length transactions involving substantially identical assets or liabilities, or from amounts quoted by a third party to purchase the assets or assume the liabilities. More frequently, fair values are based on estimations of the underlying cash flows to be received or paid, discounted to their present value using appropriate current market interest rates.

The historical accounting by Company Z for receivables or liabilities may often be premised on estimates of the amounts to be received or paid. Amounts recorded by Company A in its purchase price allocation may be expected to differ from Company Z’s historical carrying values due, at least, to the effects of the acquirer’s discounting, including differences in interest rates. Estimation of probable losses and future cash flows involves judgment, and companies A and Z may differ in their systematic approaches to such estimation. Nevertheless, assuming that both companies employ a methodology that appropriately

considers all relevant facts and circumstances affecting cash flows, the staff believes that the two estimates of undiscounted cash inflows and outflows should not differ by an amount that is material to the financial statements of Company Z, unless Company A will settle the liability in a manner demonstrably different from the manner in which Company Z had planned to do so (for example, settlement of the warranty obligation through outsourcing versus an internal service department). But the source of other differences in the estimates of the undiscounted cash flows to be received or paid should be investigated and reconciled. If those estimates of undiscounted cash flows are materially different, an accounting error in Company Z's historical financial statements may be present, or Company A may be unaware of important information underlying Company Z's estimates that also is relevant to an estimate of fair value.

The staff is not suggesting that an acquiring company should record assumed liabilities at amounts that reflect an unreasonable estimate. If Company Z's financial statements as of the acquisition date are not fairly stated in accordance with GAAP because of an improperly recorded liability, that liability should not serve as a basis for recording assumed amounts. That is, the correction of a seller's erroneous application of GAAP should not occur through the purchase price allocation. Rather, Company Z's financial statements should be restated to reflect an appropriate amount, with the resultant adjustment being applied to the historical income statement of Company Z for the period(s) in which the trends, events, or changes in operations and conditions that gave rise to the needed change in the liability occurred. It would also be inappropriate for Company Z to report the amount of any necessary adjustment in the period just prior to the acquisition, unless that is the period in which the trends, events, or changes in operations and conditions occurred. The staff would expect that such trends, events, and changes would be disclosed in Management's Discussion and Analysis in the appropriate period(s) if their effect was material to a company's financial position, results of operations or cash flows.

In summary, the staff believes that purchase price adjustments necessary to record liabilities and loss accruals at fair value typically are required, while merely adding an additional "cushion" of 10 or 20 or 30 percent to such account balances is not appropriate. To arrive at those fair values, the undiscounted cash flows must be projected, period by period, based on historical experience and discounted at the appropriate current market discount rate.

Recognition of Liabilities in Connection With an Acquisition

5.36 Liabilities for costs to exit an activity of an acquired company, involuntarily terminate employees of an acquired company, or relocate employees of an acquired company are measured and included as a cost of the acquisition in accordance with the guidance in Issue 95-3 (see **3.51–3.59**).

Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination

5.37 EITF Issue No. 96-5, "Recognition of Liabilities for Contractual Termination

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Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination," evaluates a situation in which:

A company that has agreed to a business combination develops a plan to terminate certain employees. The plan will be implemented only if the combination is consummated, but the company assesses the likelihood of the combination to be probable. . . . When terminated, the employees will be entitled to termination benefits under a preexisting plan or contractual relationship. The termination of the employees also may affect the company's assumptions in estimating its obligations for pension benefits, other postretirement benefits, and postemployment benefits (that is, the termination of the employees may trigger curtailment losses or the recording of a contractual termination benefit).

5.38 Issue 96-5 provides that "[t]he issue is whether a liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination should be recognized when (1) it is probable that the business combination will be consummated or (2) the business combination is consummated." The Issue also indicates that "[t]he Task Force reached a consensus that the liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination should be recognized when the business combination is consummated."

Unfavorable Contracts

5.39 At the 2006 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member (Joseph B. Ucuzoglu), in prepared remarks, stated the following regarding measurement considerations related to unfavorable revenue contracts acquired in a purchase business combination:

At the date of a business combination, the terms of an acquired entity's in-process revenue contracts may be less favorable than the terms that could be realized in a current market transaction. In that circumstance, Statement 141 [footnote 1] may require an unfavorable contract liability to be recognized such that the rate of return reflected in the post-acquisition financial statements of the acquirer is equal to a market return for the acquirer's remaining performance effort.

One would generally expect that the contract terms originally negotiated between the acquired entity and its customer represented a market rate of return at the date the contract was entered into, because the transaction was consummated by a willing buyer and willing seller. Accordingly, an analysis of whether a contract is unfavorable at the acquisition date would usually focus on the intervening events and changes in circumstances that occurred during the period between contract consummation and the date of the acquisition. Absent intervening events or changes in circumstances, the staff can be expected to raise concerns

about an assertion that an acquired contract was in an unfavorable position. Importantly, when determining the current market rate of return for a similar contract, the assumptions utilized should reflect the amount at which an actual transaction could be consummated in a competitive bidding environment, not the list price that a vendor would use as a starting point in contract negotiations.

Footnote 1 refers to paragraph 37(c)(2) of Statement 141.

5.40 All contracts in place at the acquired entity require consideration of whether any contain a favorable or unfavorable element to recognize in purchase accounting. In **5.39**, considerations involving determinations of whether a revenue contract is unfavorable are discussed. For contracts with a favorable element, that favorable element represents an intangible asset with measurement “at estimated fair values,” which is consistent with the guidance in paragraph 37(e) of Statement 141 for all intangible assets. For contracts with an unfavorable element, that unfavorable element represents a liability or a balance sheet credit. Paragraph A24 of Statement 141 provides that “[i]f the terms of a contract give rise to a liability or commitment (which might be the case if the terms of an operating lease or customer contract are unfavorable relative to market prices), that liability or commitment shall be recognized as required by paragraph 37(k) of this Statement.” Paragraph 37(k) of Statement 141 provides for assigning amounts to other liabilities and commitments “at present values of amounts to be paid determined at appropriate current interest rates.”

5.41 Neither Statement 141 nor Statement 142 provides direct guidance on the subsequent accounting for amounts recognized in purchase accounting for favorable or unfavorable elements of contracts. In EITF Issue No. 03-17, “Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity’s Balance Sheet,” the Task Force was asked to consider the following issues:

Issue 1 — The appropriate method of amortization of an asset arising from an executory contract

Issue 2 — The appropriate method of derecognition for a balance sheet credit arising from an executory contract.

Issue 03-17 was removed from the EITF agenda without a consensus reached. With regard to Issue 1, we expect that amortization of assets arising from favorable elements of a contract will be amortized on the basis of the guidance for all intangible assets (see **9.28–9.32**). With regard to Issue 2, we expect that entities will develop a rational and supportable method of derecognition on the basis of the

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specific facts and circumstances. We do not believe it is appropriate to accrete the balance sheet credit after the initial measurement, since the nature of the underlying arrangement between the parties (an executory contract) does not reflect a borrowing or liability arrangement that would result in interest or accretion expense.

Income Taxes — General

5.42 Paragraph 38 of Statement 141 provides that “[a] deferred tax liability or asset shall be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of FASB Statement No. 109, *Accounting for Income Taxes*.”

5.43 Paragraph 30 of Statement 109 states:

A deferred tax liability or asset shall be recognized in accordance with the requirements of this Statement for differences between the assigned values and the tax bases of the assets and liabilities (except the portion of goodwill for which amortization is not deductible for tax purposes, unallocated excess over cost (also referred to as negative goodwill), leveraged leases, and acquired Opinion 23 differences [footnote omitted]) recognized in a purchase business combination (refer to paragraphs 259–272 for additional guidance). If a valuation allowance is recognized for the deferred tax asset for an acquired entity’s deductible temporary differences or operating loss or tax credit carryforwards at the acquisition date, the tax benefits for those items that are first recognized (that is, by elimination of that valuation allowance) in financial statements after the acquisition date shall be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

5.44 In assessing the impact of any change in the acquiring entity’s valuation allowances as a result of the business combination, one should consider the guidance in paragraph 266 of Statement 109, which states:

The tax law in some tax jurisdictions may permit the future use of either of the combining enterprises’ deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. If the combined enterprise expects to file a consolidated tax return, a deferred tax asset (net of a valuation allowance, if necessary) is recognized for deductible temporary differences or carryforwards of either combining enterprise based on an assessment of the *combined* enterprise’s past and expected future results of operations as of the acquisition date. This either reduces goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creates or increases negative goodwill.

Effect of a Subsequent Change in Tax Regulations

5.45 In EITF Issue No. 99-15, “Accounting for Decreases in Deferred Tax Asset Valuation Allowances Established in a Purchase Business Combination as a Result of a Change in Tax Regulations,” the Task Force considered whether “the effect of a change in tax law or regulation that results in a decrease in a valuation allowance that initially was recorded in the allocation of the purchase price in a purchase business combination should be included in income from continuing operations pursuant to paragraph 27 of Statement 109 or as an adjustment to the purchase price allocation pursuant to paragraph 30 of Statement 109.”

Issue 99-15 indicates:

The Task Force reached a consensus that the effect of a change in tax law or regulation that results in a decrease in a valuation allowance that initially was recorded in the allocation of the purchase price in a purchase business combination should be included in income from continuing operations pursuant to paragraph 27 of Statement 109. The consensus applies to any reduction in the valuation allowance that otherwise would not have been recognized except for the change in tax law or regulation, regardless of whether the valuation allowance is reduced in the period of the tax law change or in a subsequent period.

Uncertainties Related to Income Taxes in a Business Combination

5.46 EITF Issue No. 93-7, “Uncertainties Related to Income Taxes in a Purchase Business Combination,” states, in part:

A number of uncertainties related to income taxes may exist at the time of or arise in connection with a purchase business combination. Examples include uncertainties about the allocation of the purchase price to individual assets and liabilities for income tax purposes in a taxable business combination, uncertainties about the carryover bases of assets, liabilities, and carryforwards at the date of acquisition in a nontaxable combination, or uncertainties about tax returns of the acquired company for periods prior to the acquisition date.

Statement 38 provides that the fair value of a preacquisition contingency that can be determined during the allocation period is included in the purchase price allocation. Adjustments from a preacquisition contingency that occur after the end of the allocation period are included in the determination of net income. Statement 38 did not apply to the potential tax benefits of an acquired loss carryforward. The amending language of Statement 109 indicates that Statement 38 “does not apply to potential income tax effects of (a) temporary differences and carryforwards of the acquired enterprise that exist at the acquisition date and (b) income tax uncertainties related to the acquisition (for example, an uncertainty related to the tax basis of an acquired asset that will ultimately be agreed to by the taxing authority) or adjustments that result from realization of those benefits.” Footnote 2 of Statement 38 was amended to indicate that the potential income tax effects of those items should be accounted for in accordance with Statement 109.

5.47 In Issue 93-7, the Task Force addressed whether the guidance on preacquisition contingencies applies to income tax uncertainties and, if not, how income tax uncertainties should be accounted for under Statement 109. The following is the Issue 93-7 discussion of this issue:

The Task Force reached a consensus that all income tax uncertainties that exist at the time of or arise in connection with a purchase business combination should be accounted for pursuant to Statement 109 rather than Statement 38. Further, the Task Force reached a consensus that the guidance contained in question 17 of the Special Report on Statement 109 should be applied to changes in estimates and final settlements of all income tax uncertainties that predate or result from a purchase business combination with the exception of uncertainties related to the valuation allowance of a deferred tax asset. The Task Force observed that this consensus does not apply to changes in judgment about the realization of deferred tax assets because paragraphs 26 and 30 of Statement 109 provide guidance for changes in a valuation allowance related to an acquired deductible difference or carryforward. Further, the Task Force noted that the requirement in paragraph 30 for reduction of a valuation allowance established at the acquisition date applies only to initial recognition of an acquired benefit. All other changes in the valuation allowance due to a change in judgment about the realizability of the deferred tax asset should be included in income from continuing operations pursuant to paragraph 26.

As indicated in question 17 of the Special Report, deferred tax assets and liabilities at the date of a purchase business combination should be based on management's best estimate of the ultimate tax basis that will be accepted by the tax authority, and liabilities for prior tax returns of the acquired entity should be based on management's best estimate of the ultimate settlement. At the date of a change in management's best estimate of the ultimate tax basis of acquired assets, liabilities, and carryforwards, and at the date that the tax basis is settled with the tax authority, deferred tax assets and liabilities should be adjusted to reflect the revised tax basis and the amount of any settlement with the tax authority for prior-year income taxes. Similarly, at the date of a change in management's best estimate of items relating to the acquired entity's prior tax returns, and at the date that the items are settled with the tax authority, any liability previously recognized should be adjusted. The effect of those adjustments should be applied to increase or decrease the remaining balance of goodwill attributable to that acquisition. If goodwill is reduced to zero, the remaining amount of those adjustments should be applied initially to reduce to zero other noncurrent intangible assets related to that acquisition, and any remaining amount should be recognized in income.

The Task Force observed that interest on the final settlement with the tax authority that accrues subsequent to the acquisition date should not be included in the goodwill adjustment.

The Task Force also reached a consensus that the guidance in question 17 of the Special Report is applicable to all purchase business combinations, regardless of whether the combination occurred prior to the adoption of Statement 109 and regardless of the transition method used to adopt Statement 109.

The SEC Observer noted that Statement 38 continues to apply to all other preacquisition contingencies and that application of this consensus should be limited solely to income tax uncertainties relating to purchase business combinations.

5.48 Paragraph C4 of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, addresses the effect of the Interpretation on Issue 93-7, stating:

This Interpretation does not change the consensus reached in EITF Issue No. 93-7, "Uncertainties Related to Income Taxes in a Purchase Business Combination," that all income tax uncertainties that exist at the time of or arise in connection with a purchase business combination should be accounted for pursuant to Statement 109. However, the EITF DISCUSSION section of Issue 93-7 is amended to reflect that Interpretation 48 now applies to recognition and measurement of uncertainty in income taxes recognized in accordance with Statement 109. The STATUS section of that Issue in *EITF Abstracts* will also be updated to state:

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, was issued in June 2006. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement 109, including tax positions that pertain to assets and liabilities acquired in business combinations. Therefore, the guidance in this Issue that pertains to the recognition and measurement of deferred tax assets and liabilities at the date of a business combination is no longer necessary.

Interpretation 48 does not affect the guidance pertaining to the accounting for the effects of adjustments.

Paragraph C5 of Interpretation 48 indicates the amendments made to Question 17 of FASB Staff Implementation Guide (Statement 109), "A Guide to Implementation of Statement 109 on Accounting for Income Taxes."

Deferred Revenue

5.49 EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree," provides that "Statement 141 requires that an acquiring enterprise allocate the cost of an entity acquired in a business combination to the individual assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. In some cases, the balance sheet of an acquired entity immediately before the acquisition date includes deferred revenue."

5.50 Paragraph 3 of Issue 01-3 states:

The Task Force observed that under existing accounting principles, the acquired entity might have deferred recognition of revenue for a variety of reasons. The Task Force reached a consensus that the acquiring entity should recognize a liability related to

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the deferred revenue of an acquired entity only if that deferred revenue represents a legal obligation [footnote 1] assumed by the acquiring entity (a legal performance obligation).

Footnote 1 states, "The Task Force observed that a legal obligation could arise from contractual provisions or from consumer rights in the relevant legal jurisdiction."

5.51 Paragraph 4 of Issue 01-3 states:

The Task Force noted that a legal obligation to provide goods, services, the right to use an asset(s), or some other consideration to a customer(s) would be examples of a legal performance obligation assumed by the acquiring entity. The Task Force also noted that an acquired entity might have deferred recognition of revenue because it is (or may be) obligated to grant the customer future concessions, as would be the case under a general right of return under Statement 48 or a price protection provision. The Task Force noted that the acquiring entity should recognize a liability if it has assumed a legal obligation to provide such concessions.

5.52 Paragraph 5 of Issue 01-3 provides that "[t]he Task Force noted that there are circumstances in which the deferred revenue of an acquired entity does not represent a legal performance obligation and, therefore, should not be recognized by the acquiring entity as a liability when the business combination is recorded." Exhibit 01-3A of Issue 01-3 gives examples of such circumstances.

5.53 Paragraph 6 of Issue 01-3 provides that "[t]he Task Force observed that in accordance with Statement 141, when the acquirer recognizes a legal performance obligation related to a revenue arrangement of an acquired entity, the amount assigned to that liability should be based on its fair value at the date of acquisition."

5.54 Paragraph 7 of Issue 01-3 states, in part:

The Task Force observed that a revenue arrangement acquired in a business combination might give rise to recognition by the acquiring entity of both an asset and a liability. For example, a single revenue arrangement may result in the assumption of a legal obligation to provide goods or services and the acquisition of a customer-related intangible asset. The Task Force observed that the liability recognized for the assumed legal obligation for performance and the related asset acquired should not be reported net on the balance sheet; that is, the asset and the liability should be recognized separately.

Exhibit 01-3A of Issue 01-3 gives an example of balance sheet presentation.

Deferred Postcontract Customer Support Revenue of a Software Vendor

5.55 Paragraph 4 of EITF Issue No. 04-11, "Accounting in a Business Combination for Deferred Postcontract Customer Support [PCS] Revenue of a Software Vendor," states:

The final consensus in Issue 01-3 does not specifically address whether an acquiring entity should recognize a liability for "when-and-if-available upgrades" assumed in a business combination. As a result, diversity in practice exists as to whether a customer's right to receive unspecified upgrades/enhancements on a "when-and-if-available" basis under a PCS arrangement should be recognized as a legal performance obligation and measured at fair value.

5.56 Paragraph 5 of Issue 04-11 states:

Deferred PCS revenue often is significant for a software company as a result of the revenue recognition criteria in SOP 97-2. The fair value of deferred revenue in a business combination generally is not readily available and, accordingly, in practice, the fair value of a liability (which must arise from a legal performance obligation) for deferred revenue is estimated using various methods. Some software entities only include phone support and error fixes (and a fulfillment margin thereon) in their measurement of the fair value of the liability for deferred PCS revenue. Other entities include the value of research and development activities for unspecified product upgrades/enhancements in their measurement of the fair value of the liability for deferred PCS revenue. Whether or not an entity includes the value of future research and development activities for unspecified upgrades in its measurement can have a significant effect on the amount of the liability for a PCS obligation that is recognized as deferred revenue in a business combination and, as a result, on the future earnings of the combined entity.

5.57 Paragraph 8 of Issue 04-11 provides that "the Task Force discussed this Issue, but was unable to reach a consensus. Accordingly, the Task Force agreed to discontinue discussion of this Issue and to remove it from the EITF's agenda." The diversity in practice noted in **5.55** is, therefore, expected to continue.

Preacquisition Contingencies

5.58 FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, specified "how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments that result from those contingencies." Paragraph B175 of Statement 141 states, in part:

This Statement carries forward without reconsideration the provisions in Statement 38, as amended, that relate to the accounting for preacquisition contingencies of purchased entities.

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Given the above, as noted in paragraph E1(d) of Statement 141, Statement 38 is superseded by Statement 141.

5.59 Appendix F of Statement 141 defines a “preacquisition contingency” as a “contingency of an entity that is acquired in a business combination that is in existence before the consummation of the combination. A preacquisition contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.”

5.60 Paragraph 40 of Statement 141 states:

A preacquisition contingency other than the potential tax effects of (a) temporary differences and carryforwards of an acquired entity that exist at the acquisition date and (b) income tax uncertainties related to the acquisition (for example, an uncertainty related to the tax basis of an acquired asset that will ultimately be agreed to by the taxing authority) [footnote 13] shall be included in the purchase price allocation based on an amount determined as follows:

- a. If the fair value of the preacquisition contingency can be determined during the **allocation period** [see **4.04–4.06**], that preacquisition contingency shall be included in the allocation of the purchase price based on that fair value. [Footnote 14]
- b. If the fair value of the preacquisition contingency cannot be determined during the allocation period, that preacquisition contingency shall be included in the allocation of the purchase price based on an amount determined in accordance with the following criteria:
 - (1) Information available prior to the end of the allocation period indicates that it is probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination. It is implicit in this condition that it must be probable that one or more future events will occur confirming the existence of the asset, liability, or impairment.
 - (2) The amount of the asset or liability can be reasonably estimated.

The criteria of this subparagraph shall be applied using the guidance provided in FASB Statement No. 5, *Accounting for Contingencies*, and related FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, for application of the similar criteria of paragraph 8 of Statement 5. [Footnote 15]

Footnote 13 provides that “[t]hose potential income tax effects shall be accounted for in accordance with the provisions of Statement 109.”

Footnote 14 states, “For example, if it can be demonstrated that the parties to a business combination agreed to adjust the total consideration by an amount because of a contingency, that amount would be a determined fair value of that contingency.”

Footnote 15 provides that “Interpretation 14 specifies the amount to be accrued if the reasonable estimate of the amount is a range. If some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount is accrued. If no amount within the range is a better estimate than any other amount, however, the minimum amount in the range is accrued.”

5.61 Paragraph 41 of Statement 141 states:

After the end of the allocation period, an adjustment that results from a preacquisition contingency other than a loss carryforward [footnote 16] shall be included in the determination of net income in the period in which the adjustment is determined.

Footnote 16 provides that the potential income tax effects of a loss carryforward should be accounted for in accordance with Statement 109.

5.62 When applying the above provisions of Statement 141 to preacquisition contingencies, one should consider the guidance in paragraph B178 of Statement 141 when a contingency of an acquired entity is not known to the acquiring entity at the acquisition date but becomes known during the allocation period. As indicated in paragraph B178, “in developing Statement 38, the Board considered and rejected an approach that would have made a distinction based on whether contingencies were known to the acquiring entity at the date of the purchase.”

Example 5-1

Contingency of Acquired Entity Not Known at Acquisition Date

On January 1, 20X0, Company A acquired Company B in a transaction accounted for as a business combination. In allocating the cost of Company B to the assets acquired and liabilities assumed, Company A identified preacquisition contingencies of Company B related to product liability lawsuits. Company A completed the allocation to those items on June 30, 20X0. On October 1, 20X0, Company A was named in a lawsuit for claims against Company B prior to its acquisition by Company A, which Company B was unaware of at the acquisition date. On the basis of the guidance in paragraph B178 of Statement 141, even though Company B was unaware of the claim at the acquisition date, Company A must still evaluate the existence of a preacquisition contingency for this claim since the claim became known during the allocation period. While the allocation period for other known claims ended on June 30, 20X0, the allocation period for this previously unknown claim remained open.

Section 6 — Allocating the Cost of an Acquired Entity to Identifiable Intangible Assets

6.00 Paragraph 39 of Statement 141 provides that an intangible asset should be recognized as an asset apart from goodwill if it meets either of the following criteria:

Contractual-Legal Criterion — “If the asset arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations).”

Separability Criterion — “If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). For purposes of this Statement, however, an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability.”

Intangible Assets That Meet the Criteria for Recognition as an Asset Apart From Goodwill

6.01 Paragraph A14 of Statement 141 gives examples of intangible assets that meet the criteria for recognition as an asset apart from goodwill, stating, in part:

The following illustrative list is not intended to be all-inclusive, thus, an acquired intangible asset might meet the recognition criteria of this Statement but not be included on that list. Assets designated by the symbol (†) are those that would be recognized apart from goodwill because they meet the contractual-legal criterion. [Footnote 29] Assets designated by the symbol (Δ) do not arise from contractual or other legal rights, but shall nonetheless be recognized apart from goodwill because they meet the separability criterion. The determination of whether a specific acquired intangible asset meets the criteria in this Statement for recognition apart from goodwill shall be based on the facts and circumstances of each individual business combination.

- a. Marketing-related intangible assets
 - (1) Trademarks, tradenames †
 - (2) Service marks, collective marks, certification marks †
 - (3) Trade dress (unique color, shape, or package design) †

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- (4) Newspaper mastheads †
- (5) Internet domain names †
- (6) Noncompetition agreements †
- b. Customer-related intangible assets
 - (1) Customer lists △
 - (2) Order or production backlog †
 - (3) Customer contracts and related **customer relationships** †
 - (4) Noncontractual customer relationships △
- c. Artistic-related intangible assets
 - (1) Plays, operas, ballets †
 - (2) Books, magazines, newspapers, other literary works †
 - (3) Musical works such as compositions, song lyrics, advertising jingles †
 - (4) Pictures, photographs †
 - (5) Video and audiovisual material, including motion pictures, music videos, television programs †
- d. Contract-based intangible assets
 - (1) Licensing, royalty, standstill agreements †
 - (2) Advertising, construction, management, service or supply contracts †
 - (3) Lease agreements †
 - (4) Construction permits †
 - (5) Franchise agreements †
 - (6) Operating and broadcast rights †
 - (7) Use rights such as drilling, water, air, mineral, timber cutting, and route authorities †
[Footnote 29a]
 - (8) Servicing contracts such as mortgage servicing contracts †
 - (9) Employment contracts †
- e. Technology-based intangible assets
 - (1) Patented technology †
 - (2) Computer software and mask works †
 - (3) Unpatented technology △
 - (4) Databases, including title plants △
 - (5) Trade secrets, such as secret formulas, processes, recipes. †

Footnote 29 states, “The intangible assets designated by the symbol (†) also might meet the separability criterion. However, separability is not a necessary condition for an asset to meet the contractual-legal criterion.”

Footnote 29a states, “Certain use rights may have characteristics of assets other than intangible assets. For example, certain mineral rights are considered tangible assets based

on the consensus in EITF Issue No. 04-2, 'Whether Mineral Rights Are Tangible or Intangible Assets.' Accordingly, use rights should be accounted for based on their substance."

6.02 In correspondence to the FASB staff dated August 16, 2001, then SEC Chief Accountant Lynn E. Turner notes the following:

Appendix A of SFAS No. 141 indicates that the list of identifiable intangible assets is illustrative. The SEC staff believes there is a rebuttable presumption that any intangible asset identified in the listing will be valued in a purchase business combination. In its review of filings, the staff may look to such documentation as the sales agreement, memorandums, presentations by the target to the buyer, minutes of the Board of Directors Meetings, etc. for discussions and evidence of assets, including intangibles, being purchased.

In addition to the documentation listed above, in searching for the presence of acquired intangible assets, one should consider:

- Other acquisitions by the acquirer in the same line of business.
- Acquisitions in the same industry.
- The historical financial statements and disclosures of the acquired entity for disclosure, discussion, or both, of any previously recognized or unrecognized intangibles.

Intangible Assets That Do Not Meet the Criteria for Recognition as an Asset Apart From Goodwill

6.03 As discussed in **6.00**, paragraph 39 of Statement 141 indicates that an intangible asset should be recognized as an asset apart from goodwill if it meets either the contractual-legal criterion or the separability criterion. Paragraph B165 of Statement 141 gives the following examples of intangible assets that do not meet the criteria for recognition apart from goodwill and that are thus excluded from the illustrative list in paragraph A14 of Statement 141:

- Customer base — "a group of customers that are not known or identifiable to the entity (such as customers of a fast-food franchise)."
- Customer service capability.
- Presence in geographic markets or locations.
- Nonunion status or strong labor relations.
- Ongoing training or recruiting programs.
- Outstanding credit ratings and access to capital markets.
- Favorable government relations.

Assembled Workforce

6.04 Paragraph 39 of Statement 141 provides that “[f]or purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill.” Paragraphs B168–B169 of Statement 141 specifically address the recognition apart from goodwill of an assembled workforce of at-will employees. Paragraph B169 provides that “[t]he Board concluded that techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available. Consequently, it decided to make an exception to the recognition criteria and require that the fair value of an assembled workforce acquired be included in the amount initially recorded as goodwill, regardless of whether it meets the recognition criteria in paragraph 39 [of Statement 141].” Despite this conclusion, if an acquiring entity uses a multiperiod excess earnings method to measure the fair value of another intangible asset and determines that the assembled workforce is an enabling intangible asset to the other intangible asset being measured, the assembled workforce intangible asset will need to be measured for appropriate consideration in the multiperiod excess earnings calculation. In addition, if the net assets acquired are determined not to be a business, it is necessary to assess whether an assembled workforce intangible asset is present; if present, such an asset must be recognized (see **1.05–1.08**).

6.05 Certain employees of the acquired entity may be subject to individual employment contracts, and certain groups of employees of the acquired entity may be subject to collective bargaining agreements. While Statement 141 prohibits the recognition, apart from goodwill, of an assembled workforce intangible asset, recognition of the effects of off-market rates related to employment contracts or collective bargaining agreements is required (see item (d)(9) in **6.01**).

6.06 Some entities acquired in a business combination may operate through the use of independent contractors in lieu of employees. Although arrangements with independent contractors may possess characteristics similar to those of an assembled workforce, such arrangements do not fall within the recognition exception discussed in **6.04** and instead should be considered for recognition apart from goodwill on the basis of either the contractual-legal criterion or separability criterion (see **6.00**). Such arrangements may require separate recognition of the value associated with the assembled workforce characteristic and any off-market characteristics.

Example 6-1

Agreements With Independent Contractors

Company A manufactures, installs, and services air purification systems for both home and commercial use. Company A uses a network of independent contractors to supplement its own employees in the sales of installed systems. Customers are generally unaware of whether a sales representative is an employee or independent contractor of Company A. Arrangements with independent contractors are contractual in nature, with terms such as fees to be paid and the length of the arrangement clearly defined.

Although Company A's arrangements with independent contractors possess characteristics similar to those of Company A's arrangements with its at-will employees, the exception to recognition apart from goodwill in Statement 141 applies only to employees of Company A, and thus Company A's arrangements with its independent contractors must be evaluated separately for recognition apart from goodwill on the basis of either the contractual-legal criterion or separability criterion.

Acquired Intangible Assets That Will Not Be Used in Ongoing Operations

6.07 In certain acquisitions, an acquiring entity may decide not to use an acquired intangible asset to its fullest capabilities in the ongoing operations of the combined entity. There may be many reasons for this decision, including a determination that the acquired intangible asset is duplicative of or inferior to an existing intangible asset of the acquirer. Statement 141 does not address the measurement of acquired intangible assets that will not be used in the ongoing operations of the combined entity to their fullest capabilities. Paragraph B100 of Statement 141 does, however, indicate that “[t]he Board decided that this Statement should carry forward, without reconsideration, the general guidance in Opinion 16 for assigning amounts to assets acquired and liabilities assumed.” Under Opinion 16, for acquired intangible assets that were not expected to be used to their fullest capabilities by the combined entity, practice frequently was to base measurement on the buyer’s intended use, resulting in (1) the measurement of no value if the acquired intangible asset was not to be used at all in the ongoing operations or (2) measurement of only value related to the period of expected use (which was generally shorter than the period the acquired intangible asset would be available for use).

6.08 While we understand that the SEC staff is aware of and does not object at this time to the continuation under Statement 141 of the practice described in **6.07**, the adoption of Statement 157 may affect fair value measurements of such assets. Specifically, Statement 157 introduces the notion of defensive value as a component of fair value in which an asset is not used by the holder but the holder prevents others’ access to that asset.

Grouping Complementary Assets

6.09 Statement 141 offers the following two examples of grouping of acquired assets for financial reporting purposes:

- A brand or brand name consisting of a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise (which may or may not be patented). (See paragraph A16 of Statement 141.)
- A license to own and operate a nuclear power plant. (See paragraph A10(b) of Statement 141.)

In both examples, a factor cited in support of grouping the assets for financial reporting purposes was that the individual assets have similar useful lives. In addition, whether the grouping of assets is appropriate depends on whether the assets have similar methods of amortization, since this would ensure a similar effect on financial reporting.

Customer Lists

6.10 Paragraph A18 of Statement 141 states:

A customer list consists of information about customers such as their name and contact information. A customer list also may be in the form of a database that includes other information about the customers such as their order history and demographic information. A customer list does not generally arise from contractual or other legal rights. However, customer lists are valuable and are frequently leased or exchanged. Therefore, an acquired customer list would meet the separability criterion for recognition apart from goodwill. An acquired customer list would *not* meet that criterion, however, if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

6.11 While most entities will possess some information about their customers, thereby establishing the existence of a customer-list intangible asset, the specific information possessed and the resulting value of this asset will vary.

Order or Production Backlog

6.12 Paragraph A19 of Statement 141 provides that “[i]f an acquired order or production backlog arises from contracts such as purchase or sales orders, it meets the contractual-legal criterion for recognition apart from goodwill (even if the purchase or sales orders were cancelable).” (See further discussion at **6.15**.)

Customer Contracts and Related Customer Relationships

6.13 Paragraph A20 of Statement 141 states:

If an entity establishes relationships with its customers through contracts, those customer relationships would arise from contractual rights. Therefore, customer contracts and the related customer relationships are intangible assets that meet the contractual-legal criterion. This Statement requires that those intangible assets be recognized as assets apart from goodwill even if confidentiality or other contractual terms prohibit the sale or transfer of the contract separately from the acquired entity.

6.14 Appendix F of Statement 141 defines the term “customer relationship” as follows:

[A] customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.

6.15 Statement 141 does not, however, define the term “contractual.” Therefore, consideration should be given to the interpretive guidance in EITF Issue No. 02-17, “Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination.” Paragraph 10 of Issue 02-17 provides that “[t]he Task Force reached a consensus on Issue 3 that an order or a production backlog arising from contracts such as purchase or sales orders (even if the purchase or sales orders are cancelable) as described in paragraph A19 of Statement 141 is considered a contract subject to paragraph A20.” On the basis of this consensus, the absence of enforceable rights by the parties to a particular arrangement would not appear to preclude recognition. We understand that the SEC staff agrees with this view.

6.16 In Issue 2 of Issue 02-17, the Task Force considered “[w]hether the guidance in Statement 141, paragraph A20, which states that a customer relationship meets the contractual-legal criterion if an entity establishes relationships with its customers through contracts, applies only if a contract is in existence at the date of acquisition.” Paragraph 8 of Issue 02-17 states that “[t]he Task Force reached a consensus on Issue 2 that the guidance in paragraph A20 of Statement 141 that states ‘if an entity establishes relationships with its customers through contracts, those customer relationships would arise from contractual rights,’ applies if an entity has a practice of establishing contracts with its customers, regardless of whether a contract is in existence at the date of acquisition.” The Task Force also observed in paragraph 9 “that the consensus in this Issue provides

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guidance only on when to recognize a customer relationship intangible asset apart from goodwill. The Task Force further observed that factors such as the lack of contractual rights or separability may have an impact on the fair value of that asset.” Exhibit 02-17A, Example 3, offers the following illustration of this consensus:

Company X acquires Company Y in a business combination on December 31, 20X2. Company Y does business with its customers solely through purchase and sales orders. At December 31, 20X2, Company Y has a backlog of customer purchase orders in-house 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 December 31, 20X2, Company Y does not have any open purchase orders, or other contracts, with those customers.

Evaluation: The purchase orders from 60 percent of Company Y’s customers (whether cancelable or not) meet the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since Company Y has established its relationship with 60 percent of its customers through a contract, those customer relationships meet the contractual-legal criterion and must also be recorded at fair value apart from goodwill.

Because Company Y has a practice of establishing contracts with the remaining 40 percent of its customers, those customer relationships also arise through contractual rights and, therefore, meet the contractual-legal criterion. Company X must record the customer relationship for the remaining 40 percent of Company Y’s customers at fair value apart from goodwill, even though Company Y does not have contracts with those customers at December 31, 20X2.

Customer Loyalty Programs

6.17 Customer loyalty programs generally allow customers to earn current or future discounts, free products or services, or other benefits based on cumulative purchases from the operator of the program. Many airlines, casinos, hotels, and retailers offer such programs. The program’s enrollment process is often designed to be easy to complete, with the participant generally agreeing to the terms and conditions of the program at the time of enrollment. Participants in such programs generally have no obligation to complete future purchases of products or services, and operators of such programs generally reserve the right to modify or cancel the program at any time. Despite the absence of enforceable rights between the parties as to future purchases or fulfillment of accrued benefits, such arrangements are deemed “contractual,” as that term is used in Statement 141, because the parties have agreed to certain terms and conditions, have had a previous contractual relationship (see **6.16**), or both. Any accrual of liabilities, or deferral of revenue, by the operator is also evidence that the arrangement is

“contractual” as that term is used in Statement 141. (Note that an acquiring entity, in addition to evaluating the recognition and measurement of an acquired customer-related intangible asset, must separately evaluate the recognition and measurement of assumed liabilities related to a customer loyalty program of the acquired entity in place at the date of acquisition — also see **5.54**.)

Overlapping Customers

6.18 In a business combination, it is not uncommon that certain customers of the acquiring entity are also customers of the acquired entity (“overlapping customers”). This raises an issue regarding the recognition and measurement of an acquired customer contract and a related customer-relationship intangible asset. While an acquired entity’s customer contracts would be instrumental to the acquiring entity, some have asserted that the related customer relationship is not instrumental to the acquiring entity and thus has no value to the acquiring entity. At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member (Pamela R. Schlosser), in prepared remarks, offered the following example that took exception to the view that no value to the acquiring entity was present upon acquisition in such a situation:

Company A, which sells apparel products to retail customers, acquires Company B, which sells toy products to those same retail customers. The question is: at what amount the customer relationships of Company B should be recognized, considering the fact that Company A already had relationships with those very same customers, albeit for different product sales?

Some have argued that in this situation, no value should be attributed to these intangible assets since Company A already sold its apparel products to Company B’s customer base, and thus already had pre-established relationships with them. However, we have found this argument difficult to accept. Because of the acquisition, Company A now has the ability to sell new products (that is, toy products) to its retail customers that it was unable to sell prior to the acquisition of Company B. And even if the two companies sold competing products to the same retail customers, for instance both sold toy products, the fact that Company A has increased its “shelf space” at each of its customers’ retail locations would be indicative of value to those relationships.

Considerations Regarding Valuation Techniques and Assumptions to Be Used in Measuring Fair Value of Customer-Relationship Intangible Assets

6.19 Paragraph 18 of Statement 157 provides that “[v]aluation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value.” (See **4.12**.) In the measurement of the fair value of a customer-

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relationship intangible asset, the use of a market approach is generally not possible because of the absence of market transactions involving identical or comparable assets. Regarding use of the cost approach when measuring customer-relationship intangible assets, an SEC staff member (Chad A. Kokenge) at the 2003 AICPA National Conference on Current SEC Developments, in prepared remarks, indicated:

[T]he [cost] approach only focuses on the entity's specific costs that are necessary to "establish" the relationship. Such an approach would not be sensitive to the volume of business that might be generated by the customer, other relationship aspects, such as referral capability, or other factors that may be important to how a marketplace participant might assess the asset. If these factors are significant, we believe the use of such an approach would generally be inconsistent with the Statement 142 definition of fair value.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member (Joseph B. Ucuozglu), in prepared remarks, further addressed the topic of valuing customer-relationship intangible assets in a business combination, stating:

The fact that the acquired entity has a contractual relationship with the customer may also give rise to a valuable customer relationship which must be considered in the purchase price allocation pursuant to Statement 141. [Footnote 2] This provides a nice segue into my next topic. The issue of valuing customer relationship intangible assets seems to have become an annual topic at the SEC conference.

Some have suggested that the SEC staff always requires the use of an income approach to value customer relationship intangible assets. The staff has even heard some suggest that, as long as a registrant characterizes its valuation method as an income approach, the specific assumptions used or results obtained will not be challenged by the staff, because one has complied with a perceived bright line requirement to use an income approach. Let me assure you, these statements are simply false. While an income approach often provides the most appropriate valuation of acquired customer relationship intangible assets, circumstances may certainly indicate that a different method provides a better estimate of fair value. On the flipside, even when a registrant concludes that an income approach is the most appropriate valuation methodology, the staff may nevertheless question the result obtained when the underlying assumptions, such as contributory asset charges, do not appear reasonable in light of the circumstances.

When determining the appropriate valuation of a customer relationship intangible asset, I believe that the first step in the process should be to obtain a thorough understanding of the value drivers in the acquired entity. That is, why is it that customers continually return to purchase products or services from the acquired entity? In some cases, the nature of the relationship may be such that customers are naturally "sticky," and tend to stay with the same vendor over time without frequently reconsidering their purchasing decisions. In that circumstance, it would appear that a significant portion of the ongoing cash flows that the acquired entity will generate can be attributed to the strength of its customer relationships.

At the other end of the spectrum, relationships may be a less significant value driver in an environment where customers frequently reassess their purchasing decisions and can easily switch to another vendor with a lower price or a superior product. In that environment, if customers continually return to buy products from the acquired entity, perhaps they do so in large part due to factors other than the relationship, such as a well-know[n] tradename, strong brands, and proprietary technologies. As a result, the value of the customer relationship intangible asset may be less than would be the case in a circumstance where the relationship is stronger. However, the staff would generally expect that the amount attributed to other intangible assets would be commensurately higher, reflecting the increasingly important role of those assets in generating cash flows.

Footnote 2 refers to paragraph A14(b) of Statement 141.

6.20 Paragraph B174 of Statement 141 states, in part:

Several respondents [to the 1999 Exposure Draft] noted that a present value technique might often be the best available technique with which to estimate the fair value of an acquired intangible asset. Some of those respondents asked whether the estimated cash flows used in applying that technique should be limited to the cash flows expected over the remaining legal or contractual term of the acquired asset. The Board noted that judgment is required in estimating the period and amount of expected cash flows. Those estimates should be consistent with the objective of measuring fair value and, thus, should incorporate assumptions that marketplace participants would use in making estimates of fair value, such as assumptions about future contract renewals and other benefits such as those that might result from acquisition-related synergies. The Board noted that if such information is not available without undue cost and effort, an entity should use its own assumptions.

6.21 In Issue 1 of Issue 02-17, the Task Force considered “[w]hen an entity recognizes an intangible asset pursuant to paragraph 39 of Statement 141, whether the contractual-legal or the separability criteria restrict the use of certain assumptions, such as expectations of future contract renewals and other benefits related to the intangible asset that would be used in estimating the fair value of that intangible asset.” Paragraph 6 of Issue 02-17 states:

The Task Force reached a consensus on Issue 1 that the contractual-legal and the separability criteria do not restrict the use of certain assumptions that would be used in estimating the fair value of an intangible asset. Assumptions that marketplace participants would consider, such as expectations of future contract renewals and other benefits related to the intangible asset, must be considered in the estimate of its fair value regardless of whether they meet the contractual-legal criterion or the separability criterion.

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Exhibit 02-17A offers the following two examples of the application of this consensus:

Example 1

BigCo acquired LittleCo in a business combination on December 31, 20X2. LittleCo has a five-year agreement to supply goods to BuyerCo. Both LittleCo and BigCo believe that BuyerCo will renew the supply agreement at the end of the current contract. The supply agreement is not separable.

Evaluation: The supply agreement (whether cancelable or not) meets the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since LittleCo establishes its relationship with BuyerCo through a contract, the customer relationship with BuyerCo meets the contractual-legal criterion and the customer relationship must also be recorded at fair value apart from goodwill. In determining the fair value of the customer relationship, BigCo is required to consider assumptions such as the expected renewal of the supply agreement.

Example 2

ParentCo acquired VendorCo in a business combination on December 31, 20X2. VendorCo manufactures goods in two distinct lines of business—sporting goods and electronics. RetailCo purchases both sporting goods and electronics from VendorCo. VendorCo has a contract with RetailCo to be the exclusive provider of sporting goods to RetailCo; however, there is no contract for the supply of electronics to RetailCo. Both VendorCo and ParentCo believe that there is only one overall customer relationship between VendorCo and RetailCo.

Evaluation: The contract to exclusively provide sporting goods to RetailCo (whether cancelable or not) meets the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since VendorCo establishes its relationship with RetailCo through a contract, the customer relationship with RetailCo meets the contractual-legal criterion and must also be recorded at fair value apart from goodwill. Since there is only one customer relationship with RetailCo, the fair value of that relationship would incorporate assumptions regarding VendorCo's relationship with RetailCo related to both sporting goods and electronics.

If, however, both ParentCo and VendorCo believed that there were separate customer relationships with RetailCo—one for sporting goods and one for electronics, then the customer relationship with respect to electronics would be assessed by ParentCo to determine whether it meets either the contractual-legal criterion or the separability criterion and, if so, should be recorded at fair value apart from goodwill.

Noncontractual Customer Relationships

6.22 Paragraph A21 of Statement 141 states:

If a customer relationship does not arise from a contract, this Statement requires that the relationship be recognized as an intangible asset apart from goodwill if it meets the separability criterion. Exchange transactions for the same asset or a similar type of asset provide evidence of separability of a noncontractual customer relationship and might also provide information about

exchange prices that should be considered when estimating its fair value. For example, relationships with depositors are frequently exchanged with the related deposits and, thus, meet the criteria for recognition as an intangible asset apart from goodwill.

Research and Development Assets

6.23 Paragraph 42 of Statement 141 provides that the Statement “does not change the requirement in paragraph 5 of FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, that the amounts assigned to tangible and intangible assets to be used in a particular research and development project that *have no alternative future use* shall be charged to expense at the acquisition date.”

6.24 In correspondence dated September 9, 1998, to the Chair of the AICPA SEC Regulations Committee, then SEC Chief Accountant Lynn E. Turner wrote that “[a]lthough there was no change in the relevant accounting literature, IPR&D write-offs increased significantly in the 1990’s. More intense merger activity in the technology sector may explain some of the increase, but abuses in the valuation of IPR&D are suspected.” Mr. Turner further wrote:

In light of the practice problems we encountered, we encourage the AICPA SEC Regulations Committee to provide its constituency additional guidance concerning IPR&D. A working group comprised of appraisers, auditors, and accountants from industry could be useful in the development of a comprehensive description of best practices in this area. We would be pleased to participate in those efforts, too.

The AICPA responded with the 2001 publication of a Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*. As provided therein:

This Practice Aid identifies what the task force members perceive as best practices related to defining and accounting for, disclosing, valuing, and auditing assets acquired to be used in R&D activities, including specific IPR&D projects.

While the “Notice to Readers” in the Practice Aid indicates that the “Practice Aid has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status,” its preparation was observed by both the SEC staff and FASB staff. Reference to the guidance is useful for applying the provisions of Statement 141, both specifically to acquired in-process research and development (IPR&D), and more generally to all acquired assets. For example, the Practice Aid provides guidance on and illustrations for applying the multiperiod excess earnings method.

Accounting for Deferred Income Taxes on In-Process Research and Development Activities Acquired

6.25 Paragraph 42 of Statement 141 (see **6.23**) addresses the accounting for amounts assigned to acquired tangible and intangible assets to be used in a particular R&D project that have no alternative future use, requiring that such amounts “shall be charged to expense at the acquisition date.” EITF Issue No. 96-7, “Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination,” addresses “whether a deferred tax liability should be recognized at the consummation date of a purchase business combination for the initial difference (that is, prior to the write-off of in-process R&D) between the amounts assigned for financial reporting purposes to in-process R&D and its underlying tax basis.” The Issue “assumes that in-process R&D has no underlying tax basis.”

6.26 Issue 96-7 provides that “[t]he Task Force reached a consensus that the write-off of amounts assigned for financial reporting purposes to in-process R&D occurs prior to the measurement of deferred taxes in a purchase business combination. Accordingly, deferred taxes are not provided on the initial differences between the amounts assigned for financial reporting and tax purposes, and in-process R&D is charged to expense on a gross basis at acquisition.”

Mineral Rights

6.27 EITF Issue No. 04-2, “Whether Mineral Rights Are Tangible or Intangible Assets,” defines the term “mineral rights” as “the legal right to explore, extract, and retain at least a portion of the benefits from mineral deposits.” Paragraph A14 of Statement 141 gives examples of intangible assets that meet the criteria for recognition as an asset apart from goodwill. Issue 04-2 provides that “[t]hose examples include *mineral rights* as an example of an intangible asset that should be recognized apart from goodwill.”

6.28 Paragraph 3 of Issue 04-2 states:

Mining entities generally did not change their practice of accounting for mineral rights as tangible assets upon adoption of Statements 141 and 142. That is, they believe that mineral rights are tangible assets. However, others believe that mineral rights are intangible assets. Because of those differing views, an issue has arisen in practice as to whether mineral rights are tangible or intangible assets. That distinction is important not only for classification in the statement of financial position but also for subsequent recognition of amortization and impairment.

6.29 Regarding whether mineral rights are tangible or intangible assets, the Task Force reached a consensus that mineral rights, as defined in Issue 04-2, “are tangible assets, and, accordingly, an entity should account for mineral rights as tangible assets. The Task Force also concluded that an entity should report the aggregate carrying amount of mineral rights as a separate component of property, plant, and equipment either on the face of the financial statements or in the notes to the financial statements.”

Valuing “At-the-Money” Contracts

6.30 Paragraph B173 of Statement 141 states:

The Board recognizes that the requirements in this Statement might change current practice with respect to the amounts assigned to some intangible assets, in particular those that arise from contractual or other legal rights. For example, the Board has been informed that in current practice, the amount assigned to acquired operating lease contracts (when the acquired enterprise is the lessor) and customer contracts often is based on the amount by which the contract terms are favorable relative to market prices at the date of acquisition. Thus, in some cases no amount is assigned to lease and other contracts that are “at the money” — that is, when the contract terms reflect market prices at the date of acquisition. The Board observed, however, that such “at the money” contracts are bought and sold in exchange transactions — the purchase and sale of airport gates (an operating lease) within the airline industry and customer contracts in the home security industry are two examples of those exchange transactions. The Board believes that those transactions provide evidence that a contract may have value for reasons other than terms that are favorable relative to market prices. The Board therefore concluded that the amount by which the terms of a contract are favorable relative to market prices would not necessarily represent the fair value of that contract.

Intangible Assets Associated With Income-Producing Real Estate

6.31 Income-producing real estate, such as an office or apartment building that is occupied by tenants on the date of acquisition, represents to the acquirer a collection of tangible and intangible assets and, in certain instances, liabilities. When allocating the cost of the acquired entity to such income-producing real estate, it is necessary to separately identify and measure the tangible and intangible assets and liabilities present. The following table identifies examples of tangible and intangible assets and liabilities that may be present in the acquisition of income-producing real estate, along with measurement considerations.

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Measurement Considerations	
Land and Buildings and Other Tangible Assets (Such as Equipment)	Land should be recognized separately from other assets and measured at “appraised values” (see 5.16). Buildings are to be measured on the basis of the premise of the building “as if vacant” to avoid including measurement value that may be attributable to other assets and liabilities as discussed below. (See 5.12–5.15 for general guidance on assigning amounts to plant and equipment.)
Favorable or Unfavorable In-Place Leases	In-place leases may be favorable or unfavorable at the acquisition date relative to current market rates. Favorable leases from the perspective of the acquiring entity represent assets, while unfavorable leases from the perspective of the acquiring entity represent liabilities (or balance sheet credits). Separate classification of assets and liabilities (or balance sheet credits) is required.
In-Place Leases — Intangible Asset	In-place leases provide value to the acquiring entity in that cash outflows necessary to originate leases (such as marketing, sales commissions, legal costs, and lease incentives) are avoided. Also, in-place leases enable the acquiring entity to avoid lost cash flows during an otherwise required lease-up period. Measurement of in-place leases should therefore reflect both the benefits to the acquiring entity of avoided cash outflows otherwise necessary to originate such leases as well as cash inflows (net of service costs to tenants such as security and maintenance) resulting from not having to incur an otherwise required lease-up period.
Customer Contracts and Related Customer Relationships — Intangible Asset	Existing tenants may also provide value to the acquiring entity through renewals of existing leases or other benefits (such as purchases of additional services or rentals of additional space).

6.32 The list of examples is not all-inclusive. For example, other intangible assets may be present in a particular acquisition of income-producing real estate such as a customer list, management contract, or trade name.

Section 7 — Goodwill and Negative Goodwill

Measurement of Goodwill

7.00 Paragraph 43 of Statement 141 states, in part, that “[t]he excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill.” The amount recognized as goodwill can only be properly measured through this residual method.

Negative Goodwill

7.01 Paragraph 44 of Statement 141 states:

In some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired entity (*excess over cost* or *excess*). That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets [including research and development assets acquired and charged to expense] except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets. [Footnotes omitted]

7.02 In paragraph B187 of Statement 141, the FASB expresses its belief that “substantially all business combinations are exchange transactions in which each party receives and sacrifices commensurate value. Accordingly, an excess [of fair value of acquired net assets over cost] rarely would remain if the valuations inherent in the purchase price allocation process were properly performed.” As a result, the Board provided that “if an excess [of fair value of acquired net assets over cost] remains after the initial allocation of the purchase price, the acquiring entity shall reassess whether all acquired assets and liabilities assumed have been identified and recognized. In addition, accurate and thorough remeasurements should be performed to verify that the consideration paid and the assets acquired and liabilities assumed have been properly valued.”

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7.03 Paragraph 45 of Statement 141 states:

If any excess [of fair value of acquired net assets over cost] remains after reducing to zero the amounts that otherwise would have been assigned to those assets, that remaining excess shall be recognized as an extraordinary gain as described in paragraph 11 of APB Opinion No. 30, *Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. The extraordinary gain shall be recognized in the period in which the business combination is completed unless the combination involves contingent consideration that, if paid or issued, would be recognized as an additional element of cost of the acquired entity (refer to paragraph 46). If an extraordinary gain is recognized before the end of the allocation period, any subsequent adjustments to that extraordinary gain that result from changes to the purchase price allocation shall be recognized as an extraordinary item.

7.04 Paragraph 46 of Statement 141 states:

If a business combination involves a contingent consideration agreement that might result in recognition of an additional element of cost of the acquired entity when the contingency is resolved (a contingency based on earnings), an amount equal to the lesser of the maximum amount of contingent consideration or the excess prior to the pro rata allocation required by paragraph 44 shall be recognized as if it was a liability. When the contingency is resolved and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as if it was a liability shall be recognized as an additional cost of the acquired entity. If the amount initially recognized as if it was a liability exceeds the fair value of the consideration issued or issuable, that excess shall be allocated as a pro rata reduction of the amounts assigned to assets acquired in accordance with paragraph 44. Any amount that remains after reducing those assets to zero shall be recognized as an extraordinary gain in accordance with paragraph 45.

Allocation of Excess of Fair Value of Acquired Net Assets Over Cost When No Contingent Consideration Agreement Is Present

7.05 The following example illustrates the procedures for allocating the excess of fair value of acquired net assets over cost when no contingent consideration agreement is present.

Assume Company A acquires Company B for consideration of \$500. Company A identifies and measures the following assets acquired and liabilities assumed:

Item	Fair Value
Cash	\$ 50
Inventories	100
PP&E	400
Intangible Assets	50
R&D Assets (to be expensed)	50
Liabilities	<u>(50)</u>
Total	<u>\$600</u>

Company A has calculated the following excess of fair value of acquired net assets over cost:

Fair Value of Acquired Net Assets	\$600
Less: Cost	<u>500</u>
Excess of Fair Value of Acquired Net Assets Over Cost	<u>\$100</u>

Company A will allocate the excess of fair value of acquired net assets over cost on a pro rata basis as follows:

Item	Fair Value of Assets Available for Allocation	Pro Rata Allocation Percentage	Excess of Fair Value of Acquired Net Assets Over Cost	Adjustment
PP&E	\$400	80%	\$100	\$80
Intangible Assets	50	10	100	10
R&D Assets (to be expensed)	50	10	100	10

As a result of this allocation, Company A will record the assets acquired and liabilities assumed as follows:

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Item	Initial Fair Value	Allocation	Amount to Be Assigned
Cash	\$ 50		\$ 50
Inventories	100		100
PP&E	400	\$ (80)	320
Intangible Assets	50	(10)	40
R&D Assets (to be expensed)	50	(10)	40
Liabilities	<u>(50)</u>	<u> </u>	<u>(50)</u>
Total	<u>\$600</u>	<u>\$(100)</u>	<u>\$500</u>

The allocation process results in no recognition of negative goodwill related to the combination and reduces the charge to expense related to the R&D assets acquired.

Allocation of Excess of Fair Value of Acquired Net Assets Over Cost When a Contingent Consideration Agreement Is Present

7.06 The following example illustrates the procedures for allocating the excess of fair value of acquired net assets over cost when a contingent consideration agreement is present, and the resulting effects, when the recognized liability exceeds the fair value of the contingent consideration ultimately paid.

Assume Company A acquires Company B for zero consideration paid at consummation and a contingent payment based on earnings of up to \$1,200. Company A identifies and measures the following assets acquired and liabilities assumed:

Item	Fair Value
Inventories	\$1,100
PP&E	150
R&D Assets (to be expensed)	50
Liabilities	<u>(100)</u>
Total	<u>\$1,200</u>

In the absence of the requirement to consider the contingent consideration agreement, Company A would allocate the excess of fair value of acquired net assets over cost of \$1,200 by reducing the amounts assigned to property, plant, and equipment (PP&E) and R&D assets to zero and would recognize the remaining excess of \$1,000 as an extraordinary item. However, in accordance with paragraph 46 of Statement 141, before allocating the excess of fair value of acquired net assets over cost, Company A must reduce the excess by recognizing the contingent consideration as a liability in an amount equal to the lesser of the maximum amount of the contingent consideration or the excess itself. On the basis of this requirement, Company A determined that there is no longer an excess of fair value of acquired net assets over cost and thus that no allocation is required. Accordingly, when considering the contingent consideration agreement, Company A will record the assets acquired and liabilities assumed, as indicated above, and will include a liability for the contingent consideration arrangement in the amount of \$1,200. The R&D asset recognized at \$50 will be expensed in accordance with the requirements of Interpretation 4.

If Company A settles the contingent consideration agreement for an amount equal to \$1,100 instead of the maximum of \$1,200, a reduction in the amount assigned to PP&E and R&D assets would be required.

Fair Value of Acquired Net Assets	\$1,200
Less: Cost	<u>1,100</u>
Excess of Fair Value of Acquired Net Assets Over Cost	<u>\$ 100</u>

Allocation of the excess of fair value of acquired net assets over cost on a pro rata basis would result in a \$75 reduction to PP&E and a \$25 reduction to R&D. Statement 141 does not provide guidance on the method for recording the required reduction when the asset may have been expensed (as with R&D assets) or disposed of (as with PP&E assets). With regard to R&D assets previously expensed, the adjusting credit should be recorded in the period the contingency is resolved, in the same manner that the R&D expense was recognized. Practice may differ with regard to recording a required adjustment to PP&E. If PP&E acquired consists of an asset that has been disposed of or impaired, treatment of the adjustment in a manner similar to the adjustment to the R&D asset would be expected. If the acquired PP&E has not been disposed of or impaired, the adjustment to the PP&E account generally should not take into account the effects of prior depreciation.

Allocation of Excess of Fair Value of Acquired Net Assets Over Cost to LIFO Inventories

7.07 A view may be offered that, in allocation of the excess of fair value of acquired net assets over cost, an allocation to LIFO inventories is supportable as long as there is no expectation that the LIFO inventories will be liquidated in the near term. This view is asserted on the basis that any amount allocated to LIFO inventories will not flow through income in periods immediately following the combination unless liquidation occurs, with such liquidation not expected. Despite the assertion that no liquidation is expected, existing accounting literature considers inventories to be a current asset and the guidance in paragraph 44 of Statement 141 (see **7.01**) excludes allocation of the excess of fair value of acquired net assets over cost to current assets.

Section 8 — Push-Down Basis of Accounting

8.00 For transactions within the scope of Statement 141, a new cost basis is established within the consolidated financial statements of the acquiring entity for the assets acquired and liabilities assumed, regardless of whether the acquired entity will remain as a separate corporate entity after the acquisition. If the acquired entity is to remain separate, Statement 141 does not address whether the separate financial statements of the acquired entity should reflect the new basis of accounting resulting from the acquisition through what is referred to as “push-down accounting.” In the absence of guidance in Statement 141, the applicability of push-down accounting to a specific set of facts and circumstances should be based on:

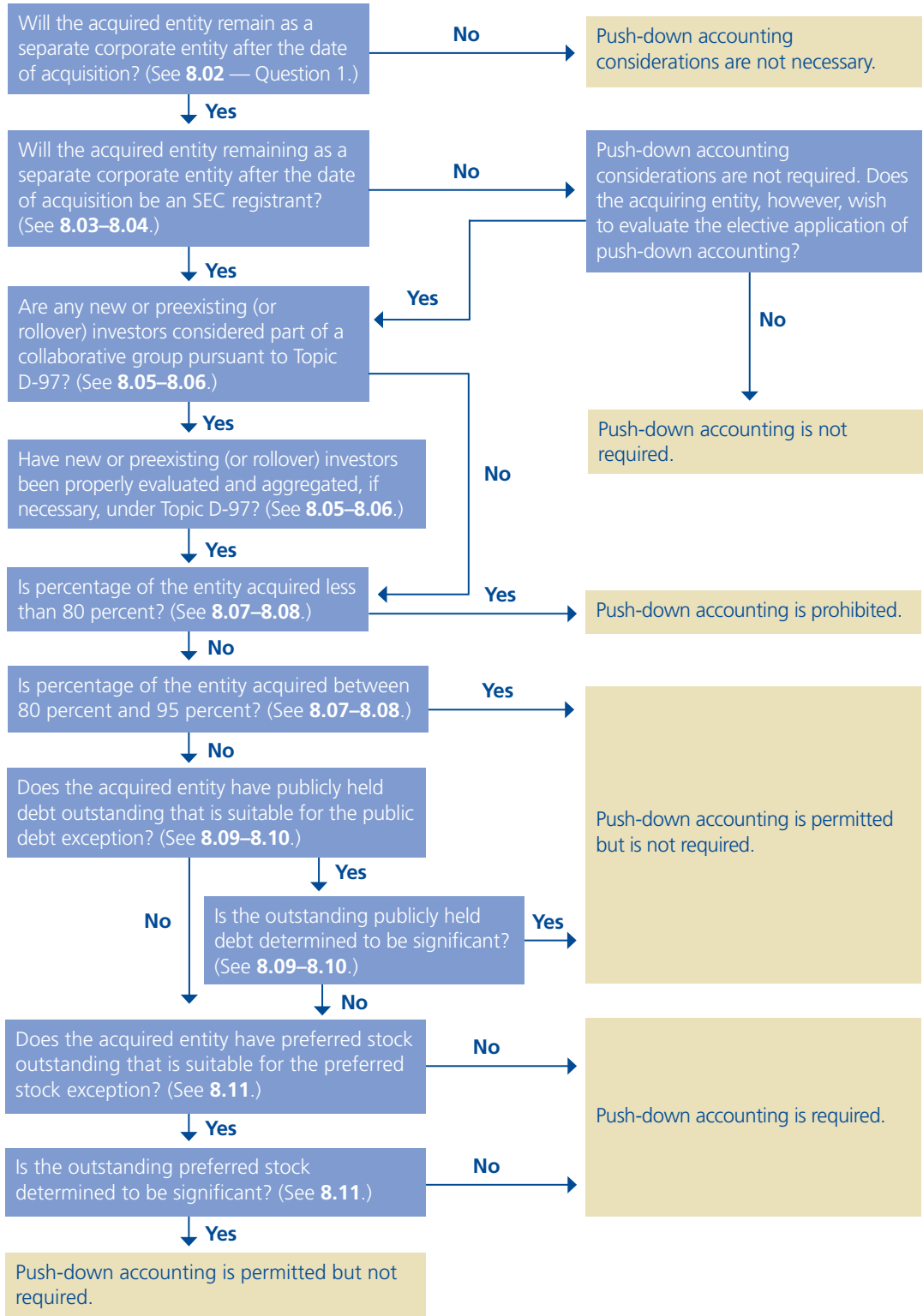
- SEC Staff Accounting Bulletin Topic 5.J, “Push Down Basis of Accounting Required in Certain Limited Circumstances.”
- EITF Topic No. D-97, “Push-Down Accounting.”
- Selected SEC staff speeches and informal comments from the SEC staff addressing the topic.

Evaluating the Applicability of Push-Down Accounting

8.01 The following flowchart provides a process for evaluating the applicability of push-down accounting to a specific set of facts and circumstances. It also refers to further discussion found herein.

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SEC SAB Topic 5.J — Push-Down Accounting Required in Certain Limited Circumstances

8.02 SAB Topic 5.J provides the following series of facts, questions, and interpretive responses:

Facts: Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1: Must Company B's financial statements presented in either its own or Company A's subsequent filings with the Commission reflect the new basis of accounting arising from Company A's acquisition of Company B when Company B's separate corporate entity is retained?

Interpretive Response: Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02(aa) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. Therefore, Company A's cost of acquiring Company B should be "pushed down," i.e., used to establish a new accounting basis in Company B's separate financial statements. [Footnote 5]

Question 2: What is the staff's position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretive [sic] Response: The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances.

Question 3: Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. [Footnote 6] Should Company B's new basis ("push down") financial statements include Company A's debt related to its purchase of Company B?

Interpretive Response: The staff believes that Company A's debt, [footnote 7] related interest expense, and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt.

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Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt. [Footnote 8] While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements 5 and 57 as well as Interpretation 45 require sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists. [Footnote 9]

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets [footnote 10] or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of its servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulation S-K.

Footnote 5 states, "The Task Force on Consolidation Problems, Accounting Standards Division of the American Institute of Certified Public Accountants issued a paper entitled 'Push Down' Accounting, October 30, 1979. This paper addresses the issues relating to 'push down' accounting, cites authoritative literature and indicates that a substantial change in ownership justifies a new basis of accounting."

Footnote 6 states, "The guidance in this SAB should also be considered for Company B's separate financial statements included in its public offering following Company B's spin-off or carve-out from Company A."

Footnote 7 states, "The guidance in this SAB should also be considered where Company A has financed the acquisition of Company B through the issuance of mandatory redeemable preferred stock."

Footnote 8 states, “The staff does not believe Company B’s financial statements must reflect the debt in this situation because in the event of default on the debt by Company A, the debt holder(s) would only be entitled to B’s stock held by Company A. Other equity or debt holders of Company B would retain their priority with respect to the net assets of Company B.”

Footnote 9 states, “For example, the staff has noted that certain registrants have indicated on the face of such financial statements (as part of the stockholder’s equity section) the actual or potential financing arrangement and the registrant’s intent to pay dividends to satisfy its parent’s debt service requirements. The staff believes such disclosures are useful to highlight the existence of arrangements that could result in the use of Company B’s cash to service Company A’s debt.”

Footnote 10 states, in part, “A material asset pledge should be clearly indicated on the face of the balance sheet. For example, if all or substantially all of the assets are pledged, the ‘assets’ and ‘total assets’ captions should include parenthetically: ‘pledged for parent company debt — See Note X.’”

Applicability of Push-Down Accounting to Companies That Are Not SEC Registrants

8.03 In EITF Issue No. 86-9, “IRC Section 338 and Push-Down Accounting,” the Task Force reached a consensus that “push-down accounting is not required for companies that are not SEC registrants.” While this subject is not addressed in Issue 86-9, current practice supports the acceptability of push-down accounting for companies that are not SEC registrants using the same acquisition thresholds as those applied by the SEC staff. (See **8.07–8.08** for discussion of the thresholds when determining whether a company has become substantially wholly owned.)

8.04 The SEC staff requires, for companies that become SEC registrants, that push-down accounting be reflected retrospectively to the extent then required by Topic D-97 and Topic 5.J.

Collaborative Groups — Topic D-97

8.05 Topic D-97 includes the following regarding a collaborative group:

In applying SAB 54 to specific facts and circumstances, a registrant must distinguish between transactions resulting in only a significant change in (recapitalization of) a company’s ownership (for example, as the result of an initial public offering for which push-down

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accounting is not required) and purchase transactions in which the company becomes substantially wholly owned and for which push-down accounting is required.

For purposes of determining whether a company has become “substantially wholly owned” as the result of a single transaction or a series of related and anticipated transactions in which investors acquire ownership interests, the SEC staff believes that it is appropriate to aggregate the holdings of those investors who *both* “mutually promote” the acquisition and “collaborate” on the subsequent control of the investee company (the collaborative group). [Footnote 1] That is, the SEC staff believes that push-down accounting is required if a company becomes substantially wholly owned by a group of investors who act together as effectively one investor and are able to control the form of ownership of the investee.

The SEC staff believes that under a “mutual promotion and subsequent collaboration” model, a member of a collaborative group would be any investor [footnote 2] that helps to consummate the acquisition and works or cooperates with the subsequent control of the acquired company. For purposes of assessing whether an investor is part of a collaborative group, the SEC staff believes that a rebuttable presumption exists that any investor investing at the same time as or in reasonable proximity to the time others invest in the investee is part of the collaborative group with the other investor(s). Determination of whether such a presumption is rebutted necessarily will involve the consideration of all pertinent facts and circumstances. Among the factors considered by the SEC staff [footnote 3] that would be indicative of an investor *not* being part of a collaborative group include:

I. Independence

- The investor is substantive. For example, the investor is an entity with substantial capital (that is, comparable to that expected for a substantive business with similar risks and rewards) and other operations. In contrast, an investor that is a special-purpose entity whose only substantive assets or operations are its investment in the investee generally would not be considered substantive.
- The investor is independent of and unaffiliated with all other investors.
- The investor’s investment in the investee is not contingent upon any other investor making investments in the investee.
- The investor does not have other relationships with any other investor that are material to either investor.

II. Risk of Ownership

- The investor is investing at fair value.
- The investor invests funds from its own resources.
- The investor fully shares with all other investors in the risks and rewards of ownership in the investee in proportion to its class and amount of investment. That is, the investor’s downside risk or upside reward are not limited, and the investor does not

receive any other direct or indirect benefits from any other investor as a result of investing in the investee. [Footnote 4]

- The funds invested by the investor are not directly or indirectly provided or guaranteed by any other investor.
- The investor is at risk only for its own investment in the investee and not another's investment in the investee. That is, the investor is not providing or guaranteeing any part of another investor's investment in the investee. [Refer to footnote 4.]

III. Promotion

- The investor did not solicit other parties to invest in the investee.

IV. Subsequent Collaboration

- The investor is free to exercise its voting rights in any and all shareholder votes.
- The investor does not have disproportionate or special rights that other investors do not have, such as a guaranteed seat(s) on the investee's board, required supermajority voting rights for major or significant corporate decisions, guaranteed consent rights over corporate actions, guaranteed or specified returns, and so forth.
- The investor's ability to sell its investee shares is not restricted, except as provided by the securities laws or by what is reasonable and customary in individually negotiated investment transactions for closely held companies (for example, a right of first refusal held by the investee on the investor's shares in the event of a bona fide offer from a third party).

The SEC staff has considered the applicability of push-down accounting in transactions in which financial investors, acting together effectively as one investor (that is, as a collaborative group), acquire ownership interests in a company. The investee company experiences a significant change in ownership, but no single financial investor obtains substantially all of the ownership interest in the company. Consider the following example:

Investor C formulates a plan to acquire and consolidate companies in a highly fragmented industry in order to achieve economies of scale. Investor C approaches Investors A and B with the plan, and they agree to invest with Investor C in the acquisition and consolidation plan. Investors A, B, and C (the Investors) are each substantive entities, with no overlap of employees but with a number of prior joint investments and other business relationships that are individually material to the Investors. Furthermore, upon completion of the current plan, the resulting entity is expected to be material to each individual investor.

Shortly thereafter, Company D is identified as an acquisition candidate in the industry. The Investors negotiate a legally binding agreement with Company D to acquire 100 percent of the outstanding common stock of Company D (to be held 40 percent, 40 percent, and 20 percent by Investors A, B, and C, respectively) for cash. In connection

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with the change in ownership, Company D's bylaws are amended to provide that the Investors each have the right to elect an equal number of members of Company D's board of directors. Company D's board of directors also is to include Company D's chief executive officer and two independent directors. In addition, the bylaws are amended to provide that no action requiring board of directors' approval may be approved without consent of a majority of the board as well as a majority of the Investor A directors, the Investor B directors, and the Investor C directors, each voting as a separate class. Effectively, any significant corporate action by Company D would require the approval of each investor.

Stock held by the Investors is to be restricted as to transfer for five years, after which each of the Investors has a right of first refusal and tag-along rights if some part of the group of Investors decides to sell its interests.

The funds invested by each investor come from the respective investor's resources; however, Investors A and B provide Investor C certain limited first-loss guarantees of its investment.

In the context of this example, the SEC staff concluded that Investors A, B, and C did not overcome the presumption that they were members of a collaborative group of investors. Furthermore, since the collaborative group of Investors acquired 100 percent of the outstanding common stock of Company D, the SEC staff concluded that push-down accounting was required to be applied in Company D's financial statements. The factors the SEC staff considered in reaching its conclusion that the presumption was not rebutted included, among others, the following:

- Investors A, B, and C acted in concert to negotiate their concurrent investments in Company D, which were made pursuant to the same contract.
- The investments by Investors A, B, and C were being made in connection with a broader strategic initiative the three investors were pursuing together.
- There were a number of prior business relationships between the Investors that were material to the Investors.
- Investor C does not share fully in the risks and rewards of ownership due to the limited first-loss guarantees provided by Investors A and B.
- No single Investor controlled the board of directors, and due to the amendments to the bylaws regarding board representation and voting, any of the three Investors could unilaterally block any board action. In other words, Investors A, B, and C were compelled to collaborate on the subsequent control of Company D.
- There are restrictions on each Investor's ability to transfer its shares.

Footnote 1 states, "A collaborative group is not necessarily the same as a control group as defined in Issue No. 88-16, 'Basis in Leveraged Buyout Transactions.'"

Footnote 2 states, “Preexisting, or rollover, investors should be evaluated for inclusion in the collaborative group on the same basis as new investors.”

Footnote 3 states, “In an assessment of whether the presumption is overcome, any single factor should not be considered in isolation.”

Footnote 4 states, “Put options, call options, tag-along rights, and drag-along rights should be carefully evaluated. They may act to limit an investor’s risk and rewards of ownership, effective voting rights, or ability to sell its investee shares. A tag-along right grants a shareholder the option to participate in a sale of shares by the controlling shareholder or collaborative group, generally under the same terms and in the same proportion. A drag-along right grants the controlling shareholder or collaborative group the option to compel shareholders subject to the drag-along provision to sell their shares in a transaction in which the controlling shareholder or collaborative group transfers control of the company, generally under the same terms and in the same proportion.”

Additional Considerations When Determining Whether a Collaborative Group Exists Under Topic D-97

8.06 Topic D-97 indicates the SEC staff belief that “a rebuttable presumption exists that any investor investing at the same time as or in reasonable proximity to the time others invest in an investee is part of the collaborative group with the other investor(s).” Overcoming this rebuttable presumption requires consideration of all pertinent facts and circumstances against the factors cited in Topic D-97. The SEC staff guidance contained in Topic D-97 is expected to continue to evolve as the SEC staff gains additional experience from specific transactions. The following are some additional considerations in applying Topic D-97 on the basis of both formal and informal comments from the SEC staff:

Risk of Ownership — Tag-along rights, drag-along rights, or both

SEC staff comments have suggested that tag-along or drag-along rights in any form not only raise issues of risk of ownership but may also indicate subsequent collaboration. (See **8.05**, footnote 4, for a description of tag-along and drag-along rights.)

Subsequent Collaboration — Disproportionate or special rights

SEC staff comments have suggested that any right, including one considered a protective right under EITF Issue No. 96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights,” may represent a special right indicating subsequent collaboration. In addition, SEC staff comments have indicated that contractual terms that provide new or

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preexisting investors with guaranteed board seats, even when they are proportionate to the equity held, may be deemed a special right indicating subsequent collaboration.

Subsequent Collaboration — Transferability restrictions

SEC staff comments have suggested that any transfer restrictions, other than those provided by securities law, may indicate subsequent collaboration.

Determining Whether a Company Has Become Substantially Wholly Owned

8.07 Topic D-97 provides that “[i]n determining whether a company has become substantially wholly owned, the SEC staff has stated that push-down accounting would be required if 95 percent or more of the company has been acquired (unless the company has outstanding public debt or preferred stock that may impact the acquirer’s ability to control the form of ownership of the company), permitted if 80 percent to 95 percent has been acquired, and prohibited if less than 80 percent of the company is acquired.”

8.08 SEC Regulation S-X, Rule 1-02(aa), “Definition of Terms Used in Regulation S-X,” provides that “[t]he term ‘wholly owned subsidiary’ means a subsidiary substantially all of whose outstanding voting shares are owned by its parents and/or the parent’s other wholly owned subsidiaries.” While the term “substantially wholly owned” is defined in SEC regulations in the context of outstanding voting securities, the SEC staff may require analysis of a parent’s investment in a subsidiary other than through outstanding voting securities (for example, nonvoting securities or instruments that are convertible into voting securities) in the determination of whether push-down accounting should be applied. Given the uncertainty of SEC staff’s views on this subject, if the parent holds other outstanding equity or debt securities or rights to equity or debt securities, and the consideration of such instruments may lead to a different conclusion about the application of push-down accounting on the basis of the thresholds noted in **8.07**, consultation with the SEC staff on a prefiling basis may be advisable.

Evaluating the Availability of the Public Debt Exception

8.09 The following general guidelines should be considered when evaluating whether outstanding public debt of the acquired entity qualifies for consideration under the exception discussed in Question 2 of Topic 5.J:

- To qualify, the public debt must be issued by the acquired entity before the date of acquisition and must remain outstanding after the date of acquisition. Public debt

issued in contemplation of the acquisition, even if replacing other public debt then outstanding, is not expected to qualify for the exception.

- If the public debt qualifying for the exception is subsequently redeemed and no other condition preventing the application of push-down accounting is then present, push-down accounting must be reflected retrospectively.

8.10 When referring to the existence of outstanding public debt, SAB Topic 5.J does not use the term “significant.” At the 1999 AICPA National Conference on Current SEC Developments, an SEC staff member (Eric W. Casey) addressed the application of push-down accounting in situations in which public debt is outstanding. In prepared remarks, Mr. Casey indicated that “while SAB 54 does not explicitly refer to significance of public debt, the staff believes that it is reasonable and consistent with the general principles of SAB 54 to consider the significance of public debt in assessing the applicability of push down accounting.” Mr. Casey further noted that “[i]n evaluating the significance of public debt, the staff believes that it is reasonable to consider both the quantitative and qualitative significance of the public debt.” Mr. Casey offered the following illustration of a quantitative and qualitative analysis of publicly held debt, concluding that the debt was neither quantitatively nor qualitatively significant and thus did not constitute a reason, in itself, not to apply push-down accounting as otherwise required:

Quantitatively, the debt amounted to approximately 5 percent of the subsidiary’s net book value and less than 1 percent of the subsidiary’s fair value. The debt holders, in the aggregate, would hold an approximately 1 percent interest in the subsidiary on an as-if-converted basis. Qualitatively, the debt holders had virtually no ability to control or influence the form of the parent’s ownership of its subsidiary, nor did the debt holders have consent rights regarding the buying out of the existing minority interests, issuing subsidiary equity, or the subsidiary paying dividends.

Evaluating the Availability of the Preferred Stock Exception

8.11 The same general guidelines in **8.09** should be followed when evaluating whether outstanding preferred stock qualifies for consideration under the exception discussed in Question 2 of SAB Topic 5.J. As with outstanding public debt, when referring to the existence of preferred stock, SAB Topic 5.J does not use the term “significant.” By analogy to the SEC staff’s remarks on outstanding public debt (referred to in **8.10**), for outstanding preferred stock to qualify for the exception, the preferred stock must be deemed significant. We are aware of no SEC staff comments on whether the determination of significance should be based solely on a quantitative analysis or on both a quantitative and qualitative analysis.

Accounting for Goodwill and Other Intangible Assets

Section 9 — Intangible Assets (Other Than Goodwill)

Finite Useful Life Versus Indefinite Useful Life

9.00 Appendix F of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, defines “intangible assets” as “[a]ssets (not including financial assets) that lack physical substance.” Intangible assets recognized apart from goodwill in a business combination or acquired individually or with a group of other assets are differentiated under Statement 142 between those subject to amortization (finite-lived) and those not subject to amortization (indefinite-lived), on the basis of a determination of the intangible asset’s expected useful life to the reporting entity. As in Statement 142, the term “intangible assets” is used herein to refer to intangible assets other than goodwill. The following is an overview of finite-lived and indefinite-lived intangible assets:

	Finite-Lived Intangible Assets	Indefinite-Lived Intangible Assets
Characteristics	Expected useful life to the reporting entity is limited.	No legal, regulatory, contractual, competitive, economic, or other factors limit the useful life to the reporting entity.
Amortization Period	Over the expected useful life to the reporting entity.	N/A
Amortization Method	Based on the pattern in which the economic benefits are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used.	N/A
Impairment Testing	<p>Tested for impairment in accordance with Statement 144.</p> <p>Testing required whenever events or circumstances indicate that the carrying amount of a long-lived asset (asset group) may not be recoverable. Impairment loss is recognized if the carrying amount of the asset or asset group tested is not recoverable and its carrying amount exceeds its fair value (two-step test).</p>	<p>Tested for impairment in accordance with Statement 142.</p> <p>Testing required annually or more frequently if events or changes in circumstances indicate that the asset might be impaired using a one-step (fair value to carrying value) test. EITF Issue No. 02-7, “Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets,” provides guidance on unit of accounting to apply (see 9.36–9.43).</p>

Internally Developed Intangible Assets

9.01 Paragraph 10 of Statement 142 provides that “[c]osts of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as an expense when incurred.”

Determining the Useful Life of an Intangible Asset

9.02 Paragraph 11 of Statement 142 states, in part:

The accounting for a recognized intangible asset is based on its **useful life** to the reporting entity. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. [Footnote omitted] The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular:

- a. The expected use of the asset by the entity [see **9.05–9.06**]
- b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate [see **9.07–9.08**]
- c. Any legal, regulatory, or contractual provisions that may limit the useful life [see **9.09–9.10**]
- d. Any legal, regulatory, or contractual provisions that enable renewal or extension of the asset’s legal or contractual life without substantial cost (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without material modifications of the existing terms and conditions) [see **9.11–9.18**]
- e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels) [see **9.19–9.20**]
- f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life) [see **9.21**]. [Footnote omitted]

9.03 Since the analysis of all pertinent factors is not limited to readily known factors or even those factors listed in paragraph 11 (see **9.02**), all relevant information must be accumulated and analyzed. Depending on the intangible asset, an analysis may require the assistance of specialists (for example, analysis of legal, regulatory, or contractual provisions).

9.04 The following are not, in themselves, sufficient to support a useful-life determination.

Examples Provided in Statement 142 — Appendix A of Statement 142 provides implementation guidance on intangible assets through examples that describe “an acquired intangible asset and the facts and circumstances surrounding the determination of its useful life and the subsequent accounting based on that determination.” In these examples, an indefinite useful life is determined for an acquired broadcast license, an acquired airline route authority, and an acquired trademark. However, paragraph A1 of Appendix A states that “[t]he facts and circumstances unique to each acquired intangible asset need to be considered in making similar determinations.” Therefore, the examples do not necessarily apply to other situations. Similarly, the statement in paragraph B60 of Statement 142 that “a taxicab medallion may be considered to have an indefinite useful life because the right associated with the asset can be renewed indefinitely at little or no cost” does not negate the requirement for each holder of such a right to perform its own useful-life determination.

Practice Examples — Intangible asset types may be common to entities in general (for example, a trade name) or to entities within a specific industry (for example, newspaper mastheads, operating and broadcasting rights). Since paragraph 11 of Statement 142 states that “[t]he useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity,” the useful-life assessments of other entities are not determinative.

Useful-Life Determination of Another Intangible Asset Within the Same Intangible Asset Class — Appendix F of Statement 142 defines “intangible asset class” as “[a] group of intangible assets that are similar, either by their nature or by their use in the operations of an entity.” Intangible asset classes could be, for a specific entity, trade names, newspaper mastheads, operating rights or broadcast rights. Since pertinent factors may vary, the useful-life determination for an intangible asset within a specific intangible asset class is not determinative for any other intangible asset within that class.

Analyzing the Expected Use of the Asset

9.05 According to paragraph 11(a) of Statement 142, in determining the useful life of an intangible asset, an entity must analyze the “expected use of the asset.”

9.06 Example 9 in paragraph A1 of Statement 142 provides the following illustration of the impact of a change in the expected use of the asset on the determination of useful life by an entity holding that asset:

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A trademark for a line of automobiles that was acquired several years ago in an acquisition of an automobile company. The line of automobiles had been produced by the acquired entity for 35 years with numerous new models developed under the trademark. At the acquisition date, the acquiring entity expected to continue to produce that line of automobiles, and an analysis of various economic factors indicated there was no limit to the period of time the trademark would contribute to cash flows. Because cash flows were expected to continue indefinitely, the trademark was not amortized. Management recently decided to phase out production of that automobile line over the next four years.

Because the useful life of that acquired trademark is no longer deemed to be indefinite, the trademark would be tested for impairment in accordance with paragraph 17 of this Statement. The carrying amount of the trademark after adjustment, if any, would then be amortized over its remaining four-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the trademark will be subject to amortization, in the future it would be reviewed for impairment under Statement 144.

Analyzing the Relationship of the Intangible Asset to Other Assets

9.07 According to paragraph 11(b) of Statement 142, determining the useful life of an intangible asset requires analysis of the “expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate.”

9.08 The relationship of an intangible asset to another asset or group of assets with a shorter useful life may limit the useful life of that intangible asset.

Example 9-1

Analyzing the Relationship of an Intangible Asset to Other Assets (Case A)

In recording an acquisition, Company A identified a nontransferable right held by the acquired entity to manufacture a specific product in a given geographic area. The remaining term is 10 years. Assuming no other factors, Company A would intend to use the right for its full remaining term. However, manufacturing the product, whose sales have steadily declined in recent years, requires significant investment in specialized equipment. The acquired entity is using specialized equipment with an estimated remaining useful life of eight years. Because of the product's declining sales and the investment necessary for replacement equipment, Company A does not intend to replace the specialized equipment at the end of its estimated useful life. Although the manufacturing right has a remaining contractual term of 10 years, the eight-year term of the specialized equipment, along with management's intention regarding replacement equipment, would effectively limit the useful life of the right to a period shorter than its remaining contractual term.

Example 9-2**Analyzing the Relationship of an Intangible Asset to Other Assets (Case B)**

In recording an acquisition, Company B identified a perpetual right held by the acquired entity to produce electric power in a given geographic area. Pursuant to this right, Company B will continue to produce electric power at an existing plant after the acquisition. Company B intends to replace this plant at the end of its remaining useful life, which is 30 years. Evidence also indicates that Company B will be able to construct a replacement plant when needed. Therefore, although the existing plant has an estimated useful life shorter than the period granted by the right to produce electric power, this would not shorten the estimated useful life of the right to produce electric power given management's intention and ability to construct a replacement plant.

Analyzing Legal, Regulatory, or Contractual Provisions That May Limit the Useful Life

9.09 According to paragraph 11(c) of Statement 142, determining the useful life of an intangible asset requires analysis of "[a]ny legal, regulatory, or contractual provisions that may limit the useful life."

9.10 Examples 4 and 5 in paragraph A1 of Statement 142, combined below, illustrate the analysis of this pertinent factor:

An acquired broadcast license that expires in five years. The broadcast license is renewable every 10 years if the company provides at least an average level of service to its customers and complies with the applicable Federal Communications Commission (FCC) rules and policies and the FCC Communications Act of 1934. The license may be renewed indefinitely at little cost and was renewed twice prior to its recent acquisition. The acquiring entity intends to renew the license indefinitely, and evidence supports its ability to do so. Historically, there has been no compelling challenge to the license renewal. The technology used in broadcasting is not expected to be replaced by another technology any time in the foreseeable future. Therefore, the cash flows from that license are expected to continue indefinitely.

The broadcast license would be deemed to have an indefinite useful life because cash flows are expected to continue indefinitely. Therefore, the license would not be amortized until its useful life is deemed to be no longer indefinite. The license would be tested for impairment in accordance with paragraph 17 of this Statement.

The FCC subsequently decides that it will no longer renew broadcast licenses, but rather will auction those licenses. At the time the FCC decision is made, the broadcast license has three years until it expires. The cash flows from that license are expected to continue until the license expires.

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Because the broadcast license can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired license would be tested for impairment in accordance with paragraph 17 of this Statement. The license would then be amortized over its remaining three-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the license will be subject to amortization, in the future it would be reviewed for impairment under Statement 144.

Analyzing Renewal or Extension Provisions

9.11 According to paragraph 11(d) of Statement 142, determining the useful life of an intangible asset requires analysis of “[a]ny legal, regulatory, or contractual provisions that enable renewal or extension of the asset’s legal or contractual life without substantial cost (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without material modifications of the existing terms and conditions).”

9.12 Paragraph B47 of Statement 142 notes:

The Board observed that legal rights often are conveyed for limited terms that may be renewed, and therefore it considered whether renewals should be assumed in establishing useful lives for those intangible assets. The Board noted that some types of licenses are initially issued for finite periods but renewals are routinely granted with little cost, provided that licensees have complied with the applicable rules and regulations. Such licenses trade at prices that reflect more than the remaining term, thereby indicating that renewal at minimal cost is the general expectation, and thus their useful lives may be indefinite. However, renewals are not assured for other types of licenses, and even if they are renewed, substantial costs may be incurred for their renewal. Because the useful lives of certain intangible assets depend on renewal and on the associated costs, the Board concluded that the useful lives assigned to those assets may reflect renewal only if there is evidence to support renewal without substantial cost.

9.13 As long as no provision prohibits renewal (see **9.09**), it is customary to evaluate the likelihood of renewal or extension. In analyzing renewal or extension of the asset’s legal or contractual life, one should consider an entity’s history with that or a similar asset as well as the history of other entities with similar assets. In addition, one should assess the current environment surrounding renewal or extension. For some assets, renewal will be viewed as perfunctory, on the basis of the history of renewal or extension, the rights of the holder of the asset to ensure renewal or extension, and the presence of nominal cost related to renewal or extension. Other fact patterns will require more judgment, including situations in which the asset has not yet come up for renewal or extension or in

which historical patterns are less uniform. Unless renewal or extension can be supported on the basis of the available facts and circumstances, treatment of an intangible asset as indefinite-lived would not be appropriate.

9.14 In EITF Issue No. 03-9, “Determination of the Useful Life of Renewable Intangible Assets Under FASB Statement No. 142,” the Task Force discussed how “substantial cost” and “material modifications” should be analyzed under paragraph 11(d) of Statement 142 in determining whether an intangible asset has an indefinite or finite useful life. Paragraph 16 of Issue 03-9 states:

At the September 29–30, 2004 meeting, the Task Force decided to remove this Issue from the EITF agenda. The Task Force discussed the meaning of both *renewal cost* and *modification* and discussed the implication that those factors have on the useful life of a renewable intangible asset. The Task Force generally agreed that limiting the useful life of a renewable intangible asset to a period that is shorter than the period over which the renewable intangible asset is expected to contribute future cash flows is inconsistent with the definition of *useful life* under Statement 142 and the market participant approach for determining fair value in Statement 141. Accordingly, the Task Force asked the Board to consider that issue. The Board agreed to consider whether to provide guidance on how the factors in subparagraph 11(d) of Statement 142 should be evaluated in determining the useful life of an intangible asset. [See **9.17–9.18**.]

9.15 After the EITF’s decision to remove Issue 03-9 from its agenda (see **9.14**), at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member (Chad A. Kokenge), in prepared remarks, stated:

Consistent with the general direction of the Task Force discussion at the June 30–July 1, 2004 EITF meeting, the SEC staff believes the types of costs and modifications that should be evaluated under paragraph 11(d) of FAS 142 for renewable intangible assets are those expected costs and modifications that an entity would not expect to incur if the intangible asset was perpetual in nature. Following on this theme, in the context of the paragraph 11 evaluation, we also believe the definitions of “renewal cost” and “modification” that were developed for the issue supplement [endnote omitted] used at the September 2004 EITF meeting are helpful. That is, renewal costs are, “costs that an entity reasonably would expect to incur that it would not otherwise incur if the renewable intangible asset was perpetual rather than renewable”, and modifications are, “changes to the terms and conditions that an entity reasonably would expect to occur that it would not otherwise expect to occur if the renewable intangible asset was perpetual rather than renewable.” So, notwithstanding the lack of consensus from the EITF, we believe these views should be helpful in analyzing transactions under paragraph 11.

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9.16 The following example illustrates the application of the above-noted SEC staff member's remarks to the example in Issue Summary 1 of Issue 03-9.

Example 9-3

Analyzing Renewal Costs of an Intangible Asset

Issue Summary 1 of Issue 03-9 provides the following example:

"Company A holds an acquired cable franchise right issued by a local franchising authority. The franchise right permits Company A to provide cable services to subscribers in the franchise area for a specified term of five years, subject to renewal or extension. The cable franchise has been renewed on two previous occasions. The direct, out-of-pocket costs of renewing the franchise right have been nominal. Company A is currently in discussions with the local franchising authority regarding renewal for another five-year term.

Pursuant to the Cable Communications Policy Act of 1984, the local franchising authority can require the cable operator to upgrade the cable system to meet the community's cable-related needs and interests. The local franchising authority has requested that Company A upgrade the cable system. Although the costs to upgrade the cable system will be significant compared to the direct costs of obtaining the renewal, Company A has readily agreed to the upgrade, viewing it as necessary to remain competitive with digital satellite service that is available in the area. The agreement to upgrade the cable system will be included in the terms of renewal. Costs of the upgrade will be capitalized as PP&E. In addition, in connection with the renewal process, Company A voluntarily committed to increase the number of employees available at its customer call-in center during off peak hours."

Analysis of Costs of Renewal — In determining the costs of renewal, Company A must analyze the direct out-of-pocket costs of renewal as well as the expected expenditures associated with the system upgrade and the increased number of employees available in the customer call-in center. To exclude an expenditure from the evaluation of substantial cost, Company A must demonstrate that the expenditure would have been incurred as long as the arrangement was perpetual. Direct out-of-pocket costs would always be considered a cost of renewal since such costs would not have been incurred in a perpetual arrangement. The expected costs to upgrade the system would most likely not be viewed as a cost of renewal since Company A views the upgrade as necessary to remain competitive and thus probably would have incurred the cost in a perpetual arrangement. Expected costs related to increasing the number of employees at its call-in center during off-peak hours would also require analysis of whether Company A would have been expected to incur such a cost in a perpetual arrangement. Expected capitalization of an expenditure does not, in itself, indicate whether such an expenditure should or should not be considered a cost of renewal. Paragraph B60 of Statement 142 states, in part, "[t]he Board noted that whether the cost of renewal is substantial should be determined based on the relationship of the renewal cost to the fair value of the intangible asset at the time it is acquired."

9.17 In December 2005, the FASB issued proposed FASB Staff Position (FSP) No. FAS 142-d, "Amortization and Impairment of Acquired Renewable Intangible Assets." Paragraphs 4–6 of the proposed FSP state the following:

4. Constituents have indicated that the application of paragraph 11(d) of Statement 142 to renewable intangible assets often results in a useful life that is shorter than the period of cash flows that were used in determining the fair value of the asset in accordance with Statement 141. Consider the following example:

Company C operates a television station. On September 1, 20X4, Company C acquired Company D in a business combination. A significant portion of the purchase price relates to a network affiliation agreement that permits Company C to operate the station as an affiliate of a major network broadcasting company. The network affiliation agreement is renewable every 2 years and has been renewed or extended on 15 previous occasions. While the relationship has remained in place for over 30 years, due to the evolution of the industry many of the terms and conditions (for example, those governing the delivery of programming and pricing) have been subject to modification over time. Company C reasonably expects that it will be required to increase its local programming for the foreseeable future (which will require an increased cash outflow to secure the programming) but will receive an increase in revenue sharing from local advertising to offset those costs. Company C does not anticipate any additional costs or changes in the terms and conditions of the contract. The nature of the historical modifications has not resulted in significant changes to the underlying economics, the overall value of the intangible asset, or the fundamental nature of the right — the right to air network programming and earn a share of advertising revenue thereon.

5. Based on the above example, Company C would likely have utilized cash flows that extend beyond the remaining two-year contractual term in determining the fair value of the asset in accordance with Statement 141. In evaluating the useful life in accordance with paragraph 11 of Statement 142, some constituents would have concluded that the expected renegotiation results in "material modifications" of the existing terms and conditions of the asset. Accordingly, these constituents would likely have determined that the asset's useful life to the reporting entity is two years and amortized the entire fair value of the asset over this period.
6. Questions have arisen as to whether the Board intended for the application of paragraph 11(d) to result in a useful life of a renewable intangible asset that is shorter than the period of cash flows used to determine the fair value of the asset under Statement 141. A similar practice issue exists for renewable intangible assets acquired outside of a business combination. Questions have also arisen as to how the phrase *material modifications* in paragraph 11(d) of Statement 142 should be interpreted.

9.18 In May 2006, the FASB voted to remove proposed FSP FAS 142-d from its agenda without providing specific guidance; however, in March 2007, the FASB voted to add another project to its agenda to provide guidance on the determination of the useful life and methods of amortization and impairment for renewable intangible assets.

Analyzing the Effects of Obsolescence, Demand, Competition, and Other Economic Factors

9.19 According to paragraph 11(e) of Statement 142, estimating the useful life of an intangible asset to an entity requires analysis of “[t]he effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels).”

9.20 Example 3 in paragraph A1 of Statement 142 provides the following illustration of the analysis of this pertinent factor:

An acquired copyright that has a remaining legal life of 50 years. An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate cash flows for approximately 30 more years.

The copyright would be amortized over its 30-year estimated useful life following the pattern in which the expected benefits will be consumed or otherwise used up and reviewed for impairment under Statement 144.

Analyzing the Level of Maintenance Expenditures

9.21 According to paragraph 11(f) of Statement 142, estimating the useful life of an intangible asset to an entity requires analysis of “the level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life).” [Footnote 10]

Footnote 10 states, “As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.”

Determining Whether an Intangible Asset Has an Indefinite Useful Life

9.22 Paragraph 11 of Statement 142 provides that “[i]f 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 infinite.”

Intangible Assets Subject to Amortization

9.23 Paragraph 12 of Statement 142 states:

A recognized intangible asset shall be amortized over its useful life to the reporting entity unless that life is determined to be indefinite. If an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset shall be amortized over the best estimate of its useful life. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used. [See **9.28–9.32.**] An intangible asset shall not be written down or off in the period of acquisition unless it becomes impaired during that period. [Footnote 11]

Footnote 11 provides that “[b]oth Statement 2 and Interpretation 4 require amounts assigned to acquired intangible assets that are to be used in a particular research and development project and that have no alternative future use [are required] to be charged to expense at the acquisition date.”

9.24 Paragraph 13 of Statement 142 states:

The amount of an intangible asset to be amortized shall be the amount initially assigned to that asset less any **residual value**. The residual value of an intangible asset shall be assumed to be zero unless at the end of its useful life to the entity the asset is expected to continue to have a useful life to another entity and (a) the reporting entity has a commitment from a third party to purchase the asset at the end of its useful life or (b) the residual value can be determined by reference to an exchange transaction in an existing market for that asset and that market is expected to exist at the end of the asset’s useful life.

Appendix F of Statement 142 defines “residual value” as “[t]he estimated fair value of an intangible asset at the end of its useful life to an entity, less any disposal costs.”

Determining the Useful Life of an Intangible Asset Subject to Amortization Each Reporting Period

9.25 Paragraph 14 of Statement 142 provides that “[a]n entity shall evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization.” Accordingly, after the initial determination of useful life, an entity must identify and evaluate those events or circumstances that, if occurring after or changed from the previous determination, may affect the remaining useful life. Some events or circumstances will represent discrete and easily identifiable events to which the entity should readily respond (e.g., a change in regulation). Other events or circumstances may develop more gradually but must be monitored by the entity (e.g., obsolescence, competition, demand).

Accounting for a Change in Remaining Useful Life of an Intangible Asset Subject to Amortization

9.26 Paragraph 14 of Statement 142 states:

If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively over that revised remaining useful life. If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset shall be tested for impairment in accordance with paragraph 17. [For the requirements for testing of intangible assets not subject to amortization, see **9.34.**] That intangible asset shall no longer be amortized and shall be accounted for in the same manner as other intangible assets that are not subject to amortization.

Recognition and Measurement of an Impairment Loss for Intangible Assets Subject to Amortization

9.27 Paragraph 15 of Statement 142 states:

An intangible asset that is subject to amortization shall be reviewed for impairment in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, by applying the recognition and measurement provisions in paragraphs 7–24 of that Statement. In accordance with Statement 144, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

See **12.14** for disclosure requirements related to intangible asset impairments.

Method of Amortization

9.28 Paragraph 12 of Statement 142 requires, for intangible assets subject to amortization, that “[t]he method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used.”

9.29 Paragraph B54 of Statement 142 states:

In considering the methods of amortization, the Board noted that Opinion 17 required that a straight-line method be used to amortize intangible assets unless another method was demonstrated to be more appropriate. However, the Board also noted that circumstances may exist in which another method may be more appropriate, such as in the case of a

license that entitles the holder to produce a finite quantity of product. The Board therefore concluded that the amortization method adopted should reflect the pattern in which the asset is consumed if that pattern can be reliably determined, with the straight-line method being used as a default.

9.30 While the example in paragraph B54 of Statement 142 (see **9.29**) of a license that permits production of a finite quantity of product may provide a reliably determinable pattern of benefits, other fact patterns may not be clear. For example, if the license instead allowed for unlimited production over a finite period, it is not clear whether to view the asset as consumed on the basis of the estimate of production or on the basis of a lapse in time (since the holder of the right has unlimited access equally throughout the license period). In Issue 03-9 the Task Force discussed these two alternative views but did not reach a consensus.

9.31 When a method of amortization is based on cash flow estimates, a separate question arises about whether the ratio of period cash flows to total cash should be based on undiscounted or discounted cash flows. Paragraph B12 of proposed FSP FAS 142-d stated:

The provisions of this FSP require that upon acquisition of a renewable intangible asset the fair value of the asset be attributed to the initial contractual period of use and all future renewal periods based on the relative value of the discounted cash flows each period compared with the total discounted cash flows. The Board discussed whether this attribution should be based on discounted or undiscounted cash flows. The Board noted that in Issue 03-9 the Task Force discussed an amortization methodology that would have been based on undiscounted cash flows. The Task Force decided on the use of undiscounted cash flows to avoid a downward sloping amortization curve for assets with ratable cash flows due solely to the time value of money. The Board observed, however, that the asset's fair value determination by an income approach uses discounted cash flows and, therefore, consistent with paragraph 12 of Statement 142, using discounted cash flows for the attribution of amortization expense better represents the pattern of consumption of the economic benefits of the asset.

As noted in **9.18**, in May 2006, the FASB voted to remove proposed FSP FAS 142-d from its agenda without providing specific guidance. Prior to any additional guidance from the FASB on the use of discounted versus undiscounted cash flows in the determination of amortization each period, the use of discounted versus undiscounted cash flows will most likely be viewed as an accounting policy election that should be consistently applied to all intangible assets subject to amortization.

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9.32 See **11.02–11.05** for discussion about the presentation of intangible asset amortization expense in the income statement.

Intangible Assets Not Subject to Amortization

Determining the Useful Life of an Intangible Asset Not Subject to Amortization Each Reporting Period

9.33 Paragraph 16 of Statement 142 states:

If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite. An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with paragraph 17. [For the requirements for testing of intangible assets not subject to amortization, see **9.34.**] That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

Recognition and Measurement of an Impairment Loss for Intangible Assets Not Subject to Amortization

9.34 Paragraph 17 of Statement 142 states:

An intangible asset that is not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. (Paragraph 8 of Statement 144 includes examples of impairment indicators.) The impairment test shall consist of a comparison of the fair value of an intangible asset with its carrying amount. [Footnote 12] If the carrying amount of an intangible asset exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

Footnote 12, which is deleted by paragraph E22 of Statement 157, states that “[t]he fair value of an intangible asset shall be estimated using the guidance in paragraphs 23–25 [of Statement 142] (except the guidance specific to estimating the fair value of a **reporting unit**).”

See **12.14** for disclosure requirements related to intangible asset impairments.

Timing of the Annual Impairment Test

9.35 Although paragraph 17 of Statement 142 does not explicitly require it, entities with intangible assets not subject to amortization are expected to select a recurring date for testing of each indefinite-lived intangible asset or unit of accounting as determined under EITF Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets." Because of the lack of a specific requirement, however, if an entity changes this recurring date, it does not have to evaluate the change as an accounting change as required by paragraph 26 of Statement 142 when the annual testing date for goodwill is changed (see **10.22–10.24**).

Unit of Accounting for Impairment Testing of Indefinite-Lived Intangible Assets

9.36 Paragraph 2 of Issue 02-7 states:

Questions have arisen on what the appropriate unit of accounting is when testing indefinite-lived intangible assets for impairment. Some entities acquire intangible assets in separate transactions; however, those individual assets are collectively used in a manner that suggests they represent one asset. For example, an entity might acquire, in separate transactions, contiguous easements to support development of a single gas pipeline. In fact patterns such as those, the question is whether the collection of legal rights should be deemed a single unit of accounting for impairment testing purposes (an easement supporting a pipeline) or whether each individually acquired legal right should be separately tested for impairment. Questions also have been raised as to when, if ever, different indefinite-lived intangible assets should be combined into a single "unit of accounting" for impairment testing purposes. An example is whether it is ever appropriate to combine (a) different trade names, (b) a trade name and a different type of indefinite-lived intangible asset such as an easement, or (c) all indefinite-lived intangible assets and test the combined asset for impairment.

9.37 Paragraph 3 of Issue 02-7 states that "[t]he issue is what the unit of accounting should be for purposes of testing indefinite-lived intangible assets for impairment pursuant to paragraph 17 of Statement 142."

9.38 Paragraph 4 of Issue 02-7 states:

The Task Force reached a consensus that separately recorded indefinite-lived intangible assets, whether acquired or internally developed, should be combined into a single unit of accounting for purposes of testing impairment if they are operated as a single asset and, as such, are essentially inseparable from one another. The Task Force agreed that determining whether several indefinite-lived intangible assets are essentially inseparable is a matter of

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judgment that depends on the relevant facts and circumstances and that the indicators set forth below should be considered in making that determination. The Task Force agreed that none of the indicators should be considered presumptive or determinative.

Indicators that two or more indefinite-lived intangible assets should be combined as a single unit of accounting for impairment testing purposes:

- The intangible assets were purchased in order to construct or enhance a single asset (that is, they will be used together).
- Had the intangible assets been acquired in the same acquisition they would have been recorded as one asset.
- The intangible assets as a group represent the highest and best use of the assets (for example, they yield the highest price if sold as a group). This may be indicated if (a) it is unlikely that a substantial portion of the assets would be sold separately or (b) the sale of a substantial portion of the intangible assets individually would result in a significant reduction in the fair value of the remaining assets as a group.
- The marketing or branding strategy provides evidence that the intangible assets are complementary, as that term is used in paragraph A16 of Statement 141.

Indicators that two or more indefinite-lived intangible assets should not be combined as a single unit of accounting for impairment testing purposes:

- Each intangible asset generates cash flows independent of any other intangible asset (as would be the case for an intangible asset licensed to another entity for its exclusive use).
- If sold, each intangible asset would likely be sold separately. A past practice of selling similar assets separately is evidence indicating that combining assets as a single unit of accounting may not be appropriate.
- The entity has adopted or is considering a plan to dispose of one or more intangible assets separately.
- The intangible assets are used exclusively by different Statement 144 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.

9.39 Paragraph 5 of Issue 02-7 states:

The Task Force made the following observations about the unit of accounting used to test indefinite-lived intangible assets for impairment.

- a. The unit of accounting should include only indefinite-lived intangible assets — those assets cannot be tested in combination with goodwill or with a finite-lived asset.

- b. The unit of accounting cannot represent a group of indefinite-lived intangible assets that collectively constitute a business.
- c. A unit of accounting may include indefinite-lived intangible assets recorded in the separate financial statements of consolidated subsidiaries. As a result, an impairment loss recognized in the consolidated financial statements may differ from the sum of the impairment losses (if any) recognized in the separate financial statements of those subsidiaries.
- d. If the unit of accounting used to test impairment of indefinite-lived intangible assets is contained in a single reporting unit, the same unit of accounting and associated fair value should be used for purposes of measuring a goodwill impairment loss in accordance with paragraph 20 of Statement 142.

9.40 Furthermore, paragraph 5 of Issue 02-7 states:

The Task Force reached a consensus that if, based on a change in the way in which intangible assets are used, a company combines as a unit of accounting for impairment testing purposes indefinite-lived intangible assets that were previously tested for impairment separately, those intangible assets should be separately tested for impairment in accordance with paragraph 17 of Statement 142 prior to being combined as a unit of accounting.

9.41 Exhibit 02-7A provides the following examples of the application of the EITF consensus on Issue 02-7:

Example 1 — Easements

Company X is a distributor of natural gas. Company X has two self-constructed pipelines, the Northern pipeline and the Southern pipeline. Each pipeline was constructed on land for which Company X owns perpetual easements. The Northern pipeline was constructed on 50 easements acquired in 50 separate transactions. The Southern pipeline was constructed on 100 separate easements that were acquired in a business combination and were recorded as 1 asset. Although each pipeline functions independently of the other, they are contained in the same reporting unit. Operation of each pipeline is directed by a different manager. There are discrete, identifiable cash flows for each pipeline; thus, each pipeline and its related easements represent a separate Statement 144 asset group. While Company X has no current plans to sell or otherwise dispose of any of its easements, Company X believes that if either pipeline was sold, it would most likely convey all rights under the easements with the related pipeline.

Evaluation: Company X would have two units of accounting for purposes of testing the easements for impairment — the collection of easements supporting the Northern pipeline and the collection of easements supporting the Southern pipeline. The 50 easements supporting the Northern pipeline represent a single unit of accounting as evidenced by the fact that (a) they are collectively used together in a single Statement 144 asset group, (b) if acquired in a single transaction, they would have been recorded as one asset, and (c) if sold,

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they would likely be sold as a group with the related pipeline. For the same reasons, the easements supporting the Southern pipeline would represent a single unit of accounting.

Because the collective land easements underlying the Northern and Southern pipelines generate cash flows independent of one another and are used exclusively by separate Statement 144 asset groups, they should not be combined into a single unit of accounting.

Example 2 — Trade Name

Company Y purchases an international vacuum cleaner manufacturer, Company A, which sells vacuums under a well-known trade name. The operations of Company A are conducted through separate legal entities in 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 a Statement 144 asset group. A single brand manager is responsible for the Company A trade name, the value of which is expected to be recovered from the worldwide sales of Company A's products.

Evaluation: The three separately recorded trade name assets should be combined into a single unit of accounting for purposes of testing the acquired trade name for impairment. The three registered trade names were acquired in the same business combination and, absent the requirement to prepare separate financial statements for subsidiaries, would have been recorded as a single asset. The trade name is managed by a single brand manager. If sold, Company X would most likely sell all three legally registered trade names as a single asset.

Example 3 — Brands

Company Z manufactures and distributes cereals under two different brands, Brand A and Brand B. Both brands were acquired in the same business combination. Company Z recorded two separate intangible assets representing Brand A and Brand B. Each brand represents a group of complementary indefinite-lived intangible assets including the trademark, the trade dress, and a recipe. Brand A has two underlying trade names for its Honey and Cinnamon cereals. The trade name and recipe of Cinnamon were internally generated subsequent to the acquisition of Brand A. Sales of Honey have decreased while sales of Cinnamon have increased over the past several years. Despite the decline in sales of Honey, the combined sales of Honey and Cinnamon have increased at the levels expected by management. Sales of Brand B also have increased at expected levels. There are discrete cash flows for Honey, Cinnamon, and Brand B, and each represents a separate Statement 144 asset group. Both Honey and Cinnamon are managed by one brand manager. A separate brand manager is responsible for Brand B; however, there are some shared resources used by these groups, such as procurement. While Company Z has no current plans to sell its brands or exit the cereal business, it believes if it ever did, it would exit the cereal business in its entirety.

Evaluation: Company Z would have two units of accounting for purposes of testing the acquired brands for impairment. Brand A's purchased Honey and internally generated Cinnamon trademarks should be combined as a single unit of accounting for purposes of impairment testing. The intangible asset associated with the Cinnamon trademark is simply a variation of the previously acquired Brand A Honey trademark. Although they are associated with different Statement 144 asset groups, they are managed by a single brand manager. Company Z would consider Brand B to be a separate unit of accounting for purposes of testing impairment because that brand is managed separately from Brand A and is used exclusively by a separate Statement 144 asset group.

Determining the Carrying Amount of an Indefinite-Lived Intangible Asset When Removing That Asset From a Unit of Accounting

9.42 Paragraph 4 of Issue 02-7 provides that “[t]he Task Force reached a consensus that separately recorded indefinite-lived intangible assets, whether acquired or internally developed, should be combined into a single unit of accounting for purposes of testing impairment if they are operated as a single asset and, as such, are essentially inseparable from one another.” An indefinite-lived intangible asset may need to be removed from a single unit of accounting if that intangible asset is sold separately from the unit of accounting, the unit of accounting is reconsidered (such as in connection with a larger reorganization of the entity), or the entity concludes that the indefinite-lived intangible asset is now finite-lived. The EITF Agenda Committee Report dated September 29–30, 2004, provides that “[q]uestions have arisen about how to determine the carrying amount of an intangible asset that previously was combined with other indefinite-lived intangible assets for impairment testing purposes.” As provided in the EITF Agenda Committee Report, “[t]he Agenda Committee decided not to add this issue to the EITF’s agenda.” In the absence of specific guidance, we believe an entity should determine the carrying amount of an intangible asset removed from a unit of accounting under Issue 02-7, on the basis of that intangible asset’s historical carrying amount when placed into the unit of accounting less the intangible asset’s allocation of any impairments recognized subsequently to the unit of accounting. The combining of indefinite-lived assets into a unit of accounting is solely for impairment testing purposes; each individually recorded intangible asset does not cease to exist as a separately recorded asset as a result of the combination. Subsequent impairments should be allocated to the intangible assets within the unit of accounting on a pro rata basis using the relative historical carrying amounts of the individual intangible assets. This approach is consistent with paragraph 14 of Statement 144 regarding the allocation of impairment losses within an asset group. The following examples illustrate the above-described general principles:

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Example 9-4

Readily Available Historical Carrying Amount

Company A holds three perpetual easements grouped into a unit of accounting for impairment testing purposes. Easements 1 and 2 were acquired as part of a single transaction for consideration of \$100 (no separate assignment of carrying amount to each easement was made at the time of the acquisition). Easement 3 was acquired separately for consideration of \$150. No impairment in the carrying amount of the unit of accounting has been recognized subsequently.

Assume that Easement 3 was disposed of in connection with the sale of the underlying property to which the easement relates. In this case, the carrying amount of the easement disposed (Easement 3) would be determined on the basis of the readily available historical carrying amount of that easement (\$150).

Note: Issue 02-7 provides that “[a] past practice of selling similar assets separately is evidence indicating that combining assets as a single unit of accounting may not be appropriate.”

While a past practice is only one of the indicators given in Issue 02-7, none of which should be considered presumptive or determinative, entities that dispose of an asset(s) within a unit of accounting must be able to support their unit of accounting conclusions both historically and prospectively in accordance with Issue 02-7’s other indicators.

Example 9-5

Historical Carrying Amount That Is Not Readily Available

Company A holds three perpetual easements grouped into a unit of accounting for impairment testing purposes. Easements 1 and 2 were acquired as part of a single transaction for consideration of \$100 (no separate assignment of a carrying amount to each easement was made at the time of the acquisition). Easement 3 was acquired separately for consideration of \$150. No impairment in the carrying amount of the unit of accounting has been recognized subsequently.

Assume that Easement 1 was disposed of in connection with the sale of the underlying property to which the easement relates. In this case, the historical carrying amount of the easement disposed (Easement 1) is not readily available since no separate assignment of a carrying amount to each easement was made at the time of the acquisition. In the absence of a readily available historical carrying amount, Company A should develop a reasonable and supportable method to determine the historical carrying amount on the basis of the best evidence of the facts and circumstances existing at the time of the easement’s acquisition.

See **Note** in Example 9-4.

Example 9-6**The Impact of a Subsequent Impairment of the Unit of Accounting**

Company A holds three perpetual easements grouped into a unit of accounting for impairment testing purposes. Easements 1 and 2 were acquired as part of a single transaction for consideration of \$100 (no separate assignment of a carrying amount to each easement was made at the time of the acquisition). Easement 3 was acquired separately for consideration of \$150. After the acquisition of the three easements, an impairment of \$50 was measured with respect to the unit of accounting.

Assume that Easement 3 was disposed of in connection with the sale of the underlying property to which the easement relates. In this case, the carrying amount of the easement disposed (Easement 3) would be determined on the basis of the readily available historical carrying amount of that easement (\$150) net of the effect of the subsequent impairment of the unit of accounting. The impairment loss should be allocated to the intangible assets of the unit of accounting on a pro rata basis using the relative historical carrying amount of those assets, which is consistent with paragraph 14 of Statement 144. In this example, the impairment loss allocable to Easement 3 would equal 60 percent (\$150 divided by \$250) of the total impairment loss of \$50, or \$30, resulting in a historical carrying amount of Easement 3 equal to \$120 (\$150 less \$30).

See **Note** in Example 9-4.

Carrying Forward the Fair Value Measurements of Indefinite-Lived Intangible Assets From One Year to the Next

9.43 Paragraph 27 of Statement 142 provides guidance on carrying forward fair value measurements of reporting units from one year to the next. Although Statement 142 does not contain guidance on carrying forward fair value measurements of identifiable intangible assets not subject to amortization, such an analogy is reasonable. Accordingly, an entity wishing to carry forward the fair value measurement of an intangible asset with an indefinite useful life from the previous year must carefully analyze the specific facts and circumstances to determine whether the following criteria, adapted from the guidance in paragraph 27 of Statement 142 (see **10.32**), are met:

1. The composition of the unit of accounting as determined under Issue 02-7 (see **9.36**) has not changed significantly since the most recent fair value determination.
2. The amount of the most recent fair value determination exceeded the carrying amount by a significant margin.
3. Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, it is unlikely that a current fair value determination would be less than the current carrying amount.

Section 10 — Goodwill

10.00 Appendix F of Statement 142 defines “goodwill” as “[t]he excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed.” Paragraph 18 of Statement 142 provides that “[g]oodwill shall not be amortized. Goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit.” Statement 142 requires that an entity with recognized goodwill do the following when testing for goodwill impairment:

- Identify reporting units (see **10.03–10.07**).
- Assign assets and liabilities to reporting units (see **10.08–10.14, 10.19**).
- Assign goodwill to reporting units (see **10.15–10.19**).

10.01 Paragraph 26 of Statement 142 provides that “[g]oodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances (refer to paragraph 28). The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.” [See **10.20–10.24**].

10.02 Paragraphs 19–22 of Statement 142 describe the two-step impairment test that paragraph 18 of Statement 142 provides “shall be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).” [See **10.25–10.39**].

Identification of Reporting Units

10.03 Paragraph 18 of Statement 142 provides that “[g]oodwill shall be tested for impairment at a level of reporting referred to as a reporting unit.” Paragraphs 30–31 of Statement 142 contain the following guidance on identifying reporting units:

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30. A reporting unit is an operating segment or one level below an operating segment (referred to as a component). [Footnote 17] A component of an operating segment is a reporting unit if the component constitutes a business [footnote 18] for which discrete financial information is available and segment management [footnote 19] regularly reviews the operating results of that component. However, two or more components of an operating segment shall be aggregated and deemed a single reporting unit if the components have similar economic characteristics. [Footnote 20] An operating segment shall be deemed to be a reporting unit if all of its components are similar, if none of its components is a reporting unit, or if it comprises only a single component. The relevant provisions of Statement 131 and related interpretive literature shall be used to determine the reporting units of an entity.
31. An entity that is not required to report segment information in accordance with Statement 131 is nonetheless required to test goodwill for impairment at the reporting unit level. That entity shall use the guidance in paragraphs 10–15 of Statement 131 to determine its operating segments for purposes of determining its reporting units.

Footnote 17 provides that “[f]or purposes of determining reporting units, an operating segment is as defined in paragraph 10 of FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*.”

Footnote 18 states that “Emerging Issues Task Force Issue No. 98-3, ‘Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,’ includes guidance on determining whether an asset group constitutes a business.”

Footnote 19 provides that “[s]egment management consists of one or more segment managers, as that term is defined in paragraph 14 of Statement 131.”

Footnote 20 states that “[p]aragraph 17 of Statement 131 shall be considered in determining if the components of an operating segment have similar economic characteristics.”

10.04 Paragraph 30 of Statement 142 discusses the necessary steps in identifying reporting units (see **10.03**). Guidance on applying paragraph 30 of Statement 142 to a specific set of facts and circumstances is found in EITF Topic No. D-101, “Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142,” which “summarizes the FASB staff’s understanding of the Board’s intent with respect to the determination of whether a component of an operating segment is a reporting unit.”

The steps in identifying reporting units, including discussion of the guidance in Topic D-101, are as follows:

Step 1 — Identify operating segments in accordance with Statement 131.

Paragraph 10 of Statement 131 states, in part:

An operating segment is a component of an enterprise:

- a. 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),
- b. Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- c. For which discrete financial information is available.

Step 2 — Identify the components of each operating segment (paragraph 30 of Statement 142 defines a "component" as "one level below an operating segment"). Determine whether each component meets the definition of a reporting unit in steps 2(a)–2(c).

Step 2(a) — Determine whether the component constitutes a business.

Topic D-101 indicates:

The determination of whether a component constitutes a business requires judgment based on specific facts and circumstances. The guidance in Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," should be considered in determining whether a group of assets constitutes a business. That guidance states that, among other things, "for a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor." The fact that operating information (revenues and expenses) exists for a component of an operating segment does not mean that the component constitutes a business. For example, a component for which operating information is prepared might be a product line or a brand that is part of a business rather than a business itself.

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Step 2(b) — Determine whether “discrete financial information” is available for the component.

Topic D-101 indicates:

The term *discrete financial information* should be applied in the same manner that it is applied in determining operating segments in accordance with paragraph 10 of Statement 131. The Statement 131 implementation guidance indicates that it is not necessary that assets be allocated for a component to be considered an operating segment (that is, no balance sheet is required). Thus, discrete financial information can constitute as little as operating information. Therefore, in order to test goodwill for impairment in accordance with Statement 142, an entity may be required to assign assets and liabilities to reporting units (consistent with the guidance in paragraphs 32 and 33 of Statement 142).

Step 2(c) — Determine whether segment management regularly reviews the operating results of the component.

Topic D-101 further notes:

Segment management, as defined in paragraph 14 of Statement 131, is either a level below or the same level as the chief operating decision maker. According to Statement 131, a segment manager is “directly accountable to and maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts, or plans for the segment.” The approach used in Statement 142 to determine reporting units is similar to the one used to determine operating segments in Statement 131; however, Statement 142 focuses on how operating segments are managed rather than how the entity as a whole is managed. The approach in Statement 142 is consistent with the Board’s intent that reporting units should reflect the way an entity manages its operations.

Step 3 — Aggregate components that have similar economic characteristics.

Components of an operating segment, determined in steps 2(a)–2(c) to constitute a business for which discrete financial information is available and segment management regularly reviews the operating results of that component, shall be aggregated and deemed a single reporting unit if the components have similar economic characteristics.

Topic D-101 indicates:

Evaluating whether two components have similar economic characteristics is a matter of judgment that depends on specific facts and circumstances. That assessment should be more qualitative than quantitative.

In determining whether the components of an operating segment have similar economic characteristics, footnote 20 to paragraph 30 of Statement 142 states that the guidance in paragraph 17 of Statement 131 should be considered. The Board intended that all of the

factors in paragraph 17 of Statement 131 be considered in making that determination. However, the Board did not intend that every factor must be met in order for two components to be considered economically similar. In addition, the Board did not intend that the determination of whether two components are economically similar be limited to consideration of the factors described in paragraph 17 of Statement 131. In determining whether components should be combined into one reporting unit based on their economic similarities, factors that should be considered in addition to those in paragraph 17 include, but are not limited to:

- The manner in which an entity operates its business and the nature of those operations
- Whether goodwill is recoverable from the separate operations of each component business or from two or more component businesses working in concert (which might be the case if the components are economically interdependent)
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects.

The fact that a component extensively shares assets and other resources with other components of the operating segment may be an indication that the component either is not a business or may be economically similar to those other components.

Components that share similar economic characteristics but relate to different operating segments may not be combined into a single reporting unit. For example, an entity might have organized its operating segments on a geographic basis. If its three operating segments (Americas, Europe, and Asia) each have two components (A and B) that are dissimilar to each other but similar to the corresponding components in the other operating segments, the entity would not be permitted to combine component A from each of the operating segments to make reporting unit A.

Disclosure Considerations Regarding Reporting Unit Determinations

10.05 See **12.16** for SEC staff discussion of disclosure considerations related to the identification of reporting units.

Identification of Reporting Units — Examples

10.06 The following examples illustrate the reporting unit structure after the process for identifying reporting units is applied to a hypothetical and limited set of facts and circumstances. Reporting unit structures will vary among entities depending on the facts and circumstances.

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Example 10-1

Identification of Reporting Units (Case A)

Assume that a parent company has three operating segments and two reportable segments determined in accordance with the provisions of Statement 131.

Step 1 — Identify the operating segments in accordance with Statement 131.

In this case, Operating Segments 1, 2, and 3 are identified.

Step 2 — Identify the components of each operating segment (paragraph 30 of Statement 142 defines a “component” as “one level below an operating segment”). Determine whether each component meets the definition of a reporting unit in steps 2(a)–2(c).

Step 2(a) — Determine whether the component constitutes a business.

Step 2(b) — Determine whether “discrete financial information” is available for the component.

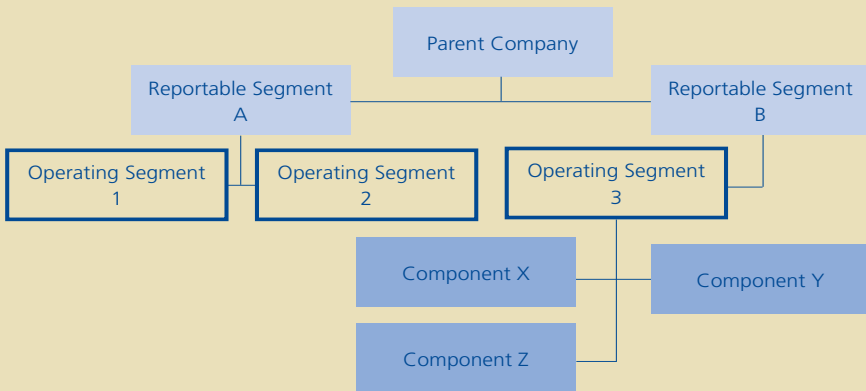
Step 2(c) — Determine whether segment management regularly reviews the operating results of the component.

Assume that Operating Segments 1 and 2 are determined to have no components that meet the conditions in steps 2(a)–2(c), while Operating Segment 3 is determined to have three components (X, Y, and Z) that meet the conditions in steps 2(a)–2(c).

Step 3 — Aggregate components that have similar economic characteristics.

Assume that Components X, Y, and Z have been determined to have similar economic characteristics.

Conclusion — Operating Segments 1, 2, and 3 are reporting units.

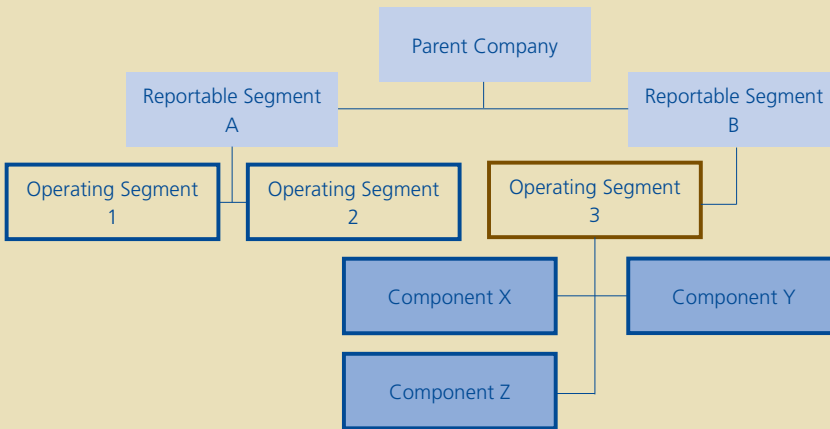


Example 10-2

Identification of Reporting Units (Case B)

Assume the same facts as Example 10-1 except that Components X, Y, and Z have been determined not to possess similar economic characteristics.

Conclusion — Operating Segment 1, Operating Segment 2, Component X, Component Y, and Component Z are reporting units.

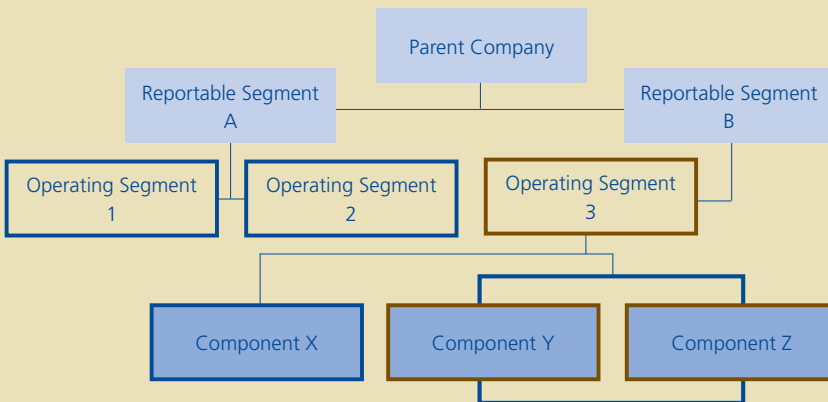


Example 10-3

Identification of Reporting Units (Case C)

Assume the same facts as Example 10-1, except that the economic characteristics of Component Y and Component Z are determined to be similar to each other but not to those of Component X.

Conclusion — Operating Segment 1, Operating Segment 2, Component X, and the combination of Component Y and Component Z are reporting units.



Example 10-4

Identification of Reporting Units (Case D)

Assume that a parent company has three operating segments and two reportable segments determined in accordance with the provisions of Statement 131.

Step 1 — Identify the operating segments in accordance with Statement 131.

In this case, Operating Segments 1, 2, and 3 are identified.

Step 2 — Identify the components of the operating segment (paragraph 30 of Statement 142 defines “component” as “one level below an operating segment”). Determine whether each component meets the definition of a reporting unit in steps 2(a)–2(c).

Step 2(a) — Determine whether the component constitutes a business.

Step 2(b) — Determine whether “discrete financial information” is available for the component.

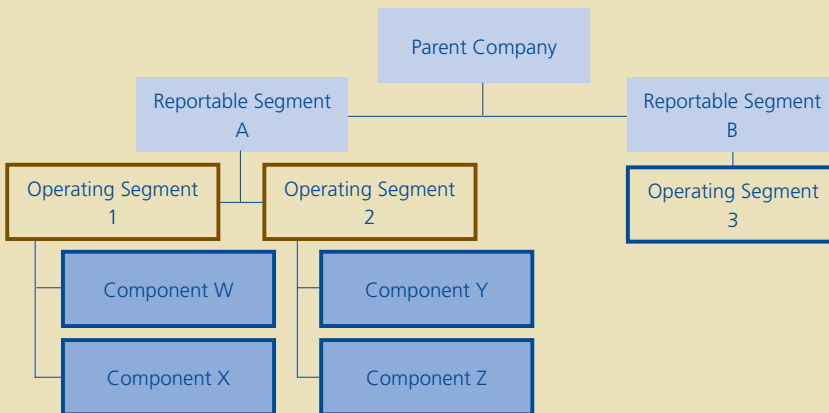
Step 2(c) — Determine whether segment management regularly reviews the operating results of the component.

Assume Operating Segment 1 has two components (Component W and Component X) that meet the conditions in steps 2(a)–2(c); Operating Segment 2 has two components (Component Y and Component Z) that meet the conditions in steps 2(a)–2(c); and Operating Segment 3 has no components that meet the conditions in steps 2(a)–2(c).

Step 3 — Aggregate components that have similar economic characteristics.

Assume that the economic characteristics of Component W of Operating Segment 1 are similar to those of Component Y of Operating Segment 2, but not to those of Component X of Operating Segment 1. Further assume that the economic characteristics of Component Z of Operating Segment 2 are similar to those of Component X of Operating Segment 1 but not to those of Component Y of Operating Segment 2. Because the components with similar economic characteristics (i.e., W/Y and X/Z) are not in the same operating segment, the components are not aggregated or deemed to represent a single reporting unit.

Conclusion — Because the economic characteristics of the components within each operating segment are not similar, Component W, Component X, Component Y, Component Z, and Operating Segment 3 are reporting units.



Comparison of Conclusions Reached Under Statement 131 and Statement 142 in Identifying Operating Segments and Reporting Units, Respectively

10.07 Topic D-101 provides the following additional observations regarding the comparison of conclusions reached under Statement 131 and Statement 142 in identifying operating segments and reporting units, respectively:

Some constituents have noted that two operating segments may have been aggregated into a reportable segment by applying the aggregation criteria in paragraph 17 of Statement 131, and have inquired about whether one or more of the components of those operating segments can be reporting units under Statement 142. The FASB staff believes it would be possible for one or more of those components to be economically dissimilar from the other components and thus be a reporting unit for purposes of testing goodwill for impairment. In particular, the FASB staff believes that the situation might occur when an entity's operating segments are based on geographic areas. The following points need to be considered in addressing this question:

- The determination of reporting units under Statement 142 begins with the definition of an operating segment in paragraph 10 of Statement 131 and considers *disaggregating* that operating segment into economically dissimilar components for the purpose of testing goodwill for impairment. The determination of reportable segments under Statement 131 also begins with a paragraph 10 operating segment, but considers whether certain economically similar operating segments should be *aggregated* into a single operating segment or into a reportable segment.
- The level at which operating performance is reviewed differs between the two Statements — it is the chief operating decision maker who reviews operating segments and the segment manager who reviews reporting units (components of operating segments). Therefore, a component of an operating segment would not be considered an operating segment for Statement 131 purposes unless the chief operating decision maker regularly reviews its operating performance; however, that same component might be a reporting unit under Statement 142 if a segment manager regularly reviews its operating performance (and if other reporting unit criteria are met).

Assigning Assets and Liabilities to Reporting Units

10.08 Paragraph 32 of Statement 142 states, in part:

For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

- a. The asset will be employed in or the liability relates to the operations of a reporting unit.
- b. The asset or liability will be considered in determining the fair value of the reporting unit.

10.09 Paragraph 32 of Statement 142 further states:

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the above criteria are met. Examples of corporate

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items that may meet those criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets.

10.10 Paragraph 33 of Statement 142 states:

Some assets or liabilities may be employed in or relate to the operations of multiple reporting units. The methodology used to determine the amount of those assets or liabilities to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. For example, assets and liabilities not directly related to a specific reporting unit, but from which the reporting unit benefits, could be allocated according to the benefit received by the different reporting units (or based on the relative fair values of the different reporting units). In the case of pension items, for example, a pro rata allocation based on payroll expense might be used.

10.11 Paragraph B116 of Statement 142 states, in part:

The Board concluded that the objective of the assignment process should be to ensure that the assets and liabilities that are assigned to a reporting unit are the same net assets that are considered in determining the fair value of that unit — an “apples-to-apples” comparison. Therefore, to the extent corporate items are reflected in the value of a reporting unit, they should be assigned to the reporting unit.

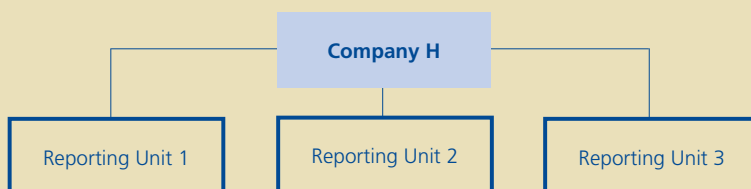
Example 10-5

Assigning Corporate-Level Assets and Liabilities to Reporting Units

This example illustrates the assignment of assets and liabilities held at the corporate level to reporting units in accordance with the guidance in Statement 142 (see **10.08–10.11**) on the basis of a hypothetical and limited set of facts and circumstances. Because facts and circumstances vary by entity, conclusions also will vary.

Company H Reporting Unit Structure

Company H has identified the following three reporting units:



Company H maintains a corporate function that holds the following assets and liabilities:

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Example 10-5		
Assigning Corporate-Level Assets and Liabilities to Reporting Units		
Assets		
Building — Net	(a)	\$ 5,000,000
Trademark — Net	(b)	40,000,000
Receivable From Reporting Unit 3	(c)	10,000,000
Liabilities		
Accounts Payable	(c)	\$10,000,000
Environmental Liability	(d)	7,000,000
Pension Obligation	(e)	6,500,000
Assignment of Corporate-Level Assets and Liabilities to Reporting Units		
(a) Building — Net		
<p>Company H owns a 100,000-square-foot building that serves as the manufacturing facility for Reporting Unit 1. If H were to sell Reporting Unit 1, the building would most likely be included in the overall sales agreement. In accordance with the criteria of paragraph 32 of Statement 142 (see 10.08), the building will be assigned to Reporting Unit 1 because it (a) is employed in the operations of Reporting Unit 1 and (b) would be considered in the determination of the fair value of Reporting Unit 1.</p>		
(b) Trademark — Net		
<p>In 1995, Company H acquired a trademark that Reporting Unit 2 continues to use. In accordance with the criteria of paragraph 32 of Statement 142 (see 10.08), the trademark will be assigned to Reporting Unit 2 because it (a) is employed in the operations of Reporting Unit 2 and (b) would be considered in the determination of the fair value of Reporting Unit 2.</p>		
(c) Receivable From Reporting Unit 3 and Related Accounts Payable		
<p>Company H recently acquired a large amount of inventory for Reporting Unit 3 to use in producing finished goods. The inventory purchase resulted in \$10 million of accounts payable. When Reporting Unit 3 received the inventory, Company H recorded the account payable and a corresponding receivable from Reporting Unit 3. Reporting Unit 3 recorded the inventory and a corresponding payable to Company H. Since the receivable from Reporting Unit 3 and the related accounts payable relate to the same reporting unit and net to zero, no amounts require assignment. In other words, if the accounts payable were assigned to Reporting Unit 3, the receivable from Reporting Unit 3 would be eliminated along with the corresponding payable by Reporting Unit 3 to Company H. Thus, the assignment would have no net effect on Reporting Unit 3.</p>		
(d) Environmental Liability		
<p>In May 2003, Company H closed a large manufacturing facility in connection with discontinuing a product line. At the time of the closure, the facility was under inspection by the Environmental Protection Agency. The inspection revealed land contamination requiring remedial action that is not yet complete. The estimated cost of completing the remedial action is recorded by Company H.</p>		

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Example 10-5

Assigning Corporate-Level Assets and Liabilities to Reporting Units

In accordance with the criteria of paragraph 32 of Statement 142 (see **10.08**), since the environmental liability will not be employed in or related to the operations of Company H's current reporting units and will not be considered in determining the fair value of any of the current reporting units, the \$7 million liability will not be assigned to a specific reporting unit.

(e) Pension Obligation

Company H has established several defined benefit pension plans that cover all employees. The benefits are based on years of service and average compensation. The liability for the pension obligation is maintained only at the corporate level but applies to all employees. Paragraph 32 of Statement 142 indicates that a pension obligation is an example of a corporate item that (a) may relate to the operations (the workforce) of all reporting units, and (b) may also be included in the determination of the fair value of the reporting units. In this example, assume Company H has determined that the criteria for allocating the pension obligation are met.

Paragraph 33 of Statement 142 (see **10.10**) provides that "[s]ome assets or liabilities may be employed in or relate to the operations of multiple reporting units. The methodology used to determine the amount of those assets or liabilities to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner." Because the pension benefits are based on years of service and average compensation, payroll expense would appear to be a reasonable and supportable method of calculating a pro rata allocation of the liability to each of the three reporting units.

Note that although not present in this example, when assigning pension or other employee benefit liabilities, an entity should consider whether any pension or employee benefit trust assets should be assigned to the reporting unit.

Assigning Assets and Liabilities When an Entity Has Only One Reporting Unit

10.12 The Agenda Committee Report dated November 21, 2002, discussed the following issues regarding the application of step 1 of the goodwill impairment test:

1. If an entity has only one reporting unit, whether all the entity's assets and liabilities must be assigned to the reporting unit.
2. If the entity has only one reporting unit, when, if ever, it is appropriate to exclude an asset or liability from that reporting unit.

In the Agenda Committee Report dated November 21, 2002, the Agenda Committee recommended that these two issues not be added to the EITF agenda. The report provided, however, that "[o]n Issues 1 and 2 above, the Agenda Committee indicated that, in its view, if an entity has only one reporting unit, all of the entity's assets and liabilities should be included in that reporting unit."

Assigning Accumulated Foreign Currency Translation Adjustments to a Reporting Unit

10.13 Paragraph 1 of EITF Issue No. 01-5, “Application of FASB Statement No. 52 to an Investment Being Evaluated for Impairment That Will Be Disposed Of,” states, in part, “[a]ccumulated foreign currency translation adjustments (CTA) are reclassified to net income only when realized upon sale or upon complete or substantially complete liquidation of the investment in the foreign entity.” Paragraph 3 further states, “Statement 52, as interpreted by Interpretation 37, is clear that no basis exists to include the CTA in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the CTA.”

10.14 Under paragraph 3 of Issue 01-5, when a reporting unit includes or is entirely a foreign entity, any related CTA balance would be included in the carrying amount of that reporting unit in the testing of goodwill for impairment only when there is a plan to sell or liquidate the investment in the foreign entity, which would result in reclassification of some or all of the CTA to net income in accordance with FASB Statement No. 52, *Foreign Currency Translation*, and FASB Interpretation No. 37, *Accounting for Translation Adjustments Upon Sale of Part of an Investment in a Foreign Entity*. When no such sale or liquidation of the investment in the foreign entity is planned, the carrying value of the reporting unit would comprise its assets net of liabilities translated at appropriate exchange rates as of the date of the test.

Assigning Goodwill to Reporting Units

10.15 Paragraph 34 of Statement 142 states:

For the purpose of testing goodwill for impairment, *all* goodwill acquired in a business combination is to be assigned to one or more reporting units as of the acquisition date. Goodwill shall be assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. The total amount of acquired goodwill may be divided among a number of reporting units. The methodology used to determine the amount of goodwill to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. In addition, that methodology shall be consistent with the objectives of the process of assigning goodwill to reporting units described in paragraph 35.

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10.16 Paragraph 35 of Statement 142 states:

In concept, the amount of goodwill assigned to a reporting unit would be determined in a manner similar to how the amount of goodwill recognized in a business combination is determined. An entity would determine the fair value of the acquired business (or portion thereof) to be included in a reporting unit — in essence a “purchase price” for that business. The entity would then allocate that purchase price to the individual assets acquired and liabilities assumed related to that acquired business (or portion thereof) [footnote omitted]. Any excess purchase price is the amount of goodwill assigned to that reporting unit. However, if goodwill is to be assigned to a reporting unit that has not been assigned any of the assets acquired or liabilities assumed in that acquisition, the amount of goodwill to be assigned to that unit might be determined by applying a “with and without” computation. That is, the difference between the fair value of that reporting unit before the acquisition and its fair value after the acquisition represents the amount of goodwill to be assigned to that reporting unit.

Example 10-6

Assigning Goodwill to Reporting Units (Case A)

Company A acquires Company B for \$100. Identifiable net assets of Company B total \$80. Company A has two reporting units (RU1 and RU2). Identifiable net assets of Company B totaling \$50 will be assigned to RU1, and identifiable net assets totaling \$30 will be assigned to RU2. The fair value measurement of the business (or portion thereof) assigned to RU1 is \$60, while the fair value measurement of the business (or portion thereof) assigned to RU2 is \$40.

Goodwill is assigned to reporting units on the basis of the difference between the fair value of the business (or portion thereof) assigned and the fair value of the identifiable net assets assigned. Under this approach, goodwill is assigned as follows:

	RU1	RU2	Total
Fair value of business (or portion thereof) assigned	\$60	\$40	\$100
Fair value of identifiable net assets assigned	<u>50</u>	<u>30</u>	<u>80</u>
Goodwill assigned	<u>\$10</u>	<u>\$10</u>	<u>\$ 20</u>

Example 10-7**Assigning Goodwill to Reporting Units (Case B)**

Company A acquires Company B for \$200. Identifiable net assets of Company B total \$160. Company A has three reporting units (RU1, RU2, and RU3). Identifiable net assets of Company B totaling \$100 will be assigned to RU1, and identifiable net assets totaling \$60 will be assigned to RU2. No identifiable net assets will be assigned to RU3; however, RU3 is expected to benefit from the synergies of the combination. The fair value measurement of the business (or portion thereof) assigned to RU1 is \$115, and the fair value measurement of the business (or portion thereof) assigned to RU2 is \$75. The fair value of RU3 before the acquisition is \$200; after the acquisition, it is \$210.

Goodwill is assigned to RU1 and RU2 on the basis of the difference between the fair value of the business (or portion thereof) assigned and the fair value of the identifiable net assets assigned. For RU3, goodwill is assigned on the basis of a “with and without” computation. Under this approach, goodwill is assigned as follows:

	RU1	RU2	RU3	Total
Fair value of business (or portion thereof) assigned	\$115	\$75	\$10	\$200
Fair value of identifiable net assets assigned	<u>100</u>	<u>60</u>	<u>—</u>	<u>160</u>
Goodwill assigned	<u>\$ 15</u>	<u>\$15</u>	<u>\$10</u>	<u>\$ 40</u>

Allocation of Goodwill to Reporting Units for a Mining Enterprise

10.17 EITF Issue No. 04-4, “Allocation of Goodwill to Reporting Units for a Mining Enterprise,” addresses “whether an entity in the mining industry should assign goodwill to a reporting unit that consists of an individual operating mine.” Issue 04-4 indicates:

Some argue that assigning goodwill to an operating mine results in a day-two impairment of the goodwill. That is, the fair value of the reporting unit only consists of the fair value of the operating mine (primarily mineral deposits) and, accordingly, there is no additional fair value in the reporting unit to support the recognition of goodwill. Others acknowledge that any goodwill assigned to an operating mine ultimately will be impaired because an operating mine is a wasting asset. Some argue that goodwill represents the premium for the exploration and development activities and relates to the enterprise’s overall ability to sustain and replicate itself as a going concern entity and, therefore, goodwill should not be assigned to individual operating mines.

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10.18 Issue 04-4 further notes:

The Task Force discussed this Issue and observed that the guidance in Statement 142 is clear — goodwill should be allocated to reporting units and an individual operating mine may constitute a reporting unit. Further, the Task Force acknowledged that the allocation of goodwill to an individual operating mine likely will result in an eventual goodwill impairment due to the wasting nature of the primary asset of the reporting unit and could result in a day-two goodwill impairment. However, the Task Force agreed that because the guidance in Statements 131 and 142 is clear, the Task Force cannot resolve this Issue. Accordingly, the Task Force agreed to discontinue discussion of this Issue and to remove it from the Task Force’s agenda.

Reorganization of Reporting Structure — Reassigning Assets, Liabilities, and Goodwill

10.19 Paragraph 36 of Statement 142 states:

When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in paragraphs 32 and 33 shall be used to reassign assets and liabilities to reporting units affected. However, goodwill shall be reassigned to the reporting units affected using a relative fair value approach similar to that used when a portion of a reporting unit is to be disposed of (refer to paragraph 39) [see **10.41**]. For example, if existing reporting unit A is to be integrated with reporting units B, C, and D, goodwill in reporting unit A would be assigned to units B, C, and D based on the relative fair values of the three portions of reporting unit A prior to those portions being integrated with reporting units B, C, and D.

When to Test Goodwill for Impairment

10.20 Paragraph 26 of Statement 142 states:

Goodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances (refer to paragraph 28). [See **10.21**.] The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.

10.21 Paragraph 28 of Statement 142 states:

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include:

- a. A significant adverse change in legal factors or in the business climate
- b. An adverse action or assessment by a regulator

- c. Unanticipated competition
- d. A loss of key personnel
- e. A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- f. The testing for recoverability under Statement 144 of a significant asset group within a reporting unit
- g. Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

In addition, goodwill is required to be tested for impairment after a portion of goodwill has been allocated to a business to be disposed of. (See **10.41**.)

Change in Date of the Annual Goodwill Impairment Test — Preferability Letter Requirements

10.22 Section II.G.2 of the SEC's *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006), indicates the following about a registrant's ability to change the date of annual goodwill impairment testing:

SFAS 142 requires that goodwill be tested, at the reporting unit level, for impairment on an annual basis. An impairment test also could be triggered between annual tests if an event occurs or circumstances change. A reporting unit is required to perform the annual impairment test at the same time every year, however, nothing precludes a registrant from changing the date of the annual impairment test. If a registrant chooses to change the date of the annual impairment test, it should ensure that no more than 12 months elapse between the tests. The change in testing dates should not be made with the intent of accelerating or delaying an impairment charge. The staff will likely raise concerns if a registrant is found to have changed the date of its annual goodwill impairment test frequently.

Any change to the date of the annual goodwill impairment test would constitute a change in the method of applying an accounting principle, as discussed in paragraph 4 of SFAS 154, and therefore would require justification of the change on the basis of preferability. The registrant is required by Rule 10-01(b)(6) of Regulation S-X to disclose the date of and reason for the change. The registrant is also required by Item 601 of Regulation S-K to file, as an exhibit to the first Form 10-Q or 10-QSB after the date of the change, a letter from the registrant's independent registered public accounting firm indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. See Staff Accounting Bulletin Topic 6.G.2.b. for additional guidance.

10.23 Paragraph 7 of Statement 154 states:

An entity shall report a change in accounting principle through retrospective application of the new accounting principle to all periods, unless it is impracticable to do so. Retrospective application requires the following:

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- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
- b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
- c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

10.24 While the required annual and trigger-based testing of goodwill for recoverability under Statement 142 may lead to a presumption that a change to a new testing date, when applied to prior periods, will not yield a different financial statement result, to comply with the requirements of Statement 154, an entity making a change in its annual testing date for goodwill must perform sufficient procedures to support that such retrospective application would not yield a different financial statement result or must otherwise demonstrate that such a determination is impracticable, as provided in paragraph 11 of Statement 154.

Performing the Two-Step Goodwill Impairment Test

10.25 On the basis of the fair value determined for each reporting unit (see **10.26–10.32**), paragraphs 19–21 of Statement 142 outline the following two-step goodwill impairment test.

Step 1

Determine whether the fair value of the reporting unit is less than its carrying amount, including goodwill.

If the fair value of the reporting unit is less, proceed to step 2.

If the fair value of the reporting unit is not less, further testing of goodwill for impairment is not performed.

Step 2

Determine the implied fair value of goodwill of the reporting unit by allocating the fair value of the reporting unit used in step 1 to all the assets and liabilities of that reporting unit (including any recognized and unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit.

Compare the implied fair value of goodwill to the carrying amount of goodwill to determine whether goodwill is impaired.

Note: Paragraph 21 of Statement 142 provides that the allocation process in **Step 2** “shall be performed only for the purpose of testing goodwill for impairment; an entity shall not write up or write down a recognized asset or liability, nor should it recognize a previously unrecognized intangible asset as a result of that allocation process.”

Example 10-8		
Illustration of a Goodwill Impairment Test When the Fair Value of a Reporting Unit Exceeds the Carrying Amount (Step 2 Not Required)		
Step 1		Step 2
Reporting Unit		Not Required
Cash	\$ 100	
PP&E	800	
Goodwill	<u>400</u>	
Subtotal	1,300	
Liabilities	<u>(200)</u>	
Carrying Amount	1,100	
Fair Value of Reporting Unit	<u>1,200</u>	
Result: Pass Step 1*	<u>\$ 100</u>	
*Because the fair value of the reporting unit exceeds the carrying amount, no further testing of goodwill for impairment is necessary.		

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Example 10-9

Illustration of a Goodwill Impairment Test When Step 2 Is Required and Goodwill Impairment Results

Step 1		Step 2	
Reporting Unit		Reporting Unit	
Cash	\$ 100	Cash	\$ 100
PP&E	1,100	PP&E	1,200
Goodwill	<u>400</u>	Trademark*	<u>50</u>
Subtotal	1,600	Subtotal	1,350
Liabilities	<u>(200)</u>	Liabilities	<u>(200)</u>
Carrying Amount	1,400	Difference	1,150
Fair Value of Reporting Unit	<u>1,200</u>	Fair Value of Reporting Unit	<u>1,200</u>
Result: Fail Step 1	<u><u>\$ (200)</u></u>	Implied Fair Value of Goodwill	<u><u>\$ 50</u></u>
		Carrying Amount of Goodwill	\$ 400
		Impairment Amount	\$ 350

*Trademark represents a previously unrecognized intangible asset.

Example 10-10

Illustration of a Goodwill Impairment Test When Step 2 Is Required but No Goodwill Impairment Results

Step 1		Step 2	
Reporting Unit		Reporting Unit	
Cash	\$ 100	Cash	\$ 100
PP&E	1,100	PP&E*	950
Goodwill	<u>400</u>		
Subtotal	1,600	Subtotal	1,050
Liabilities	<u>(200)</u>	Liabilities	<u>(200)</u>
Carrying Amount	1,400	Difference	850
Fair Value of Reporting Unit	<u>1,300</u>	Fair Value of Reporting Unit	<u>1,300</u>
Result: Fail Step 1	<u><u>\$ (100)</u></u>	Implied Fair Value of Goodwill	<u><u>\$ 450</u></u>
		Carrying Amount of Goodwill	\$ 400
		Impairment Amount	\$ 0

*Even though Reporting Unit 1 failed Step 1, no goodwill impairment is recognized because the implied fair value of goodwill is \$450. The decline in fair value of the reporting unit is due to the decline in fair value of PP&E. Before step 1 of the goodwill impairment test, the PP&E was not considered impaired. See guidance on the order of testing in paragraph 29 of Statement 142.

Fair Value Measurements

10.26 Paragraph 23 of Statement 142 (as amended by paragraph E22 of Statement 157) states:

The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.

10.27 Paragraph 25 of Statement 142 states:

In estimating the fair value of a reporting unit, a valuation technique based on multiples of earnings or revenue or a similar performance measure may be used if that technique is consistent with the objective of measuring fair value. Use of multiples of earnings or revenue in determining the fair value of a reporting unit may be appropriate, for example, when the fair value of an entity that has comparable operations and economic characteristics is observable and the relevant multiples of the comparable entity are known. Conversely, use of multiples would not be appropriate in situations in which the operations or activities of an entity for which the multiples are known are not of a comparable nature, scope, or size as the reporting unit for which fair value is being estimated.

10.28 Paragraph 36 of Statement 157 states:

This Statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year.

10.29 Paragraph 22 of Statement 157 states, in part:

To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

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Paragraph 23 of Statement 142 (see **10.26**) indicates that measuring the fair value of a reporting unit by referring to the quoted market price of the individual equity securities of that reporting unit (price times quantity) may require adjustment for a control premium. Statement 157 does not amend the guidance in paragraph 23 of Statement 142 regarding a control premium (see **10.26**). Accordingly, when the fair value of a reporting unit is measured by reference to quoted market prices of individual equity securities of that reporting unit, the presence of a control premium must be evaluated and included, if deemed appropriate. An adjustment for control premium, if deemed applicable, renders the fair value measurement a lower level than Level 1. Paragraphs A24(h) and A25(e) of Statement 157 provide examples of Level 2 and Level 3 inputs, respectively, for a reporting unit.

10.30 Entities with more than one reporting unit will generally rely on Level 2 and Level 3 inputs in the measurement of fair value of each reporting unit. In cases of multiple reporting units, the SEC staff had indicated that the entity should be able to reconcile the aggregate fair values of all reporting units to the market capitalization of the entity, including a control premium, if deemed applicable. While Statement 142 does not specifically state this requirement and while completion of such a reconciliation may require additional estimates or assumptions when an entity has portions of its business that do not have goodwill assigned (and thus do not have a requirement for the periodic measurement of fair value), entities should be able to offer such a reconciliation as part of an overall assessment of the fair values measured for reporting units.

10.31 See **4.23** for discussion about the use of a third-party specialist to assist in the measurement of fair value.

Carrying Forward the Fair Value of a Reporting Unit From One Annual Testing Date to the Next

10.32 Paragraph 27 of Statement 142 states:

A detailed determination of the fair value of a reporting unit may be carried forward from one year to the next if all of the following criteria have been met:

- a. The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination. (A recent significant acquisition or a reorganization of an entity's segment reporting structure is an example of an event that might significantly change the composition of a reporting unit.)
- b. The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.

- c. Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

Applying the Goodwill Impairment Test to a Reporting Unit With a Negative Carrying Value

10.33 The Agenda Committee Report dated November 21, 2002, indicated EITF Agenda Committee consideration of the following issue regarding the application of step 1 of the goodwill impairment test:

If a reporting unit has a negative carrying value, that is, the liabilities of the reporting unit exceed its assets, whether the reporting unit passes Step 1 of the goodwill impairment test solely based on its negative carrying value, assuming its fair value is zero or greater.

10.34 The Agenda Committee recommended in the Agenda Committee Report dated November 21, 2002, that this issue not be added to the EITF's agenda. The Agenda Committee Report provided, however, that "the Agenda Committee agreed that paragraph 19 of Statement 142 requires that 'If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary.' While the Agenda Committee members agreed that [the issue] (involving negative carrying value) warranted further consideration, they indicated that resolution of that Issue would require Board involvement and perhaps an amendment to Statement 142." To date, the FASB has provided no further guidance on this issue.

Deferred Income Tax Considerations in Applying the Goodwill Impairment Test

10.35 EITF Issue No. 02-13, "Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142," indicates:

In the context of recognizing and measuring impairment of goodwill, questions have arisen regarding how an entity should account for differences between the book and tax bases of assets and liabilities (that is, deferred tax balances) in determining (a) a reporting unit's fair value, (b) a reporting unit's carrying amount, and (c) the implied fair value of goodwill.

The Task Force considered the following issues in Issue 02-13:

Issue 1 — Whether the fair value of a reporting unit should be estimated by assuming that the unit would be bought or sold in a nontaxable transaction versus a taxable transaction.

Issue 2 — Whether deferred income taxes should be included in the carrying amount of a reporting unit for purposes of Step 1 of the Statement 142 goodwill impairment test.

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Issue 3 — For purposes of determining the implied fair value of a reporting unit's goodwill in Step 2 of the Statement 142 goodwill impairment test, what income tax bases an entity should use for a reporting unit's assets and liabilities in order to measure deferred tax assets and liabilities. That is, should an entity use the existing income tax bases or assume new income tax bases for the unit's assets and liabilities.

Paragraphs 4 and 5 of Issue 02-13 state:

4. The Task Force reached a consensus on Issue 1 that the determination of whether to estimate the fair value of a reporting unit by assuming that the unit could be bought or sold in a nontaxable transaction versus a taxable 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 (a) whether the assumption is consistent with those that marketplace participants would incorporate into their estimates of fair value, (b) the feasibility of the assumed structure, and (c) whether the assumed structure results in the highest economic value to the seller for the reporting unit, including consideration of related tax implications.
5. The Task Force observed that in determining the feasibility of a nontaxable transaction, an entity should consider, among other factors, (a) whether the reporting unit could be sold in a nontaxable transaction and (b) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction.

Paragraph 6 of Issue 02-13 provides that “[t]he Task Force reached a consensus on Issue 2 that deferred income taxes should be included in the carrying value of the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming it would be bought or sold in a taxable or nontaxable transaction.”

Paragraphs 7 and 8 of Issue 02-13 state:

7. The Task Force reached a consensus on Issue 3 that an entity should use the income tax bases of a reporting unit's assets and liabilities implicit in the tax structure assumed in its estimation of fair value of the reporting unit in Step 1. That is, an entity should use its existing income tax bases if the assumed structure used to estimate the fair value of the reporting unit was a nontaxable transaction, and it should use new income tax bases if the assumed structure was a taxable transaction.
8. The Task Force observed that in performing Step 2 of the goodwill impairment test, the implied fair value of a reporting unit's goodwill is determined in the same manner

that the amount of goodwill recognized in a business combination accounted for in accordance with Statement 141 is determined. Paragraph 38 of Statement 141 indicates that a deferred tax liability or asset shall be recognized for differences between the assigned values and the income tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of Statement 109. To the extent present, tax attributes that will be transferred in the assumed tax structure, such as operating loss or tax credit carryforwards, should be valued consistent with the guidance contained in paragraph 135 of Statement 109.

10.36 Examples demonstrating the consensuses reached in Issue 02-13 are given in paragraph 9, which notes that “these examples may not necessarily be indicative of actual income tax liabilities that would arise in the sale of a reporting unit or the relationship of those liabilities in a taxable versus nontaxable structure.”

Reporting Requirements When the Second Step of the Goodwill Impairment Test Is Not Complete

10.37 Paragraph 22 of Statement 142 states:

If the second step of the goodwill impairment test is not complete before the financial statements are issued and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of that loss shall be recognized in those financial statements. [Footnote omitted] Paragraph 47(c) requires disclosure of the fact that the measurement of the impairment loss is an estimate [see **12.15**]. Any adjustment to that estimated loss based on the completion of the measurement of the impairment loss shall be recognized in the subsequent reporting period.

Goodwill Impairment Testing by a Subsidiary

10.38 Paragraph 37 of Statement 142 states:

All goodwill recognized by a public or nonpublic subsidiary (subsidiary goodwill) in its separate financial statements that are prepared in accordance with generally accepted accounting principles shall be accounted for in accordance with this Statement. Subsidiary goodwill shall be tested for impairment at the subsidiary level using the subsidiary's reporting units. If a goodwill impairment loss is recognized at the subsidiary level, goodwill of the reporting unit or units (at the higher consolidated level) in which the subsidiary's reporting unit with impaired goodwill resides must be tested for impairment if the event that gave rise to the loss at the subsidiary level would more likely than not reduce the fair value of the reporting unit (at the higher consolidated level) below its carrying amount (refer to paragraph 28(g)). Only if goodwill of that higher-level reporting unit is impaired would a goodwill impairment loss be recognized at the consolidated level.

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Example 10-11

Goodwill Impairment Testing by a Subsidiary When the Subsidiary Is Public and Has Goodwill Recorded

Assume Company P (Parent) acquired 100 percent of Company B, electing to retain Company B as a separate corporate entity (Subsidiary B). Subsidiary B, an SEC registrant through the issuance of public debt, has goodwill recorded on its books entirely as a result of the application of push-down accounting by Company P (see **Section 8** for discussion of push-down accounting). In accordance with paragraph 37 of Statement 142, goodwill recognized in the separate financial statements of Subsidiary B must be tested for impairment using the reporting unit structure identified for Subsidiary B. Also, in accordance with paragraph 37 of Statement 142, if a goodwill impairment loss is recognized by Subsidiary B, goodwill of the reporting unit or units at Company P in which Subsidiary B resides must be tested for impairment if the event that gave rise to the loss at Subsidiary B would more likely than not reduce the fair value of the reporting unit at Company P below its carrying amount. Only if goodwill of that higher-level reporting unit is impaired would an impairment of goodwill be recognized at the consolidated level of Company P.

Example 10-12

Goodwill Impairment Testing by a Subsidiary When the Subsidiary Is Nonpublic and Has Goodwill Assigned Under Statement 142

Assume Company P (Parent) acquired 100 percent of Company B, electing to retain Company B as a separate corporate entity (Subsidiary B). Subsidiary B is not an SEC registrant and has no preexisting goodwill recognized. Subsidiary B has been identified as a reporting unit of Company P, which has elected not to apply push-down accounting (see **Section 8** for discussion of push-down accounting). Although Subsidiary B has no goodwill recognized in its separate financial statements, as a reporting unit of Company P, Company P has determined an assignment of goodwill to the reporting unit is necessary. Further assume that separate financial statements for Subsidiary B are prepared in accordance with GAAP for statutory reporting purposes. Although Subsidiary B has separate financial statements prepared in accordance with GAAP, goodwill testing at the separate subsidiary level is not required, since goodwill is not recognized in the separate financial statements of Subsidiary B but is only assigned to Subsidiary B as a reporting unit of Company P.

Goodwill Impairment Testing When a Noncontrolling Interest Exists

10.39 Paragraph 38 of Statement 142 states:

Goodwill arising from a business combination with a continuing noncontrolling interest shall be tested for impairment using an approach consistent with the approach used to measure the noncontrolling interest at the acquisition date. (A noncontrolling interest is sometimes referred to as a minority interest.) For example, if goodwill is initially recognized based only on the controlling interest of the parent, the fair value of the reporting unit used in the impairment test should be based on that controlling interest and should not reflect the portion of fair value attributable to the noncontrolling interest. Similarly, the implied fair value

of goodwill that is determined in the second step of the impairment test and used to measure the impairment loss should reflect only the parent company's interest in that goodwill.

Disposal of All or a Portion of a Reporting Unit

10.40 Paragraph 39 of Statement 142 provides that “[w]hen a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal.”

10.41 Paragraph 39 of Statement 142 further states:

When a portion of a reporting unit that constitutes a business [footnote 23] 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 amount of goodwill to be included in that carrying amount shall be based on the relative fair values of the business to be disposed of and the portion of the reporting unit that will be retained. For example, if a business is being sold for \$100 and the fair value of the reporting unit excluding the business being sold is \$300, 25 percent of the goodwill residing in the reporting unit would be included in the carrying amount of the business to be sold. However, if the business to be disposed of was never integrated into the reporting unit after its acquisition and thus the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the current carrying amount of that acquired goodwill shall be included in the carrying amount of the business to be disposed of. That situation might occur when the acquired business is operated as a stand-alone entity or when the business is to be disposed of shortly after it is acquired. When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained shall be tested for impairment in accordance with paragraphs 19–22 (using its adjusted carrying amount).

Footnote 23 refers to the guidance in Issue 98-3.

10.42 Paragraph B166 of Statement 142 states, in part:

[T]his Statement requires that the relative-fair-value allocation method [see paragraph 39 of Statement 142 and **10.41**] *not* be used to allocate goodwill to a business being disposed of if that business was not integrated into the reporting unit after its acquisition. Board members noted that those situations (such as when the acquired business is operated as a stand-alone entity) would be infrequent because some amount of integration generally occurs after the acquisition.

10.43 When assets of a reporting unit that do not constitute a business (as determined under Issue 98-3) are disposed of, no amount of goodwill is included in the carrying amount of those assets since goodwill is only associated with a business. Goodwill of the reporting unit may, however, require testing for impairment if the disposal is determined to constitute an event or circumstance requiring testing of goodwill of the reporting unit between annual dates (see **10.21**).

Assessing the Impact of Goodwill Assignments on the Determination of Gain or Loss on Disposal of a Reporting Unit

10.44 Paragraph 39 of Statement 142 provides that “[w]hen a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit when determining the gain or loss on disposal.” Questions have arisen about when a subsidiary (constituting a reporting unit) issues separate financial statements and the parent has assigned a different amount of goodwill to that subsidiary (reporting unit) than that recorded in the subsidiary’s separate financial statements. When determining the gain or loss on disposal, only the amount of goodwill allocated by the parent to the reporting unit to be disposed should be included when determining the carrying value of that reporting unit. Since the assignment of goodwill to the reporting unit for Statement 142 impairment testing purposes may not have resulted in a formal entry to the accounts of the reporting unit, an adjustment will be necessary at the parent’s consolidated level to reclassify goodwill to or from the reporting unit disposed of in order to properly calculate the parent’s gain or loss on disposal. Example 10-13 illustrates these principles.

Example 10-13

Determining Gain or Loss on Disposal of a Reporting Unit With Goodwill Assigned

Assume the following:

- Company A acquired Company B, resulting in goodwill of \$200.
- Company A retained Company B as a separate subsidiary (Subsidiary X) and applied push-down accounting in the separate financial statements of Subsidiary X, recognizing \$200 of goodwill in these financial statements.
- Company A determined that Subsidiary X represented a separate reporting unit under Statement 142.
- On the basis of the expected synergies of the acquisition of Company B, Company A assigned \$150 of the \$200 recorded goodwill to Subsidiary X and \$50 to Subsidiary Y, a separate reporting unit of Company A.

Illustration 1 — Company A will dispose of Subsidiary X in its entirety.

In determining the gain or loss on the disposal of Subsidiary X, Company A should consider only the assigned goodwill amount of \$150. An adjustment will thus be necessary at the parent’s consolidated level to exclude \$50 of goodwill from the disposed assets of Subsidiary X in order to appropriately account for the gain or loss on disposal.

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Example 10-13

Determining Gain or Loss on Disposal of a Reporting Unit With Goodwill Assigned

Illustration 2 — Company A will dispose of Subsidiary Y in its entirety.

In determining the gain or loss on the disposal of Subsidiary Y, Company A should consider the assigned goodwill amount of \$50. An adjustment will thus be necessary at the parent's consolidated level to include \$50 of goodwill from Subsidiary X with the disposed assets of Subsidiary Y in order to appropriately account for the gain or loss on disposal.

Note: In both Illustration 1 and Illustration 2, the separate historical financial statements of Subsidiary X and Subsidiary Y would not reflect the parent's consolidated-level adjustments. For example, assume Company C acquires Subsidiary X from Company A and is required to present financial statements of Subsidiary X under SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired." Subsidiary X's historical financial statements would be presented exclusive of any adjustments made by Company A at its consolidated level related to the assignment of goodwill for Statement 142. Therefore, Subsidiary X's historical financial statements would include \$200 of goodwill.

Equity Method Investments

10.45 Paragraph 40 of Statement 142 states:

The portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill in accordance with paragraph 19(b) of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (equity method goodwill) shall not be amortized. However, equity method goodwill shall not be tested for impairment in accordance with this Statement. Equity method investments shall continue to be reviewed for impairment in accordance with paragraph 19(h) of Opinion 18.

Financial Statement Presentation and Disclosure Requirements

Section 11 — Financial Statement Presentation Requirements

Intangible Assets

11.00 Statement 142 includes financial statement presentation requirements for intangible assets, whether those intangible assets are acquired individually, with a group of other assets, or in a business combination.

Presentation of Intangible Assets in the Statement of Financial Position

11.01 Paragraph 42 of Statement 142 provides that “[a]t a minimum, all intangible assets shall be aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets or classes of intangible assets as separate line items.”

Presentation of Intangible Asset Amortization Expense and Impairment Losses in the Income Statement

11.02 Paragraph 42 of Statement 142 states, in part:

The amortization expense and impairment losses for intangible assets shall be presented in income statement line items within continuing operations as deemed appropriate for each entity. Paragraphs 14 and 16 require that an intangible asset be tested for impairment when it is determined that the asset should no longer be amortized or should begin to be amortized due to a reassessment of its remaining useful life. An impairment loss resulting from that impairment test shall *not* be recognized as a change in accounting principle.

11.03 Regarding determination of the appropriate income statement classification of intangible asset amortization expense, the SEC staff has emphasized the need for consideration of (1) cost of sales and (2) selling, general, and administrative expense. Accordingly, classification within a general caption such as “amortization expense,” even if within continuing operations, may not be deemed appropriate.

Section 11

Financial Statement Presentation and Disclosure Requirements

11.04 Factors to consider in determining the appropriate income statement classification of intangible asset amortization expense should include, but are not limited to, the function of the intangible asset and the requirements of SEC Regulation S-X, Rule 5-03, "Income Statements," and SEC Staff Accounting Bulletin Topic 11.B, "Depreciation and Depletion Excluded From Cost of Sales." For example, if the entity acquires a patent necessary to produce goods for sale, the amortization expense of the patent would generally be presented as a component of cost of sales or a similar expense category.

11.05 Regarding the appropriate income statement classification of amortization expense for intangible assets specific to acquired technology marketed to others, the SEC staff refers to the guidance in Question 17 of FASB Staff Implementation Guide (Statement 86), "Computer Software: Guidance on Applying Statement 86," which addresses the amortization expense presentation of capitalized software costs. Question 17 provides that "[s]ince the amortization relates to a software product that is marketed to others, the expense would be charged to cost of sales or a similar expense category."

Goodwill

11.06 Statement 142 provides financial statement presentation requirements for goodwill recognized in accordance with Statement 141.

Presentation of Goodwill in the Statement of Financial Position

11.07 Paragraph 43 of Statement 142 provides that "[t]he aggregate amount of goodwill shall be presented as a separate line item in the statement of financial position."

Presentation of Goodwill Impairment Losses in the Income Statement

11.08 Paragraph 43 of Statement 142 states:

The aggregate amount of goodwill impairment losses shall be presented as a separate line item in the income statement before the subtotal *income from continuing operations* (or similar caption) unless a goodwill impairment loss is associated with a discontinued operation. A goodwill impairment loss associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.

Section 12 — Financial Statement Disclosure Requirements

Business Combination Disclosures

12.00 Paragraph B195 of Statement 141 provides that “[b]ecause a business combination often results in a significant change to an entity’s operations, the nature and extent of the information disclosed about the transaction bear on users’ abilities to assess the effects of such changes on postacquisition earnings and cash flows.” Appendix C of Statement 141 provides examples illustrating some of the Statement’s disclosure requirements.

Material Business Combinations

12.01 Paragraph 51 of Statement 141 provides:

The notes to the financial statements of a combined entity shall disclose the following information in the period in which a material business combination is completed:

- a. The name and a brief description of the acquired entity and the percentage of voting equity interests acquired
- b. The primary reasons for the acquisition, including a description of the factors that contributed to a purchase price that results in recognition of goodwill
- c. The period for which the results of operations of the acquired entity are included in the income statement of the combined entity
- d. The cost of the acquired entity and, if applicable, the number of shares of equity interests (such as common shares, preferred shares, or partnership interests) issued or issuable, the value assigned to those interests, and the basis for determining that value
- e. A condensed balance sheet disclosing the amount assigned to each major asset and liability caption of the acquired entity at the acquisition date
- f. Contingent payments, options, or commitments specified in the acquisition agreement and the accounting treatment that will be followed should any such contingency occur

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- g. The amount of purchased research and development assets acquired and written off in the period (refer to paragraph 42) and the line item in the income statement in which the amounts written off are aggregated
- h. For any purchase price allocation that has not been finalized, that fact and the reasons therefor. In subsequent periods, the nature and amount of any material adjustments made to the initial allocation of the purchase price shall be disclosed.

12.02 Paragraph 52 of Statement 141 states:

The notes to the financial statements also shall disclose the following information in the period in which a material business combination is completed if the amounts assigned to goodwill or to other intangible assets acquired are significant in relation to the total cost of the acquired entity:

- a. For intangible assets subject to amortization [footnote 21]:
 - (1) The total amount assigned and the amount assigned to any major **intangible asset class** [Appendix F of Statement 141 defines "intangible asset class" as "[a] group of intangible assets that are similar, either by their nature or by their use in the operations of an entity."]
 - (2) The amount of any significant **residual value**, in total and by major intangible asset class [Appendix F of Statement 141 defines "residual value" as "[t]he estimated fair value of an intangible asset at the end of its useful life to the entity, less any disposal costs."]
 - (3) The weighted-average amortization period, in total and by major intangible asset class
- b. For intangible assets *not* subject to amortization, [footnote 22] the total amount assigned and the amount assigned to any major intangible asset class
- c. For goodwill:
 - (1) The total amount of goodwill and the amount that is expected to be deductible for tax purposes
 - (2) The amount of goodwill by reportable segment (if the combined entity is required to disclose segment information in accordance with FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*), unless not practicable. [Footnote 23]

Footnotes 21 and 22 refer to Statement 142 for guidance on determining whether an intangible asset is subject to amortization.

Footnote 23 states, “For example, it would not be practicable to disclose this information if the assignment of goodwill to reporting units (as required by Statement 142) has not been completed as of the date the financial statements are issued.”

Immaterial Business Combinations

12.03 Paragraph 53 of Statement 141 states:

The notes to the financial statements shall disclose the following information if a series of individually immaterial business combinations completed during the period are material in the aggregate:

- a. The number of entities acquired and a brief description of those entities
- b. The aggregate cost of the acquired entities, the number of equity interests (such as common shares, preferred shares, or partnership interests) issued or issuable, and the value assigned to those interests
- c. The aggregate amount of any contingent payments, options, or commitments and the accounting treatment that will be followed should any such contingency occur (if potentially significant in relation to the aggregate cost of the acquired entities)
- d. The information described in paragraph 52 [of Statement 141 — see **12.02**] if the aggregate amount assigned to goodwill or to other intangible assets acquired is significant in relation to the aggregate cost of the acquired entities.

Additional Disclosures by a Public Business Enterprise

12.04 Appendix F of Statement 141 defines a “public business enterprise” as:

An enterprise that has issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that is required to file financial statements with the Securities and Exchange Commission, or that provides financial statements for the purpose of issuing any class of securities in a public market.

12.05 Paragraph 54 of Statement 141 states:

If the combined entity is a **public business enterprise**, the notes to the financial statements shall include the following supplemental information on a pro forma basis for the period in which a material business combination occurs (or for the period in which a series of individually immaterial business combinations occur that are material in the aggregate):

- a. Results of operations for the current period as though the business combination or combinations had been completed at the beginning of the period, unless the acquisition was at or near the beginning of the period

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- b. Results of operations for the comparable prior period as though the business combination or combinations had been completed at the beginning of that period if comparative financial statements are presented.

12.06 Paragraph 55 of Statement 141 states:

At a minimum, the supplemental pro forma information shall display revenue, income before extraordinary items and the cumulative effect of accounting changes [footnote 23a], net income, and earnings per share. In determining the pro forma amounts, income taxes, interest expense, preferred share dividends, and depreciation and amortization of assets shall be adjusted to the accounting base recognized for each in recording the combination. Pro forma information related to results of operations of periods prior to the combination shall be limited to the results of operations for the immediately preceding period. Disclosure also shall be made of the nature and amount of any material, nonrecurring items included in the reported pro forma results of operations.

Footnote 23a states, "After the effective date of FASB Statement No. 154, *Accounting Changes and Error Corrections*, voluntary changes in accounting principle will no longer be reported via a cumulative-effect adjustment through the income statement of the period of change."

Extraordinary Gains

12.07 Paragraph 56 of Statement 141 provides that "[i]n the period in which an extraordinary gain is recognized related to a business combination (paragraphs 45 and 46 [see **7.03–7.04**]), the notes to the financial statements shall disclose the information required by paragraph 11 of Opinion 30."

Business Combinations Completed After the Balance Sheet Date

12.08 Paragraph 57 of Statement 141 provides that "[t]he notes to the financial statements also shall disclose the information required by paragraphs 51 and 52 [see **12.01–12.02**] if a material business combination is completed after the balance sheet date but before the financial statements are issued (unless not practicable)."

Interim Financial Information

12.09 Paragraph 58 of Statement 141 states:

The summarized interim financial information of a public business enterprise shall disclose the following information if a material business combination is completed during the current year up to the date of the most recent interim statement of financial position presented:

- a. The information described in paragraphs 51(a)–(d) [see **12.01 (a)–(d)**].
- b. Supplemental pro forma information that discloses the results of operations for the current interim period and the current year up to the date of the most recent interim statement of financial position presented (and for the corresponding periods in the preceding year) as though the business combination had been completed as of the beginning of the period being reported on. That pro forma information shall display, at a minimum, revenue, income before extraordinary items and the cumulative effect of accounting changes [footnote 23b] (including those on an interim basis), net income, and earnings per share.
- c. The nature and amount of any material, nonrecurring items included in the reported pro forma results of operations.

Footnote 23b indicates that after the effective date of Statement 154, voluntary changes in accounting principle will no longer be reported via a cumulative-effect adjustment through the income statement of the period of change.

Disclosure Requirement Related to a Plan to Exit an Activity, Involuntarily Terminate Employees, or Relocate Employees of an Acquired Company

12.10 Issue 95-3 indicates:

The following information should be disclosed only if the activities of the acquired company that will not be continued are significant to the combined company's revenues or operating results or if the costs recognized under the consensus as of the consummation date are material to the combined company.

1. Notes to the financial statements of the combined company for the period in which a purchase business combination occurs should disclose the following:
 - (a) If the acquiring company has not finalized a plan to exit an activity or involuntarily terminate (relocate) employees of the acquired company as of the balance sheet date, a description of unresolved issues, the types of additional liabilities that may result in an adjustment to the allocation of the acquisition cost for the business combination, and how any adjustments will be reported.
 - (b) A description of the type and amount of liabilities assumed and included in the acquisition cost allocation for costs to exit an activity of the acquired company or to involuntarily terminate (relocate) employees of the acquired company.
 - (c) A description of the major actions that comprise the plan to exit an activity or involuntarily terminate (relocate) employees of an acquired company, activities of the acquired company that will not be continued, including the method of disposition, and the anticipated date of completion and a description of employee group(s) to be terminated (relocated).

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2. Notes to the financial statements of the combined company for all periods presented subsequent to the acquisition date in which a purchase business combination occurred, through and including the period in which all actions under a plan to exit an activity or involuntarily terminate (relocate) employees of the acquired company have been fully executed, should disclose the following:
 - (a) A description of the type and amount of exit costs, involuntary employee termination costs, and relocation costs paid and charged against the liability.
 - (b) The amount of any adjustment(s) to the liability account and whether the corresponding entry was an adjustment of the cost of the acquired company or included in the determination of net income for the period.

Business Combinations Between Parties With a Preexisting Relationship

12.11 Issue 04-1 indicates:

[T]he following disclosures should be required for business combinations between parties with a preexisting relationship:

- a. The nature of the preexisting relationship
- b. The measurement of the amount of the settlement of the preexisting relationship, if any, and the valuation method used to determine the settlement amount
- c. The amount of any settlement gain or loss recognized and its classification in the statement of operations.

Goodwill and Intangible Assets Disclosures

Disclosures in the Period of Acquisition

12.12 Paragraph 44 of Statement 142 states:

For intangible assets acquired either individually or with a group of assets, the following information shall be disclosed in the notes to the financial statements in the period of acquisition:

- a. For intangible assets subject to amortization:
 - (1) The total amount assigned and the amount assigned to any major **intangible asset class** [defined in Appendix F of Statement 142 as “[a] group of intangible assets that are similar, either by their nature or by their use in the operations of an entity”]
 - (2) The amount of any significant residual value, in total and by major intangible asset class
 - (3) The weighted-average amortization period, in total and by major intangible asset class

- b. For intangible assets *not* subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class
- c. The amount of research and development assets acquired and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

Disclosures, Including Segment Information, in Each Period Presented

12.13 Paragraph 45 of Statement 142 states:

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. For intangible assets subject to amortization:
 - (1) The gross carrying amount and accumulated amortization, in total and by major intangible asset class
 - (2) The aggregate amortization expense for the period
 - (3) The estimated aggregate amortization expense for each of the five succeeding fiscal years
- b. For intangible assets *not* subject to amortization, the total carrying amount and the carrying amount for each major intangible asset class
- c. The changes in the carrying amount of goodwill during the period including:
 - (1) The aggregate amount of goodwill acquired
 - (2) The aggregate amount of impairment losses recognized
 - (3) The amount of goodwill included in the gain or loss on disposal of all or a portion of a reporting unit.

Entities that report segment information in accordance with Statement 131 shall provide the above information about goodwill in total and for each reportable segment and shall disclose any significant changes in the allocation of goodwill by reportable segment. If any portion of goodwill has not yet been allocated to a reporting unit at the date the financial statements are issued, that unallocated amount and the reasons for not allocating that amount shall be disclosed.

Intangible Asset Impairments

12.14 Paragraph 46 of Statement 142 states:

For each impairment loss recognized related to an intangible asset, 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 impaired intangible asset and the facts and circumstances leading to the impairment

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- b. The amount of the impairment loss and the method for determining fair value
- c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated
- d. If applicable, the segment in which the impaired intangible asset is reported under Statement 131.

Goodwill Impairments

12.15 Paragraph 47 of Statement 142 states:

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 associated reporting unit (whether based on quoted market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof)
- c. If a recognized impairment loss is an estimate that has not yet been finalized (refer to paragraph 22), that fact and the reasons therefore and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

Disclosure Considerations Regarding Reporting Unit Determinations

12.16 Section II.L.5 of the SEC's *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006), indicates the following:

Given the impact the identification of reporting units can have on the determination of a goodwill impairment charge, registrants should consider providing disclosure in the critical accounting estimates section of MD&A. This disclosure may be particularly important when the amount of goodwill is material. The disclosure should address how the reporting units were identified, how goodwill is allocated to reporting units, and whether there have been any changes in the number of reporting units, or the manner in which goodwill was allocated. If such changes have taken place, they should be explained.

Comparison of Statement 141 to IFRS 3 and to FASB Proposed Replacement

Section 13 — Comparison of Statement 141 to IFRS 3

13.00 The international financial reporting standard (IFRS) addressing the accounting for business combinations is IFRS 3, *Business Combinations*.

13.01 Statement 141 and IFRS 3 have achieved convergence in many important aspects of accounting for business combinations. (For example, both Statement 141 and IFRS 3 require all business combinations within the scope of the respective statement to be accounted for using the purchase method.) However, areas of divergence remain, including the following:

- Business combinations resulting in the acquisition of less than 100 percent of the equity interests in the acquiree — accounting basis for the consolidated assets and liabilities (see **13.02**).
- Measurement date for marketable equity securities of the acquirer issued to effect a business combination (see **13.03**).
- Contingent consideration (see **13.04**).
- Recognition of liabilities associated with restructuring or exit activities of the acquiree (see **13.05**).
- Provisional measurement of assets acquired and liabilities assumed (see **13.06**).
- Deferred taxes (see **13.07**).
- Research and development assets (see **13.08**).
- Excess of fair value of acquired net assets over cost (see **13.09**).

As discussed in **Section 14**, the FASB and International Accounting Standards Board (IASB) are now jointly reconsidering their guidance on applying the purchase method of accounting to business combinations. Eventually, the two boards hope to develop a common and comprehensive standard that could be used for both domestic and cross-border financial reporting.

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Comparison of Statement 141 to IFRS 3 and
to FASB Proposed Replacement

Business Combinations Resulting in the Acquisition of Less Than 100 Percent of the Equity Interests in the Acquiree — Accounting Basis for the Consolidated Assets and Liabilities

13.02 In a transaction involving the acquisition of equity interests, neither Statement 141 (paragraph 9) nor IFRS 3 (paragraph 4) requires that 100 percent of the equity interests be acquired to qualify that transaction for consideration as a business combination. Accordingly, a business combination may occur under both Statement 141 and IFRS 3 when a portion of the equity interests remains as a noncontrolling interest (minority interest). Statement 141 and IFRS 3 provide the following regarding the accounting basis for the consolidated assets and liabilities in such a situation:

Statement 141	IFRS 3
The accounting basis for the consolidated assets and liabilities represents a combination of fair value, to the extent acquired, and historical cost for the noncontrolling interest (often referred to as minority interest) then remaining (see 1.13).	Paragraph 40 of IFRS 3 provides that “[b]ecause the acquirer recognises the acquiree’s identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at the acquisition date, any minority interest in the acquiree is stated at the minority’s proportion of the net fair values of those items.”

Summary of Comparison — Under Statement 141, minority interest is reflected at the date of acquisition at historical cost, while IFRS 3 requires that assets and liabilities of the acquiree, except for goodwill, be recognized at the date of exchange at fair value equivalent to 100 percent ownership. Thus, under IFRS 3, minority interest, except for goodwill, is reflected at the date of exchange at fair value. The computation of goodwill is the same under Statement 141 and IFRS 3.

Measurement Date for Marketable Equity Securities of the Acquirer Issued to Effect a Business Combination

13.03 Statement 141 and IFRS 3 provide the following regarding the measurement date when a transaction determined to be a business combination involves the acquirer’s issuing of its marketable equity securities:

Statement 141	IFRS 3
<p>Issue 99-12 offers interpretive guidance on Statement 141 regarding the date under Statement 141 for valuing marketable equity securities of the acquirer issued to effect a business combination. This guidance provides that in certain situations, the measurement date should occur before the acquisition date (see 3.02–3.12).</p>	<p>Paragraph 24 of IFRS 3 provides that “[t]he acquirer shall measure the cost of the business combination as the aggregate of: (a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus (b) any costs directly attributable to the business combination.” [Emphasis added]</p>

Summary of Comparison — When a transaction determined to be a business combination involves the acquirer’s issuing of its own marketable equity securities, under Issue 99-12, the securities’ measurement date may be prior to the acquisition date. If a measurement date prior to the acquisition date is used, it will differ from the measurement date applied under IFRS 3, which is always the date of exchange (consummation date).

Contingent Consideration

13.04 Both Statement 141 and IFRS 3 provide that no adjustment to the cost of acquisition results from arrangements involving a contingency based on security prices. While both Statement 141 and IFRS 3 allow for recognition in the cost of the acquisition as a result of other defined contingent consideration arrangements, they differ on the potential timing of recognition (but not of amounts). Statement 141 and IFRS 3 provide the following:

Statement 141	IFRS 3
<p>Paragraph 28 of Statement 141 provides that “[a]dditional consideration may be contingent on maintaining or achieving specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring entity shall record the fair value of the consideration issued or issuable as an additional cost of the acquired entity.” [Footnote omitted] (See 3.37.)</p>	<p>Paragraph 32 of IFRS 3 provides that “[w]hen a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is <i>probable</i> and can be measured reliably.” Paragraph 33 of IFRS 3 provides that “[i]f the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.”</p>

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Summary of Comparison — While the effect on the cost of the acquisition resulting from contingent consideration arrangements discussed above is the same under Statement 141 and IFRS 3 once the contingency is resolved and the additional consideration is distributable, under IFRS 3 amounts may require recognition earlier than under Statement 141 if the adjustment is probable and can be measured reliably.

Recognition of Liabilities Associated With Restructuring or Exit Activities of the Acquiree

13.05 Statement 141 and IFRS 3 contain differing criteria for recognition of liabilities associated with restructuring or exit activities of the acquiree:

Statement 141	IFRS 3
Issue 95-3 offers interpretive guidance on Statement 141 providing that the cost of an entity acquired should include certain liabilities recognized by the acquiring entity in connection with the acquisition as a result of a plan to exit an activity of an acquired company, involuntarily terminate employees of an acquired company, or relocate employees of an acquired company (see 3.51–3.59).	Paragraph 41 of IFRS 3 provides that “the acquirer recognises separately as part of allocating the cost of the combination only the identifiable assets, liabilities and contingent liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria in paragraph 37. Therefore: (a) the acquirer shall recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i> ; and (b) the acquirer, when allocating the cost of the combination, shall not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination.”

Summary of Comparison — The recognition criteria in Issue 95-3 related to restructuring or exit activities of the acquiree will permit recognition as a cost of the acquisition those plans put in place by the acquirer that were not recognized as liabilities of the acquiree. Such arrangements would be precluded from recognition as a cost of the acquired entity under IFRS 3.

Provisional Measurement of Assets Acquired and Liabilities Assumed

13.06 The reporting of provisional measurements of assets acquired and liabilities assumed under Statement 141 is discussed in **4.07–4.08**. As noted in **4.08**, Statement 141 is silent about how adjustments to provisional measurements are to be reported.

Provided that the provisional measurement was appropriately prepared on the basis of all information then available, the adjustment is generally accounted for as a change in accounting estimate. Paragraph 19 of Statement 154 provides that “[a] change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.” This accounting differs from IFRS 3, which provides for retrospective application of changes to amounts determined provisionally. Paragraph 62 of IFRS 3 provides:

If the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected because either the fair values to be assigned to the acquiree’s identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer shall account for the combination using those provisional values. The acquirer shall recognise any adjustments to those provisional values as a result of completing the initial accounting:

- (a) within twelve months of the acquisition date; and
- (b) from the acquisition date. Therefore:
 - (i) the carrying amount of an identifiable asset, liability or contingent liability that is recognized or adjusted as a result of completing the initial accounting shall be calculated as if its fair value at the acquisition date had been recognised from that date.
 - (ii) goodwill or any gain recognised in accordance with paragraph 56 shall be adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.
 - (iii) comparative information presented for the periods before the initial accounting for the combination is complete shall be presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortization or other profit or loss effect recognised as a result of completing the initial accounting.

Deferred Taxes

13.07 Statement 141 and IFRS 3 provide the following regarding a subsequent realization of a deferred tax asset not recognized at the acquisition date:

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Statement 141	IFRS 3
<p>Paragraph 38 of Statement 141 provides that “[a] deferred tax liability or asset shall be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of FASB Statement No. 109, <i>Accounting for Income Taxes</i>.”</p> <p>Paragraph 30 of Statement 109 provides that “[i]f a valuation allowance is recognized for the deferred tax asset for an acquired entity’s deductible temporary differences or operating loss or tax credit carryforwards at the acquisition date, the tax benefits for those items that are first recognized (that is, by elimination of that valuation allowance) in financial statements after the acquisition date shall be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.” (See 5.43–5.44.)</p>	<p>Paragraph 65 of IFRS 3 provides that “[i]f the potential benefit of the acquiree’s income tax loss carry-forwards or other deferred tax assets did not satisfy the criteria in paragraph 37 for separate recognition when a business combination is initially accounted for but is subsequently realised, the acquirer shall recognise that benefit as income in accordance with IAS 12 <i>Income Taxes</i>. In addition, the acquirer shall: (a) reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date; and (b) recognise the reduction in the carrying amount of the goodwill as an expense. However, this procedure shall not result in the creation of an excess as described in paragraph 56, nor shall it increase the amount of any gain previously recognised in accordance with paragraph 56.”</p>

Summary of Comparison — The above provisions of Statement 141 and IFRS 3 allow for different presentation in the income statement and the potential for different presentation in the balance sheet when a deferred tax asset not recognized at the acquisition date is subsequently recognized.

Research and Development Assets

13.08 Both Statement 141 and IFRS 3 address the recognition of research and development assets. The related provisions are as follows:

Statement 141	IFRS 3
<p>Paragraph 42 of Statement 141 provides that “amounts assigned to tangible and intangible assets to be used in a particular research and development project that <i>have no alternative future use</i> shall be charged to expense at the acquisition date.” (See 6.23–6.26.)</p>	<p>Paragraph 45 of IFRS 3 provides that “[i]n accordance with paragraph 37, the acquirer recognises separately an intangible asset of the acquiree at the acquisition date only if it meets the definition of an intangible asset in IAS 38 <i>Intangible Assets</i> and its fair value can be measured reliably. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset and its fair value can be measured reliably.”</p>

Summary of Comparison — The fair value of a particular research and development project that has no alternative future use is charged to expense at the acquisition date under Statement 141. The fair value of that research and development project, under IFRS 3, would be recognized as a separate intangible asset if it meets the IAS 38 definition of an intangible asset and can be measured reliably. The amount assigned to a research and development project would never, under IFRS 3, be charged to income at the acquisition date.

Excess of Fair Value of Acquired Net Assets Over Cost

13.09 Both Statement 141 and IFRS 3 address the determination and recognition of an excess of fair value of net assets acquired over cost. The related provisions are as follows:

Statement 141	IFRS 3
<p>Paragraph 44 of Statement 141 provides that “[i]n some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired entity (<i>excess over cost or excess</i>). That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets [including research and development assets acquired and charged to expense] except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets.” [Footnote omitted]</p> <p>Paragraph 45 of Statement 141 provides that “[i]f any excess [of fair value of acquired net assets over cost] remains after reducing to zero the amounts that otherwise would have been assigned to those assets, that remaining excess shall be recognized as an extraordinary gain The extraordinary gain shall be recognized in the period in which the business combination is completed unless the combination involves contingent consideration that, if paid or issued, would be recognized as an additional element of cost of the acquired entity.” (See 7.01–7.07.)</p>	<p>Paragraph 56 of IFRS 3 provides that “[i]f the acquirer’s interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised in accordance with paragraph 36 exceeds the cost of the business combination, the acquirer shall: (a) reassess the identification and measurement of the acquiree’s identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and (b) recognise immediately in profit or loss any excess remaining after that reassessment.”</p>

Summary of Comparison — While Statement 141 and IFRS 3 both provide for the recognition of income related to an excess of fair value of acquired net assets over cost, the method of calculating that amount differs, such that the amount determined under

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Statement 141, if any, will most likely be less because of the Statement's requirement to reduce pro rata the amounts assigned to certain assets.

13.10 U.S. GAAP and IFRS also differ regarding the subsequent accounting for goodwill. Statement 142 provides that goodwill shall be tested for impairment at a level of reporting referred to as a "reporting unit," defined as an "operating segment" or "component" (one level below an operating segment), and requires a two-step impairment test (see **Section 10 — Goodwill**). IAS 36, *Impairment of Assets*, requires testing of goodwill at the cash-generating-unit level, defined as "the smallest identifiable group of assets generating cash inflows that are largely independent of the cash inflows from other assets or groups of assets," and requires a one-step impairment test.

Section 14 — Comparison of Statement 141 to FASB Proposed Replacement

14.00 In August 1996, the FASB added to its agenda the project on business combinations to reconsider APB Opinion No. 16, *Business Combinations*, and APB Opinion No. 17, *Intangible Assets*. The first part of this project resulted in the issuance in June 2001 of Statements 141 and 142, discussed in **Sections 1–12**. In a subsequent phase of the project, the FASB is reconsidering the existing guidance on applying the purchase method of accounting to business combinations (now to be called the “acquisition method”) that Statement 141 carried forward without reconsideration.

14.01 On June 30, 2005, the FASB issued an Exposure Draft of a proposed Statement of Financial Accounting Standards (the “Exposure Draft”) intended to replace Statement 141. Paragraph B23 of the Exposure Draft indicates the following:

The decisions in this Statement are guided by the Board’s decision to apply the following fundamental principles in recognizing all business combinations.

- a. *The acquirer obtains control of the acquiree at the acquisition date and, therefore, becomes responsible and accountable for all of the acquiree’s assets, liabilities, and activities, regardless of the percentage of its ownership in the acquiree.* The Board concluded that obtaining control of a business is a remeasurement event regardless of how control is obtained. Thus, to provide information that is both relevant and reliable, the acquirer’s accounting for those assets, liabilities, and activities begins at the acquisition date and if the acquirer held a noncontrolling equity investment in the acquired entity, its accounting for that investment comes to an end.
- b. *The identifiable assets acquired and liabilities assumed in a business combination should be recognized at their fair values on the date control is obtained.* The Board concluded that that faithfully reflects the underlying economic circumstances at that date and, thus, improves the relevance and comparability of the information reported.
- c. *The total amount to be recognized for the acquiree should be the fair value of the acquiree as a whole.* The Board concluded that that faithfully and consistently reflects the underlying economic value of the acquiree, regardless of the ownership interest in the acquiree at the acquisition date or whether control was achieved in stages (involving two or more purchases of equity interests in the acquiree), or without a

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purchase on the acquisition date and, thus, improves the relevance and comparability of the information reported.

- d. *Business combinations generally are exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values.* Therefore, the Board concluded that “in the absence of evidence to the contrary, the exchange price (referred to as the consideration transferred in this Statement) paid by the acquirer on the acquisition date is presumed to be the best evidence of the acquisition-date fair value of the acquirer’s interest in the acquiree” [reference omitted] and should be used as a basis for measuring the fair value of the acquiree.

14.02 The following compares the current guidance in Statement 141 with the proposed guidance from the Exposure Draft. Consult the FASB’s Web site for current project activities, including any redeliberations:

Scope

Statement 141	Exposure Draft
Paragraph 9 of Statement 141 provides that “[f]or purposes of applying this Statement, a <i>business combination</i> occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. This Statement does not address transactions in which control is obtained through means other than an acquisition of net assets or equity interests.” [Footnotes omitted] (See Section 1.)	The summary section of the Exposure Draft provides that “[a] business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.” The Exposure Draft notes that “[t]he requirements of this proposed Statement would be applicable to business combinations involving only mutual entities, business combinations achieved by contract alone, and the initial consolidation of variable interest entities that are businesses.”

Business Combinations Resulting in the Acquisition of Less Than 100 Percent of the Equity Interests in the Acquiree — Accounting Basis for the Consolidated Assets and Liabilities

Statement 141	Exposure Draft
The accounting basis for the consolidated assets and liabilities represents a combination of fair value, to the extent acquired, and historical cost for the noncontrolling interest (often referred to as minority interest) then remaining (see 1.13).	The summary section of the Exposure Draft provides that “[t]his proposed Statement would require the acquirer in business combinations in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date, to recognize the identifiable assets and liabilities at the full amount of their fair values, with limited exceptions, and goodwill as the difference between the fair value of the acquiree, as a whole, and the fair value of the identifiable assets acquired and liabilities assumed.”

Acquisitions of Additional Noncontrolling Interests

Statement 141	Exposure Draft
<p>While paragraph 11 of Statement 141 indicates that “[t]he acquisition of some or all of the noncontrolling interests in a subsidiary is not a business combination” as defined therein, paragraph 14 of Statement 141 provides that such acquisitions “shall be accounted for using the purchase method.” (See 1.14.)</p>	<p>The summary section of the Exposure Draft provides that “[a]cquisitions of additional noncontrolling interests after the business combination would not be permitted to be accounted for using the acquisition method. In accordance with Proposed Statement, <i>Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries</i>, [expected to be finalized by the FASB at the same time as the Exposure Draft] acquisitions (or dispositions) of noncontrolling interests after the business combination would be accounted for as equity transactions.”</p>

Measurement Date for Marketable Equity Securities of the Acquirer Issued to Effect a Business Combination

Statement 141	Exposure Draft
<p>Issue 99-12 offers interpretive guidance on Statement 141 regarding the date under Statement 141 to value marketable equity securities of the acquirer issued to effect a business combination. The guidance provides that in certain situations, the measurement date should occur before the acquisition date (see 3.02–3.12).</p>	<p>Appendix E of the Exposure Draft provides that the proposed Statement nullifies Issue 99-12 “because it requires that all consideration transferred in a business combination, including equity securities issued as consideration, be measured at their fair value on the acquisition date.”</p>

Contingent Consideration

Statement 141	Exposure Draft
<p>Paragraph 28 of Statement 141 provides that “[a]dditional consideration may be contingent on maintaining or achieving specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring entity shall record the fair value of the consideration issued or issuable as an additional cost of the acquired entity.” [Footnote omitted] (See 3.37.)</p>	<p>The summary section of the Exposure Draft provides that “[t]his proposed Statement would require all items of consideration transferred by the acquirer to be measured and recognized at fair value at the acquisition date. Therefore, this proposed Statement would require the acquirer to recognize contingent consideration arrangements at fair value as of the acquisition date. Subsequent changes in fair value of contingent consideration classified as liabilities would be recognized in income, unless those liabilities are in the scope of, and therefore accounted for, in accordance with, FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i>.”</p>

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Costs of the Acquisition

Statement 141	Exposure Draft
Paragraph 24 of Statement 141 provides that “[t]he cost of an entity acquired in a business combination includes the direct costs of the business combination.” (See 3.43 .)	The summary section of the Exposure Draft provides that “[t]his proposed Statement would require the costs the acquirer incurs in connection with the business combination to be accounted for separately from the business combination accounting.”

Recognition of Liabilities Associated With Restructuring or Exit Activities of the Acquiree

Statement 141	Exposure Draft
Issue 95-3 offers interpretive guidance on Statement 141 providing that the cost of an entity acquired include certain liabilities recognized by the acquiring entity in connection with the acquisition as a result of a plan to exit an activity of an acquired company, involuntarily terminate employees of an acquired company, or relocate employees of an acquired company (see 3.51–3.59).	The summary section of the Exposure Draft notes that “[t]his proposed Statement would prohibit costs associated with restructuring or exit activities that do not meet the recognition criteria in FASB Statement No. 146, <i>Accounting for Costs Associated With Exit or Disposal Activities</i> , as of the acquisition date from being recognized as liabilities assumed. Rather, they would be recognized as postcombination expenses of the combined entity when incurred.”

Provisional Measurement of Assets Acquired and Liabilities Assumed

Statement 141	Exposure Draft
As discussed in 4.07–4.08 , Statement 141 is silent about how adjustments to provisional measurements are to be reported. Provided that the provisional measurement was appropriately prepared on the basis of all information then available, the adjustment is generally accounted for as a change in accounting estimate. Paragraph 19 of Statement 154 provides that “[a] change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.” (See 4.07–4.08 .)	Paragraph 67 of the Exposure Draft provides that “[t]he acquirer shall recognize any adjustments to the provisional values during the measurement period as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for periods presented in financial statements shall be adjusted, including any change in depreciation, amortization, or other income effect recognized as a result of completing the initial accounting.”

Deferred Taxes

Statement 141	Exposure Draft
<p>Paragraph 38 of Statement 141 refers to Statement 109 for guidance regarding the recognition of a deferred tax liability or asset for the difference between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination.</p> <p>Paragraph 266 of Statement 109 requires that a reduction of the <i>acquirer's</i> valuation allowance as a result of a business combination be recognized through a corresponding reduction to goodwill or certain noncurrent assets or an increase in negative goodwill. (See 5.44.)</p>	<p>The summary section of the Exposure Draft provides that “[t]he acquirer would be required to account for any changes in the amount of its deferred tax benefits that are recognizable (through the increase or reduction of the acquirer’s valuation allowance on its previously existing deferred tax assets) as a result of a business combination separately from that business combination.”</p>

Preacquisition Contingencies

Statement 141	Exposure Draft
<p>Paragraph 40(b) of Statement 141 provides that “[i]f the fair value of the preacquisition contingency cannot be determined during the allocation period, that preacquisition contingency shall be included in the allocation of the purchase price based on an amount determined in accordance with the following criteria:</p> <ol style="list-style-type: none"> <li data-bbox="126 1103 632 1365">(1) Information available prior to the end of the allocation period indicates that it is probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination. It is implicit in this condition that it must be probable that one or more future events will occur confirming the existence of the asset, liability, or impairment. <li data-bbox="126 1403 632 1459">(2) The amount of the asset or liability can be reasonably estimated.” (See 5.58–5.62.) 	<p>The summary section of the Exposure Draft provides that “[t]his proposed Statement would amend FASB Statement No. 5, <i>Accounting for Contingencies</i>, to exclude from its scope assets or liabilities arising from contingencies acquired or assumed in a business combination. This proposed Statement would require assets and liabilities arising from contingencies that are acquired or assumed as part of a business combination to be measured and recognized at their fair value at the acquisition date if the contingency meets the definition of an asset or liability in FASB Concepts Statement No. 6, <i>Elements of Financial Statements</i>, even if it does not meet the recognition criteria in Statement 5. After initial recognition, contingencies would be accounted for in accordance with applicable generally accepted accounting principles, except for those that would be accounted for in accordance with Statement 5 if they were acquired or incurred in an event other than a business combination. Those contingencies would continue to be measured at fair value with changes in fair value recognized in income in each reporting period.”</p>

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Research and Development Assets

Statement 141	Exposure Draft
<p>Paragraph 42 of Statement 141 provides that "amounts assigned to tangible and intangible assets to be used in a particular research and development project that <i>have no alternative future use</i> shall be charged to expense at the acquisition date." (See 6.23–6.26.)</p>	<p>The summary section of the Exposure Draft provides that "[t]he acquirer would be required to recognize separately from goodwill the acquisition-date fair value of research and development assets acquired in a business combination. This Statement supersedes [FASB] Interpretation 4, which required research and development assets acquired in a business combination that have no alternative future use to be measured at their fair value and expensed at the acquisition date."</p>

Bargain Purchase (an Excess of Fair Value of Acquired Net Assets Over Cost)

Statement 141	Exposure Draft
<p>Paragraph 44 of Statement 141 provides that "[i]n some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired entity (<i>excess over cost or excess</i>). That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets [including research and development assets acquired and charged to expense] except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets." [Footnote omitted]</p> <p>Paragraph 45 of Statement 141 provides that "[i]f any excess [of fair value of acquired net assets over cost] remains after reducing to zero the amounts that otherwise would have been assigned to those assets, that remaining excess shall be recognized as an extraordinary gain. . . . The extraordinary gain shall be recognized in the period in which the business combination is completed unless the combination involves contingent consideration that, if paid or issued, would be recognized as an additional element of cost of the acquired entity." (See 7.01–7.07.)</p>	<p>The summary section of the Exposure Draft provides that "[t]his proposed Statement would require the acquirer in a business combination in which the acquisition-date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest (referred to as a bargain purchase) to account for that excess by first reducing the goodwill related to that business combination to zero, and then by recognizing any excess in income."</p>

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