

Accounting Standards Codification 805 – Business Combination



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Welcome to our “Uniquis’ ASC Insights Series: Guide to Accounting Standards,” where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, this guide helps you navigate complex accounting scenarios and deepen your knowledge.

This is the thirteenth publication in our “Uniquis’ ASC Insights Series: Guide to Accounting Standards”, focusing on “ASC 805, Business Combinations”. In this installment, we delve into the specifics of ASC 805, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners.

The primary objective of ASC 805 is to provide guidance on the principles for identifying business combinations and their consequential accounting requirements. The overall principle of ASC 805 indicates that when the acquirer entity acquires control of the acquired entity (or the target), the fair value of the underlying exchange transaction is used to establish a new basis of accounting for the acquired entity.

We hope you enjoy reading this document and find this series valuable!

Thank you.

Yours faithfully

For Uniquis Consultech Inc.



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In today's era, most entities are focusing on inorganic growth as a mechanism to grow in size, diversify their product offerings, or expand into new markets or geographies. To achieve synergies in business opportunities, entities engage in acquisitions, mergers, or reverse mergers as a growth strategy. Business acquisition accounting can be complex and begins with determining whether an acquisition should be accounted for as a business combination.

ASC 805 addresses the financial accounting and reporting requirements for a business combination transaction, which is defined in the ASC master glossary as "a transaction or other event in which an acquirer obtains control of one or more businesses."

This publication provides an overview of the key accounting considerations and implementation matters relating to ASC 805 (Business Combination). The technical views and accounting positions on the framework keep enhancing.

We sincerely hope you find this quick reference guide informative in identifying and evaluating the issues related to the Business Combination. We will be happy to participate in any discussions required to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.



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ASC 805 requires an entity to account for a business combination by using the acquisition method of accounting. Before applying the accounting principles, the first step includes assessing whether the acquisition transaction meets the definition of a business combination. Generally, a business combination occurs when an entity purchases the equity interests or the net assets of one or more businesses in exchange for cash, equity interests of the acquirer, or other consideration.

A transaction that does not meet the definition of a business combination should be accounted for as an asset acquisition as per the ASC 805-50 principles.



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1 Business Combination Vs. Asset Acquisition

Distinguishing between a business combination and an asset acquisition is important because there are many differences between the accounting for each. Determining whether an acquisition is a "Business Combination" or an "Asset Acquisition" is a two-step process.

Step 1: Applying the 'substantially all' threshold

01

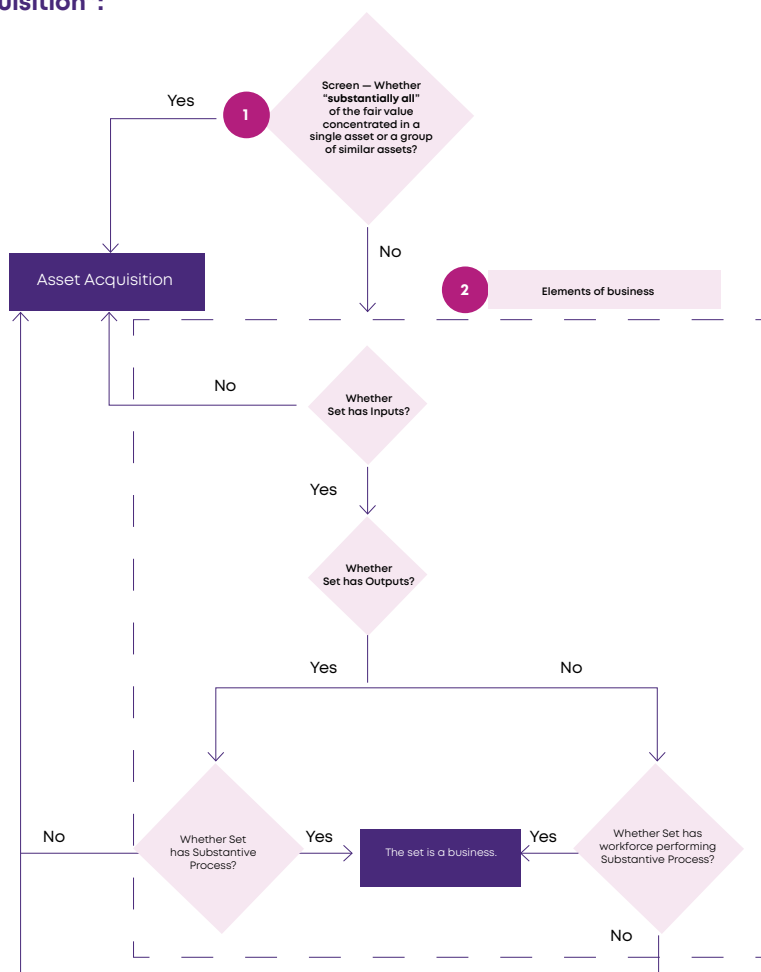
This step includes using a "screen" to assess whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. If that threshold is met, the set is not a business and does not require further evaluation.

Step 2: Determining whether inputs and a substantive process exist

02

If the screen is not met, the entity must apply a "framework" to determine whether the acquired set includes, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. If so, the acquired set is a business.

The following decision tree summarizes key steps in assessing "Business Combination Vs. Asset Acquisition":



1. Guidance

The entity shall apply the following steps to the “Fair value threshold” test:

- Step 1 — Combine the identifiable assets into a single identifiable asset.
- Step 2 — Combine the assets into similar assets.
- Step 3 — Measure the fair value of the gross assets acquired.
- Step 4 — Determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

Implementation matters

- The following assets shall be considered as dissimilar for threshold assessment:
 - Tangible assets and intangible assets
 - Identifiable intangible assets in different major intangible asset classes (e.g., customer-related intangibles, trademarks, in-process research and development (IPR&D))
 - Financial assets and non-financial assets
 - Different major classes of financial assets (e.g., accounts receivable and marketable securities)
 - Different major classes of tangible assets (e.g., inventory, manufacturing equipment, automobiles)
 - Identifiable assets within the same major asset class that have significantly different risk characteristics
- For the purpose of evaluating whether substantially all of the fair value is concentrated in a single identifiable asset or a group of similar identifiable assets, gross assets acquired:
 - **Include** goodwill arising from the business combination. However, bargain purchase gain arising in a business combination is not an asset and should be excluded.
 - **Excludes**
 - cash and cash equivalents,
 - deferred tax assets and
 - any goodwill arising from the recognition of DTL created in a business combination.
- In the absence of explicit guidance/ threshold on “substantially all”, the entities will need to apply judgment to determine what is considered “substantially all”. The term is used throughout GAAP (e.g., in ASC 810, ASC 606, and ASC 842) and is generally interpreted to mean 90 percent or more. However, the Financial Accounting Standards Board (FASB) did not intend for entities to treat the term as a bright line; thus, judgment must be applied in circumstances in which the quantitative result of the screen is close to 90 percent

2. Guidance

- Minimum requirements for a set of activities to be considered as a business include:
 - an input and a substantive process that together significantly contribute to the ability to create outputs.
- Assessment of the existence of substantive process depends upon whether output exists or not.
 - **When the set does not generate or generate insignificant output:** In such a case, the conclusion is based upon whether the set includes employees with the necessary skills, knowledge, or experience to perform an acquired process that is critical to the ability to generate output.
 - **When a set does generate output:** In such a case, the conclusion is based on the existence of any of the following:
 - Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process, OR

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- Acquired process has the ability to produce output and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs, OR
- An acquired process has the ability to produce output and is considered unique or scarce.

Implementation matters

- The existence of a substantive process is mandatory to conclude that the set of activities constitutes a business, and this is one of the distinguishing factors from a transaction that can be considered an asset acquisition.
- In the case of an early-stage company that has not generated revenues, i.e., a set has no output, it can be concluded that the set has both an input and a substantive process that together significantly contribute to the ability to create outputs only if the set includes employees with the necessary skills, knowledge, or experience to perform an acquired process that is critical to the ability to develop or convert an acquired input or inputs into outputs. However, this shall not include an outsourced workforce.
- The Board concluded that, under the circumstances, a set that generates output before and after a transaction is more likely to include an input and substantive process than a set that does not generate outputs. This requires judgment.

Illustrative example

XYZ Inc. acquired ABC Inc., which has an automated process (e.g., through acquired technology, infrastructure, or specialized equipment) that significantly contributes to the ability to continue producing outputs. ABC inc. does not include the workforce. Whether there exists a substantive process element of business?

Analysis: The Board has clarified that a set that includes an automated process (e.g., through acquired technology, infrastructure, or specialized equipment) that significantly contributes to the ability to continue producing outputs could be a substantive process, even if it does not include an organized workforce.

However, entities should evaluate the extent to which employee involvement or intervention is necessary for the automated routines to continue producing outputs when determining whether an acquired set includes a substantive automated process. This requires significant judgment.

Based on the above, it can be concluded that there are substantive process elements of business with respect to ABC Inc.



SEC registrants are required to use the definition of a business in SEC Regulation S-X, Rule

11-01(d), when evaluating the requirements of SEC Regulation S-X, Rule 3-05, and SEC Regulation S-X, Article 11. The definition of a business in Rule 11-01(d) differs from that in ASC 805-10.

2 Business Combination Accounting

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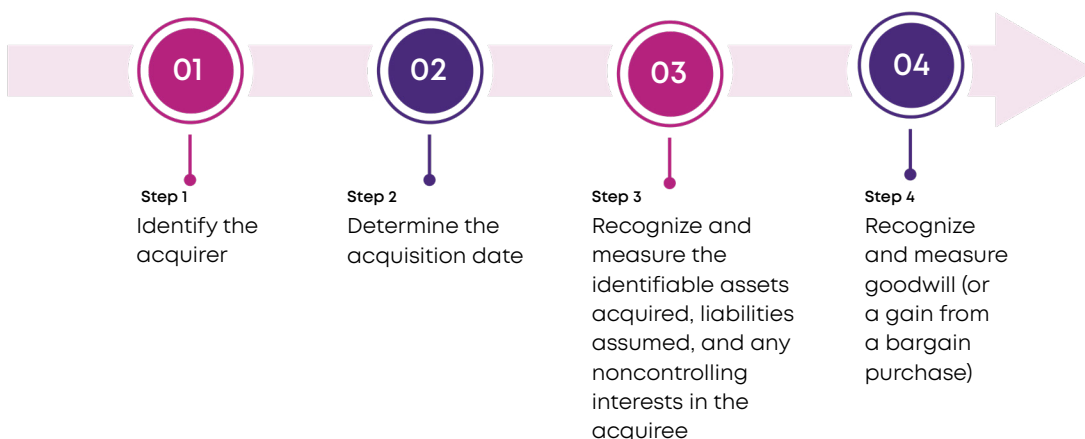
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The acquirer entity shall apply the acquisition method of accounting to account for the Business Combination. The acquisition method of accounting includes the following steps:



01 Step 1 Identify the acquirer

The first step in acquisition accounting includes identifying the accounting acquirer. The acquirer is the entity that acquires control of the acquiree entity. Acquisition of Control¹ is the primary condition to identify the accounting acquirer.

Legal Acquirer Vs Accounting Acquirer

General rule: An Entity that transfers the consideration (e.g., cash, other assets, or its equity interests) is generally considered the acquirer for accounting purposes.

Exception to the general rule: Identification of the accounting acquirer in a business combination transaction is not straightforward and requires deep diving into the facts. It also requires significant judgment. A legal acquirer is the entity that issues its equity interest, which may or may not be an accounting acquirer. There are circumstances such as reverse acquisitions wherein the entity issuing equity interest, i.e., the legal acquirer, is considered as the accounting acquiree, while the entity whose equity interests are acquired (the "legal acquiree") is, for accounting purposes, the acquirer (also called the "accounting acquirer").

Illustrative example

ABC Inc. issues shares to the shareholders of XYZ Inc. in exchange for all of the outstanding shares of XYZ Inc. The original shareholders of ABC Inc. will have 51% of the voting interests of the combined entity (there are no other equity instruments outstanding at ABC Inc. or XYZ Inc.).

The Board of Directors will consist of five directors from XYZ Inc. and four from ABC Inc., all with 5-year terms. A two-thirds vote of the ownership interests is required for the removal of Board members.

Senior management will consist of one member from ABC Inc. (Chairman) and two from XYZ Inc. (CEO and CFO).

All other relevant factors to consider in the transaction are neutral (i.e., they do not favor either party as the accounting acquirer).

Analysis: ABC Inc. is the legal acquirer (i.e., the issuer of shares). As per the facts of the given case, although ABC Inc. will have the largest portion of the voting rights, XYZ Inc. shareholders appear to have the most influence over the combined entity, dominating the Board of Directors and senior management. Therefore, XYZ Inc. would be considered the accounting acquirer.

¹ For detailed guidance on assessment and existence of control refer to our recent publication titled, [ASC Insights Series Guide to Accounting Standards on ASC 810 Consolidation](#).

Identification of Accounting Acquirer in a SPAC transaction

Transactions involving special-purpose acquisition companies (SPACs) have been common in the marketplace. In such transactions, private operating companies ("targets") have been raising capital by merging with SPACs rather than using traditional IPOs or other financing activities. A SPAC is a newly formed company that raises cash in an IPO and uses that cash or the equity of the SPAC, or both, to fund the acquisition of a target.

One key consideration in a SPAC merger transaction is determining which entity is the **accounting acquirer**. The accounting acquirer is the entity that obtains control of the reporting entity and may be different from the legal acquirer.

Accounting Considerations related to each potential outcome are as follows:

Accounting Acquirer- SPAC	Accounting Acquirer- Target
SPAC must assess whether or not the target meets the definition of a business in accordance with U.S. GAAP. If it does, the transaction is accounted for as a business combination as per the principles of ASC 805. If the target is determined to be a group of assets that does not meet the definition of a business in accordance with U.S. GAAP. In that case, the transaction is accounted for as an asset acquisition.	The substance of the transaction is a recapitalization of the target (i.e., a reverse recapitalization) rather than a business combination or an asset acquisition. In such a situation, the transaction would be accounted for as though the target issued its equity for the net assets of the SPAC and, since a business combination has not occurred, no goodwill or intangible assets would be recorded.



ASC 805-10-55-11 through ASC 805-10-55-15 includes factors that may indicate which party is the accounting acquirer, including:

- Relative voting rights in the reporting entity,
- Existence and size of a single minority voting interest in the reporting entity,
- Composition of the governing body of the reporting entity,
- Composition of the senior management of the reporting entity,
- Terms of the exchange of equity interests (entity that pays a premium), and
- Relative size of the entities.

The determination of the accounting acquirer will require the exercise of professional judgment based on an evaluation of all factors in aggregate. This may be particularly challenging in situations where the factors are mixed (that is, some of the factors may point to one of the combining entities as the accounting acquirer, whereas other factors may point to the other combining entity as the accounting acquirer).

02 Step 2 Determine the acquisition date

- Acquisition date is the date on which the acquirer acquires control of the business, which generally coincides with the date on which the acquirer-
 - Legally transfers the consideration to the seller, receives the assets, and incurs or assumes the liabilities (i.e., the closing date or consummation date).
- Circumstances under which the acquisition date can be before or after the closing date-
 - Control is obtained by contract: The acquisition date would be the date the contract is executed
 - Control is obtained by an investor as a result of an investee share buyback: The acquisition date is the date the investor obtains a majority voting interest.

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- Written agreement is in place as of the designated date, i.e., preceding the closing date, that provides for transfer of control of the acquired entity to the acquirer on that date.
- Determining the acquisition date is important because a business combination transaction is accounted for on this date.



There may be circumstances wherein a business combination requires regulatory or shareholder approval by the acquirer entity or the acquiree entity. We believe that under such circumstances, the acquisition date is the date on which approval is obtained.

However, this requires critical evaluation of facts and significant judgment, particularly when approval is considered perfunctory. For example, if management and the board of directors control sufficient votes to approve the transaction, and thus shareholder approval is considered perfunctory, a transfer of control might be deemed to occur prior to the date of shareholder approval and prior to the closing date.

Step 3

03

Recognize and measure the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquiree

Recognition principle

ASC 805 requires an acquirer to recognize the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree separately from goodwill. The recognition principle enables an acquirer to recognize certain assets and liabilities that were not previously recognized in the acquiree's financial statements, such as certain intangible assets like customer relationships, non-competitive rights, etc.

Measurement principle

General Rule: Identifiable assets acquired, liabilities assumed, and any noncontrolling interest (NCI) in the acquiree are recognized and measured as of the acquisition date at fair value determined as per the principles defined in ASC 820.

Exception to General Rule:

Asset/ Liability	Measurement Principle	Implementation matters
Preacquisition contingencies	• Measured at fair value if determinable; otherwise, default to ASC 450 recognition and measurement criteria, i.e. • Available information indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date; and • The amount of assets or liabilities can be reasonably estimated.	• Estimating the fair value of preacquisition contingencies is highly subjective and judgmental, which requires consideration of all the relevant facts and circumstances of a market participant.
Income taxes	• Tax effect of temporary differences (taxable/ deductible) for assets acquired, or liabilities assumed, or operating loss or tax credit carry forwards shall be measured as per the principles of ASC 740.	• The recognition and measurement of the tax effect of temporary differences arising from business combinations depends upon the tax nature of the business combination, i.e., whether

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		it is taxable or non-taxable. In a nontaxable business combination, the acquirer's tax bases in the assets acquired and the liabilities assumed are generally the acquiree's tax bases immediately before the acquisition date. They generally do not step up to the respective fair values (as in the case of a taxable business combination), resulting in temporary differences, i.e., Book Basis vs Tax base. No DTA/ DTL is recognized for the portion of goodwill that is not tax-deductible and leveraged leases.
Employee benefit obligations	Assumed pension and postretirement benefit obligations are measured and recognized in accordance with the guidance in ASC 715	
Indemnification assets	Acquirer shall measure Indemnification asset using assumptions consistent with those used to measure the liabilities to which they relate.	The measurement of indemnification assets should be subject to any contractual limitations as to the indemnification amount and management's assessment of collectability.
Leases	- For leases (Operating and finance leases) acquired under a business combination: Acquiree was a lessee: For acquired finance and operating leases, lease liability and right-of use assets are measured as per the principles of ASC 842, as if the leases are acquired as per the principles of ASC 842, as if the leases are acquired as new leases at the acquisition date. Acquiree was a lessor: Sales-type or direct financing lease: Recognizes and measures the net investment in the lease as per the principles of ASC 842 as if the leases are acquired as new leases at the acquisition date.	
Contract assets and contract liabilities	Acquirer shall measure contract assets and contract liabilities as per the principles of ASC 606.	
Assets held for sale	Long-lived assets (or disposal groups) acquired with the intention of selling immediately after acquisition and that meet	

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	the criteria for held-for-sale classification on the acquisition date should be measured at fair value less cost to sell as per the principles of ASC 360-10.	
Reacquired rights	• An acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. • Examples of such rights include a right to use the acquirer's trade name under a franchise agreement. • The acquirer shall measure the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract, regardless of whether market participants would consider potential contractual renewals in determining its fair value.	
Share-based payment awards	• In respect of Replacement awards granted to the grantees of the acquiree entity in exchange for share-based payment awards held by grantees, only the portion of the replacement awards related to pre-combination vesting (i.e., past goods or services) should form part of the consideration transferred in the business combination. However, the portion of replacement awards related to post-combination vesting (i.e., future goods or services) should be recognized as compensation cost in the post-combination period.	
Purchased financial assets with credit deterioration (PCD)	• An acquirer initially measures the amortized cost of a PCD asset by (1) determining the acquisition-date estimate of expected credit losses under the applicable impairment model as defined in ASC 326 and (2) adding that amount to the asset's fair value.	

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- Excess of the aggregate of (1) the consideration transferred, (2) the fair value of any noncontrolling interest in the acquiree, and (3) the fair value of the acquirer's previously held equity interest in the acquiree over net of the acquisition-date fair values of the identifiable assets acquired and the liabilities assumed represents Goodwill arising from business combination.
- If the sum of (1) through (3) above is less than the net of the acquisition-date values of the identifiable assets acquired and the liabilities assumed. In such a case, the acquirer recognizes a gain, referred to as a bargain purchase gain, in earnings on the acquisition date.
- Once recognized, goodwill is tested for impairment in accordance with ASC 350-20, which also provides an accounting alternative for the subsequent accounting for goodwill for entities that do not meet the definition of a public business entity (PBE) or are not-for-profit entities. Such entities may elect to amortize the goodwill acquired in a business combination and to use a simplified, one-step impairment test.
- ASC 805 requires the acquirer to reassess both recognition and measurement of bargain purchases before their recognition since bargain purchases are expected to be infrequent, which might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.
- Reassessment is intended to ensure that the assets acquired and liabilities assumed are correctly measured at their fair value (avoiding the scenario of overstatement of assets or understatement of liabilities). More commonly, bargain purchase gains occur because not all assets acquired or liabilities assumed are recognized or measured at their fair values. For example, an acquirer would be expected to pay less for a business with a contingent liability, but that liability may go unrecognized when the business combination is accounted for if the liability does not meet the recognition criteria in ASC 805.



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3.1 Consideration transferred

Overview

Consideration transferred refers to the total value exchanged by the acquiring company to obtain control over the acquired entity in a business combination. Under ASC 805, consideration transferred is comprised of the acquisition-date fair values of:



It encompasses various components such as cash, tangible and intangible assets, a business or subsidiary of the acquiring entity, instruments of the acquiring entity (e.g., common stock, preferred stock, options, warrants, and debt instruments), or other promised future payments of the acquiring entity, including contingent payments.

*Liabilities incurred: Does not include liabilities of the target assumed by the acquirer. It refers to the obligations of the acquirer to the former owners of the target company.

Measurement Principles

- The consideration transferred is measured at fair value, which reflects the amount that would be paid in an orderly transaction between market participants at the acquisition date.
- Cash consideration is calculated based on the cash and cash equivalents transferred to the acquiree.
- Equity consideration involves determining the fair value of equity instruments issued by the acquirer in the transaction.
- Contingent consideration is valued using probability-weighted scenarios based on the likelihood of payout and discounted at an appropriate rate.

Implementation matters

- **Business combination achieved without the transfer of consideration:** Under the circumstances wherein business combination is achieved without transfer of consideration such as by contract or by a lapse in participating rights of a minority shareholder **the acquirer** must substitute the acquisition-date fair value of the consideration transferred with acquisition-date fair value of its interest in the acquiree to measure goodwill or a gain on a bargain purchase.
- **Derivatives undertaken to hedge risks associated with the business combination transactions:** Under the circumstances wherein derivatives are undertaken by the acquirer to hedge foreign currency risks associated with the consideration that the acquirer will pay, or to hedge risks of changes in the value of the acquiree's net assets, these instruments are treated as freestanding financial instruments on the acquirer's books.
- Therefore, the costs of and proceeds from entering into these instruments (including subsequent gains and losses) are not part of the consideration transferred in the business combination and are accounted for in accordance with other applicable GAAP (e.g., ASC 815).
- For example, if a forward contract is executed in connection with a business combination to economically hedge the foreign currency risk associated with the consideration to be paid, the acquirer initially recognizes the forward contract

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derivative at fair value, with subsequent changes in the derivative's fair value recorded in earnings.

- **Acquisition-related costs:** Acquisition costs incurred by the acquirer may include:
 - **Direct costs of the transaction**, such as costs for the services of lawyers, investment bankers, accountants, and other third parties.
 - **Indirect costs of the transaction**, such as recurring internal costs (e.g., the cost of maintaining an acquisition department)
 - **Financing costs**, such as costs to issue debt or equity instruments used to effect the business combination (i.e., issuance costs)

FASB clarifies that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the acquired business; instead, they are separate transactions with a service provider. Therefore, direct and indirect acquisition-related costs shall be expensed in the period that the related services are received.

On the other hand, Financing costs do not represent costs of the acquisition; instead, these are the costs incurred to issue debt or equity instruments to finance the business combination. Generally, debt issuance costs (such as fees paid to an investment banker for providing underwriting services to finance a business combination) are reported in the balance sheet as a direct deduction from the face amount of the debt and amortized over the term of the debt through EIR method, while equity issuance costs (such as cost of registering and issuing equity shares) are deducted from the proceeds of the issuance (i.e., a reduction of equity).

If the seller has incurred transaction costs on the buyer's behalf, the buyer would recognize those costs as expenses when incurred by the seller, with an offsetting liability to repay the seller. Under such circumstances, the acquirer would increase the price payable to the seller for the acquired business to compensate the seller for the expenses it incurred on behalf of the acquirer (and thus increasing the consideration for the acquired business and goodwill). This requires critical evaluation of elements of consideration transferred to identify the inclusion of any payments that might be related to goods and services that are separate from the business combination which might not be related to the fair value of the acquired business or the assets acquired, and liabilities assumed and hence should be excluded from consideration transferred.

- **Contingent Consideration:** Additional consideration payable to the former shareholders of the acquiree company in the future if certain future events occur or conditions are met represents Contingent consideration or "earn-out" provisions. It is recognized as part of the consideration transferred for the acquisition at fair value on the acquisition date. When determining the fair value of contingent consideration, the acquirer should consider all relevant information available at the acquisition date, including probabilities of achieving the contingency and discount rates. Contingent consideration, classified as equity, is not remeasured; contingent consideration, classified as a liability, is remeasured to fair value at each reporting date until it is settled.

Examples of Contingent Consideration Scenarios:

- Payment based on the future earnings of the acquired business.
- Earn-outs based on achieving specific performance targets.
- Contingent consideration linked to the retention of key employees or customers.
- Payment contingent on the outcome of legal disputes related to the acquired business.

Contingent Consideration Related to Post-Combination Services:

- If contingent payments are solely for post-combination services and not related to the consideration for the business combination, they are accounted for as compensation expense when earned.
- Characteristics indicating that contingent payments are for post-combination services include the nature of the services, the continued employment of key individuals, and the link between services and payments.

3.2. Business Combination achieved in stages

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Overview

- Business combinations achieved in stages or step acquisition refer to transactions where an acquirer obtains control of an acquiree in more than one step.
- For example, on December 31, 2023, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchased an additional 40 percent interest in Entity B, which gave it control of Entity B.

Measurement Principles

- For a business combination achieved in stages, the acquirer must remeasure its previously held equity interest in the acquiree as of the acquisition date and recognize the resulting gain or loss, if any, in earnings as a pre-business combination adjustment.
- The step acquisition results in a change from holding a noncontrolling investment in an entity to obtaining control of that entity. The fair value of previously held equity interest represents consideration given to acquire the controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations.
- Goodwill/ Gain on bargain purchase for step acquisition can be computed as follows
Fair value of Consideration transferred
Add-Fair value of non-controlling interest in the acquiree
Add-Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
Less-Fair value of Net Assets acquired, and liabilities assumed
Goodwill/ Gain on Bargain purchase

Implementation matters

- In prior periods, the previously held interest may have been remeasured to fair value, with changes recognized in other comprehensive income. In such cases, any amounts in accumulated comprehensive income related to the previously held interest should be reclassified and included in the calculation of the gain or loss.

Illustrative example

Fact Pattern

- Company X acquired a 35 percent interest in Company Y, a PBE, for \$20,000 on January 1, 2023. (The deferred tax accounting implications are ignored in this example.) Company X accounts for 35 percent of its interest in Company Y by using the equity method of accounting.
- On December 31, 2024, Company X purchases the remaining 65 percent interest for \$65,000 and obtains control of Company Y. Company X accounts for the transaction as a business combination. Company X's identifiable net assets are recognized at \$80,000 under ASC 805, and the fair value of Company X's 35 percent interest in Company Y is \$35,000. The book value of that interest is \$25,000.

How should company X account for the acquisition of Company Y.

Analysis

Company X should account for the acquisition of Company Y as follows:

Remeasurement of previously held interest-	\$	25,000
Carrying value of previously held interest		35,000
Fair value of previously held interest on the acquisition date	\$	10,000
Gain recognized in Company X's earnings on remeasurement of previously held interest		
 Computation of Goodwill or (Gain on Bargain Purchase)-	\$	65,000
Consideration transferred for 65 percent interest in B		35,000
Add: fair value of previously held interest		(80,000)
Less: Fair value of net identifiable assets	\$	20,000
Goodwill		

3.3. Measurement period adjustment

Overview

- The measurement period is the time frame following the acquisition date during which an acquirer can adjust provisional amounts as it finalizes the fair values of acquired assets and liabilities in a business combination transaction. The measurement period is intended to allow the acquirer to obtain additional information to finalize the initial accounting for the business combination.
- The measurement period cannot exceed one year from the acquisition date, providing companies with a reasonable timeline to complete the valuation process.

Measurement Principles

- Adjustments during the measurement period should only pertain to items that were initially incomplete at the acquisition date.
- These adjustments must be recognized in the reporting period when the adjustment amount is determined, ensuring accuracy in financial reporting.
- Acquirers should focus on completing the valuation of identifiable assets, assumed liabilities, noncontrolling interests, consideration transferred, equity interests, and any goodwill related to the transaction.
- Ensuring that the adjustments made during the measurement period align with the criteria set forth by ASC 805 is crucial for compliance and transparency in financial reporting.
- If the acquirer becomes aware of new information during the measurement period related to conditions that existed as of the acquisition date, it must make subsequent adjustments to the provisional amounts, and additional assets acquired or liabilities assumed might be identified for recognition and measurement.
- **Balance sheet impact-** During the measurement period, the acquirer shall recognize adjustments to the provisional amounts with a corresponding adjustment to goodwill in the reporting period in which the adjustments to the provisional amounts are determined.
- **Income Statement impact-** Impact of measurement period adjustment on the Income Statement must be recognized in the reporting period in which the adjustment amounts are determined (rather than retrospectively). For example, if a measurement-period adjustment increases the value of fixed assets or finite-lived intangible assets, the acquirer should recognize any catch-up depreciation or amortization in the reporting period in which the adjustment is determined.

Implementation matters

- Adjustments identified after the measurement period has ended can be made by revising the accounting of a business combination only to correct an error in accordance with Topic 250.
- Measurement period adjustments do not include adjustments resulting from decisions made by the combined company or changes in facts and circumstances or economic conditions that occurred after the acquisition date. Determining whether an adjustment to assets acquired, or liabilities assumed is a measurement-period adjustment or is due to a change in fact or circumstance after the acquisition date may require significant judgment.
- The adjustment of new information as a measurement period adjustment depends upon whether the new information is related to facts and circumstances that existed as of the acquisition date or occurred after the acquisition date. New information received soon after a business combination is more likely to reflect facts and circumstances that existed as of the acquisition date than information received later during an open measurement period.

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Fact Pattern

- On 1 January 2024, Company X acquired an entire shareholding of Company Y and accounted for the transaction as a business combination under ASC 805. The following summarizes the scenarios related to measurement period adjustments:

(a) Scenario 1: As of the acquisition date, Company X determined that a potential litigation liability relating to a defective product existed and recorded a provisional liability of \$200,000. On 1 April 2024, Company X obtained additional information from a third-party consultant, which Company X hired to determine the nature of the damage caused by the defective product. Based on information received from the third-party consultant, Company X determined that the damage caused by the defective product was understated and the liability should have been recorded at \$300,000 as of the acquisition date.

(b) Scenario 2: As of the acquisition date, Company X did not know about the defective product. However, on 1 May 2024 (before the measurement period ended), Company X became aware of the damage caused by the defective product that existed as of the acquisition date. Based on this new information, Company X determines that a potential liability of \$300,000 should have been realized as of the acquisition date.

(c) Scenario 3: On 1 May 2024 (before the measurement period ended), Company X becomes aware of the damage caused by the defective product. However, the damage caused by the defective product did not exist as of the acquisition date. Based on this new information, Company X determines that a potential liability of \$300,000 should be recognized.

Analysis

As per the principles of ASC 805, if the acquirer becomes aware of new information during the measurement period related to conditions that existed as of the acquisition date, it must make subsequent adjustments to the provisional amounts. Further, adjustments during the measurement period should only pertain to items that were initially incomplete at the acquisition date. Application of principles of measurement period adjustment to the facts of each scenario:

- Scenario 1:** Considering the fact that the new information received on 1 April 2024 about the defective product relates to facts and circumstances that existed at the acquisition date, Company X should recognize an increase of \$100,000 to the provisional liability and a corresponding increase to goodwill.
- Scenario 2:** The contingency existed as of the acquisition date, even though Company X did not identify it until new information became available during the measurement period. If Company X was aware of the existence of the defective product on the acquisition date, Company X would have recognized a liability for that date. Therefore, Company X should adjust the acquisition-date accounting to reflect the \$300,000 estimated amount of liability in accordance with ASC 805-10-25-16 with a corresponding increase to goodwill.
- Scenario 3:** Considering the fact that the contingency did not exist as of the acquisition date, there is no adjustment to the acquisition-date accounting to reflect the \$3,000 estimated amount of the liability. Rather, the \$300,000 liability would be recorded as an expense in the current period.

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3.4. Accounting for Common Control transactions

Overview

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- ASC 805-50 (“Business Combinations — Related Issues”) provides guidance on transactions between entities under common control, which are not considered business combinations for accounting purposes. This is different from typical business combinations covered by ASC 805-10 through 805-30.
 - Common control transactions include transferring net assets or exchanging equity interests between entities under common control.

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- Although a transfer between entities under common control may appear to change control from the viewpoint of the standalone reporting entity, there is no change in control at the level of the ultimate parent or controlling shareholder. As a result, unlike typical business combinations, these transactions are not accounted for using fair value. Instead, common control transactions are generally recorded using the carrying amount of the net assets or equity interests being transferred.
- Since transactions between entities under common control do not result in a change in control at the ultimate parent level, they have no impact on the consolidated financial statements of the parent. Any difference between the consideration exchanged and the carrying value of the net assets is treated as an equity transaction. These differences are eliminated in consolidation, and no gain or loss is recognized in the parent’s consolidated financial statements.

Measurement Principles

- In a shared control transfer, the receiving entity records the transferred assets and liabilities at their carrying amounts as reflected in the transferring entity’s financial statements on the transfer date. This approach is applied even if the fair value of the transferred items is readily available and reliably measurable.
- When the receiving entity pays cash as part of the transfer, any amount paid in excess of the carrying value of the net assets received is treated as an equity transaction, such as a dividend. If the receiving entity issues equity interests instead of cash. In that case, those interests are recorded at the carrying amount of the net assets transferred, regardless of whether the fair value of the equity issued can be reliably determined.
- In some cases—such as when pushdown accounting has not been applied in the transferring entity’s financial statements—the carrying amounts of a subsidiary’s net assets may differ from the historical cost reflected in the consolidated financial statements of the ultimate parent or controlling shareholder. In these situations, the receiving entity should record the transferred net assets at the historical cost recognized by the ultimate parent.

Implementation matters

- The receiving entity’s financial statements should present the results of operations for the period in which the transfer occurs as if the transfer of net assets or exchange of equity interests had occurred at the beginning of that period. As a result, the period’s financial results will reflect the combined operations of the previously separate entities from the start of the period up to the transfer date, and the consolidated operations from the transfer date through the end of the period.
- To ensure consistency, the effects of intra-entity transactions prior to the transfer should be eliminated, allowing the pre-transfer results to be presented on a basis comparable to post-transfer operations. Where possible, intra-entity impacts on current assets, current liabilities, revenue, cost of sales, and beginning retained earnings for all periods presented should also be eliminated.
- Financial statements and related financial information for prior periods must also be retrospectively adjusted to provide meaningful comparative data. All restated financial statements and summaries should clearly disclose that the financial information reflects the combination of previously separate entities. However, prior period adjustments should only be made for the periods during which the entities were under common control.
- For periods before the combining entities came under common control as presented, the financial statements should reflect only the operations of the entity

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identified as the predecessor, up to the date common control was established. For example: Parent H owns 100% of two voting interest entities—Subsidiary S1, acquired in May 2022, and Subsidiary S2, acquired in July 2023. In January 2024, Subsidiary S2 issued additional shares to Parent H in exchange for all of Parent's ownership interest in Subsidiary S1. -

- This transaction represents a common control transaction, as both Subsidiary S1 and Subsidiary S2 are wholly owned by Parent H. Accordingly, the financial statements are retrospectively adjusted as if the combination had occurred at the beginning of the period during which both entities were under common control.
- However, since the entities were not under common control for the entire period required for financial reporting (e.g., a three-year comparative presentation), a predecessor entity must be designated.
- Despite the legal form of the transaction—where Subsidiary S2 acquires Subsidiary S1—Subsidiary S1 is identified as the predecessor entity, as it was under Parent's control prior to Subsidiary S2. Therefore, for periods prior to July 2023, the financial statements reflect only the operations of Subsidiary S1, up to the point when common control began.
- **Accounting impact in the books of transferring entity-** Any difference between the proceeds received by the transferring entity and the book value of the asset group (after impairment, if any) would be recognized as an equity transaction (i.e., dividend or capital transaction), and no gain or loss would be recorded.

3.5. Preexisting relationships between parties to the business combination

Overview

- The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination.
- A business combination involving parties with a preexisting relationship must be assessed to determine whether it includes the settlement of that prior relationship. Such a transaction is considered a multiple-element arrangement, with one component representing the business combination and the other representing the settlement of the existing relationship.

Measurement Principles

- In case of settlement of preexisting relationship in a business combination, the acquirer must recognize a gain or loss, measured as follows:
 - a. **For a preexisting non-contractual relationship** (e.g., a lawsuit), the gain or loss is measured at **fair value**. A settlement gain or loss is recognized when a lawsuit (including threatened litigation) is effectively settled as part of a business combination, unless existing authoritative guidance states otherwise. The recognized amount may differ from any amount the acquirer previously recorded in its financial statements related to the preexisting relationship (for example, a liability recognized under ASC 450 for matters that are effectively settled through the acquisition of the target).
 - b. **For a preexisting contractual relationship**, the gain or loss is measured as the lesser of the following two amounts:
 1. The amount by which the contract is favorable or unfavorable to the acquirer compared to current market terms for similar transactions. An unfavorable contract refers to one that is less favorable than current market conditions, but it does not necessarily mean the contract results in a loss where the unavoidable costs exceed expected benefits.
 2. The amount specified in any settlement provisions within the contract that the counterparty (to whom the contract is unfavorable) can enforce. If this stated amount is lower than the amount calculated in (1), the difference is accounted for as part of the business combination.

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- For preexisting contractual relationship, the gain or loss is measured as lower of amount specified in any settlement provisions and amount by which the contract is favorable or unfavorable to the acquirer compared to current market terms for similar transactions, therefore If a preexisting contract settled as part of a business combination can be canceled without penalty, the stated settlement amount is considered to be zero, and no settlement gain or loss is recognized in the combination.
- If the contract lacks stated settlement terms and cannot be cancelled without penalty, a settlement gain or loss must be recognized based on how favorable or unfavorable the contract is to the acquirer, specifically, the fair value of the contract as of the acquisition date.

Illustrative example

A. Settlement of Contractual relationships

Fact Pattern

- ABC Inc. (the “Acquirer Company” or “Acquirer”) purchases electronic components from XYZ Inc. (“Acquiree” or “Target”) under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than those at which Acquirer could purchase similar electronic components from another supplier. The supply contract allows the Acquirer to terminate the contract before the end of the initial 5-year term only by paying a \$6 million penalty.
- With 3 years remaining under the supply contract, Acquirer pays \$50 million to acquire Target, which is the fair value of Target based on what other market participants would be willing to pay.
- The total fair value of Target is \$8 million, which is related to the fair value of the supply contract with Acquirer. The \$8 million represents a \$3 million component that is at-market because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a \$5 million component for pricing that is unfavorable to Acquirer because it exceeds the price of current market transactions for similar items.
- Target has no other identifiable assets or liabilities related to the supply contract, and Acquirer has not recognized any assets or liabilities related to the supply contract before the business combination.

Analysis

- In the given case, it would be inappropriate for ABC Inc. to recognize a separate customer relationship intangible asset related to the supply contract with Target. In essence, the Acquirer cannot recognize a customer relationship intangible asset with itself. The supply contract is effectively settled as part of the business combination.
- Acquirer recognizes a loss of \$5 million (the lesser of the \$6 million stated settlement amount and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The \$3 million at-market component of the contract is part of goodwill.

B. Settlement of non-contractual relationships

Fact Pattern

- XYZ Inc. (“Acquiree” or “Target”) is suing ABC Inc. (the “Acquirer Company” or “Acquirer”) for patent infringement. The acquirer has recognized a \$100 million liability related to the lawsuit in accordance with the provisions of ASC 450. The acquirer pays \$1,000 million to acquire Target. The fair value of Target includes a \$150 million fair value associated with its lawsuit against Acquirer.

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Analysis

- In a business combination, Acquirer would recognize a settlement loss of \$50 million in connection with the effective settlement of the lawsuit with Target (\$150 million fair value less the previously recognized liability of \$100 million) and the remaining \$850 million (\$1,000 million of acquisition consideration less the \$150 million fair value of the lawsuit) would be included as consideration transferred in the business combination.

3.6. Non-Controlling Interest

Overview

- Noncontrolling interest (NCI) represents the portion of a subsidiary's ownership that isn't held by the parent. This can include common stock, options, warrants, or preferred stock outside investors own.

Measurement Principles

- When an acquirer gains control of a business, either all at once or in stages, but doesn't acquire 100% ownership, any remaining NCI in the acquired entity is recognized. According to ASC 805, these NCIs are initially recorded at their fair value on the acquisition date.

Implementation matters

- According to ASC 810, only financial instruments that a subsidiary classifies as equity in its financial statements can be treated as NCI in the consolidated financial statements. If a subsidiary classifies an instrument as a liability (based on other accounting standards), it doesn't qualify as NCI because it's not an equity interest. For instance, Preferred stock redeemable for a predetermined cash amount is classified as a liability and consequently does not qualify as an NCI.

3.7. Reverse Acquisition

Overview

In a reverse acquisition, the roles are flipped from a typical merger. Here's how it generally works:

- The company that issues shares or pays for the transaction (also referred to as "the legal acquirer") is considered the "accounting acquiree".
- Conversely, the company whose shares are acquired (also referred to as "the legal acquiree") is treated as the accounting acquirer.
- Essentially, the legal acquirer, despite issuing shares, becomes the company that is "acquired" for accounting purposes. This legal acquirer usually continues to exist as the main legal entity of the combined company. Even though the legal acquirer maintains its financial statements, these statements are often presented under the name of the legal acquiree (the accounting acquirer).
- The financial information reported will primarily be that of the accounting acquirer (the legal acquiree). The only exception is the equity section, which is retroactively adjusted to reflect the equity of the accounting acquiree (the legal acquirer).

Measurement Principles

- Measurement of consideration transferred: In a reverse acquisition, the accounting acquiree or legal acquirer typically gives its shares to the owners of the accounting acquirer as payment. However, to apply the acquisition method of accounting, the accounting acquirer must figure out a hypothetical amount of consideration it would have paid to acquire the accounting acquiree. This is done to achieve the same ownership percentage in the new combined company.

Therefore, the fair value of the consideration transferred is based on how many shares the accounting acquirer would have needed to issue to the accounting acquiree's owners to get that specific ownership ratio in the combined entity. **Generally, this fair value equals the fair value of the accounting acquiree.**

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For example, ABC Inc. Legal Acquirer (or accounting acquiree) is a public company with 100 shares outstanding and a fair value of \$1,000 per share (total fair value of \$100,000). XYZ Inc. Accounting Acquirer (or legal acquiree) is a public company with 500 shares outstanding and a fair value of \$800 per share (total fair value of \$400,000). ABC Inc. issues 400 shares of common stock to acquire all of the outstanding common shares of XYZ Inc.. After the transaction consummation, former XYZ Inc. shareholders will own 80% of the combined entity (400 shares issued/500 shares outstanding), and the shareholders of ABC Inc. will own 20% of the combined entity.

2. Business Combination Accounting

At the acquisition date, the fair value of the consideration transferred is determined based on the number of shares XYZ Inc. would have had to issue to the shareholders of ABC Inc. for the ownership ratio in the combined entity to be the same.

3. Application Issues

3.1 Consideration transferred

Fair value of Combined entity: \$500,000 (\$400,000+\$100,000)

Fair value of XYZ Inc. share: \$800 per share

3.2 Business Combination achieved in stages

Ownership ratio of shareholders of ABC Inc. in the combined entity: 20%

Number of shares of XYZ Inc. to be issued for the same ownership ratio in the combined entity: 125 (\$500,000*20%/800)

3.3 Measurement period adjustment

3.4 Accounting for Common Control transactions

If XYZ Inc. issues 125 shares to ABC Inc., the shareholders of ABC Inc. would own 125 shares out of a total of 625 shares (20%), which is the same ratio the shareholders of ABC Inc. own after the reverse acquisition. As such, the fair value of the consideration transferred is \$100,000 (125 shares x \$800 per share).

3.5 Preexisting relationships between parties to the business combination

- Accounting acquiree's assets and liabilities are measured as per the principles of ASC 805. Excess of the fair value of the consideration effectively transferred over.
- Non-Controlling Interest:** In a reverse acquisition, some shareholders of the accounting acquirer might not participate in the deal. These shareholders retain their legal interest in the accounting acquirer but do not gain a legal interest in the legal acquirer. This means that, legally, noncontrolling interests can exist in the accounting acquirer (which is now the legal acquiree) after the reverse acquisition.

3.6 Non-Controlling Interest

3.7 Reverse Acquisition

3.8 Push down accounting

In the combined company's consolidated financial statements, this legal noncontrolling interest is presented as such. The accounting acquirer's assets and liabilities are recorded at their historical carrying values from before the combination. Consequently, any remaining noncontrolling interest in the accounting acquirer is recognized based on its legal status as a noncontrolling interest in the accounting acquirer's net assets. Upon completing the reverse acquisition, this noncontrolling interest is essentially reclassified within the accounting acquirer's historical capital accounts and measured based on its proportionate share of the predecessor's (now legal subsidiary's) net assets' carrying value.

3.9 Business Combinations involving a "NewCo" or "Newly-formed entity"

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Implementation matters

- The guidance on reverse acquisitions only applies if the accounting acquiree (which is the legal acquirer) qualifies as a business under ASC 805. If it doesn't, the transaction is treated as either a reverse asset acquisition or a capital transaction, depending on its true nature.
- In reverse acquisitions between a public and a private company, where the public company is the legal acquirer but the accounting acquiree, it's usually easier to determine the fair value of the public company's shares. Because of this, the consideration transferred might be valued using the legal acquirer's (public company's) shares instead of the legal acquiree's (private company's) shares.

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Illustrative example:

Fact Pattern

- Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity instruments and therefore the legal parent, on September 30, 2024. The statements of financial position of Entity A and Entity B immediately before the business combination are as follows.

(All amounts in \$)

	Entity A	Entity B
	(Legal Parent, Accounting Acquiree)	(Legal Subsidiary, Accounting Acquirer)
Current Assets	500	700
Noncurrent Assets	1,300	3,000
Total Assets	1,800	3,700
Current Liabilities	300	600
Noncurrent Liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 common shares	300	-
60 common shares	-	600
Total shareholders' equity	1,100	2,000
Total liabilities and shareholders' equity	1,800	3,700

- On September 30, 2024, Entity A issues 2.5 shares in exchange for each common share of Entity B. All of Entity B's shareholders exchange their shares with Entity B. Therefore, Entity A issues 150 common shares in exchange for all 60 common shares of Entity B.
- The fair value of each common share of Entity B at September 30, 2024, is \$40. The quoted market price of Entity A's common shares at that date is \$16.
- The fair values of Entity A's identifiable assets and liabilities at September 30, 20X6, are the same as their carrying amounts, except that the fair value of Entity A's noncurrent assets at September 30, 2024, is \$1,500.

Example: ignore the accounting for any income tax effects.

Analysis

- Fair value of the consideration transferred:** As a result of the issuance of 150 common shares by Entity A (legal parent, accounting acquiree), Entity B's shareholders own 60 percent of the issued shares of the combined entity, that is, 150 of 250 issued shares. The remaining 40 percent are owned by Entity A's shareholders. If the business combination had taken the form of Entity B, issuing additional common shares to Entity A's shareholders in exchange for their common shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 percent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is \$1,600 (40 shares with a per-share fair value of \$40). The fair value of the consideration effectively transferred should be based on the most reliable measure. In this Case, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares 100 shares with a per-share fair value of \$16.
- Computation of Goodwill:** Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognized identifiable assets and liabilities, as follows:

Particulars	(Amounts in \$)	
Consideration effectively transferred		1,600
Net recognized values of Entity A's identifiable assets and liabilities		
Current assets	500	
Noncurrent assets	1,500	
Current liabilities	(300)	
Noncurrent liabilities	(400)	(1,300)
Goodwill		300

3.8. Push down accounting

Overview

- In some business combinations, the company being acquired may prepare its separate financial statements following the acquisition. In these situations, the acquiree can choose between using its historical amounts for its assets and liabilities or adopting the acquiring company's basis of accounting. When the acquiree adopts the acquirer's basis of accounting in its separate financial statements, this approach is referred to as "pushdown accounting."

Measurement Principles

- If elected, pushdown accounting essentially "pushes down" the fair values determined in the business combination by the acquirer to the acquiree's standalone financial statements, requiring the acquiree to re-measure its identifiable assets acquired and liabilities assumed at their fair values as of the acquisition date, consistent with how the acquirer accounted for them in its consolidated financial statements.
- Goodwill, the excess of the consideration transferred over the fair value of net identifiable assets acquired, is also recognized in the acquiree's separate financial statements if pushdown accounting is applied. This means the acquiree will have goodwill on its balance sheet. However, bargain purchase gains recognized by the acquirer, if any, shall not be recognized in the acquiree's income statement. The acquiree shall recognize the bargain purchase gains recognized by the acquirer as an adjustment to additional paid-in capital.

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- Any acquisition-related liability incurred by the acquirer shall also be recognized by the acquiree only if the liability represents an obligation of the acquiree.

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Implementation matters

- An acquired entity can elect to apply pushdown accounting upon each event in which an acquirer obtains control of it. The decision by an acquiree to elect pushdown accounting is not an accounting policy choice that would be required to be applied to future transactions. So, if a company is acquired, it might decide to use pushdown accounting for that specific acquisition. However, if that same company is acquired again later by a different owner, it's not obligated to apply pushdown accounting a second time.
- Delayed Election of Pushdown Accounting:** Even if an acquired company initially foregoes pushdown accounting when control changes hands, it has the ability to elect it later. This later election would involve applying pushdown accounting retroactively to the most recent acquisition event.
- When an acquiree entity chooses to apply pushdown accounting, it must do so comprehensively. This means it cannot selectively apply it to only certain assets or liabilities; the entire financial statement must reflect the new basis of accounting from the acquisition.

Illustrative example

(a) Delayed election of pushdown accounting

- On 1 January 2024, Company X acquires 95% of the outstanding voting shares of Company Y and accounts for the business combination under ASC 805. Company Y elects not to apply pushdown accounting at the time Company X obtains control of it. Company Y, which has a calendar year end, issues its 2024 financial statements in February 2025. Therefore, the 2024 financial statements reflect the net assets of Company X at their historical carrying amounts.
- In October 2025, there is a significant change in Company Y's investor mix such that pushdown accounting is more relevant to the new investors. Therefore, Company Y elects to apply pushdown accounting to the most recent event in which an acquirer obtained control of it (i.e., the 1 January 2024 acquisition by Company X) in its 2025 financial statements.

Analysis

Company X's decision to subsequently apply pushdown accounting is accounted for retrospectively as a change in accounting principle pursuant to ASC 250. Accordingly, Company Y will restate the 2024 financial information included in its 2025 financial statements to retrospectively apply pushdown accounting from the acquisition date (1 January 2024). Therefore, the 2025 financial statements (which include the 2024 comparative period) reflect the net assets of Company Y at the basis of accounting established by Company X.

3.9. Business Combinations involving a “NewCo” or “Newly-formed entity”

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Overview

A business combination may be carried out through the formation of a new entity (often referred to as a “Newco”) that engages in no significant activities prior to the combination, **except for issuing shares to the shareholders of the merging entities**. In these cases, irrespective of how many entities are involved in the transaction, ASC 805-10-55-15 precludes Newco from being identified as the acquirer, unless NewCo has been involved in significant pre-combination activities (e.g., raising capital, identifying acquisition targets, negotiating transactions, and promoting the business combination) and **hence is determined to be substantive**.

For example, Company A and Company B agree to merge and form a new entity. In such a case, the accounting rules require that one of the original companies involved in the merger (e.g., Company A or Company B) must be identified as the acquirer. This approach aligns with the underlying principle of accounting for these transactions: that an actual pre-existing business is acquiring another pre-existing business, even if a new legal shell is used to facilitate the deal.

Implementation matters

- As per the SEC staff, a newly formed entity with significant pre-combination activities cannot be viewed as an entity formed solely to issue equity interests to effect a business combination. In such cases, Newco would be considered substantive and therefore could be deemed the accounting acquirer.
- Determination of whether a NewCo is involved in “significant pre-combination activities” is a matter of judgment and requires consideration of all facts and circumstances. The establishment of and capitalization of a new entity by equity investment would not, in and of itself, be considered a significant pre-combination activity.
- The following are some of the indicators that a newly formed entity is involved in significant pre-combination activities:
 - If the new company raises debt financing for use as consideration in an acquisition transaction, that financing activity would qualify as a significant pre-combination activity.
 - If Newco holds assets beyond just the initial cash it received from investors, especially if it already owns stock in the company, it’s about to combine with – that suggests it’s more than just a temporary vehicle. These activities indicate that Newco might have had a more substantive role or strategic intent before the formal combination took place.
 - If the Newco continues to exist and operate after the transaction—meaning it isn’t just a temporary shell created to facilitate the merger and then disappear—that’s a strong sign it might be considered the actual buyer (the accounting acquirer) in the business combination.

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Example of factors indicating that NewCo has a substance:

- Newco survives the transaction.
- Changes in control when considering the ownership structure of Newco compared to the ownership structure of the target prior to the merger.
- Newco issues debt and/or pays cash in exchange for its interest in the target.
- The reason a Newco was used to affect the business combination has substance.
- Newco is involved in significant pre-combination activities, such as:
 - Raising capital
 - Identifying acquisition targets
 - Negotiating transactions
 - Promoting the business combination
- Significant change in governance structure (e.g., board composition) and/or composition of management of Newco (compared to that of the target)



Example of factors indicating that NewCo does not have a substance:

- Newco is transitory and does not survive the transaction.
- No changes in control when considering the ownership structure of Newco compared to the ownership structure of the target prior to the merger.
- Newco only issues equity in exchange for its interest in the target.
- The reason a Newco was used to effect the business combination lacks substance.
- Newco is not involved in significant pre-combination activities, such as:
 - Raising capital
 - Identifying acquisition targets
 - Negotiating transactions
 - Promoting the business combination
- No change in the governance structure (e.g., board composition) and/or composition of management of Newco (compared to that of the target)

- If the Newco (the newly formed company) is identified as the buyer (the accounting acquirer), then every other company that merges into it is considered a target (an acquiree) in a business combination transaction.
- This means the Newco must apply the acquisition method to each of these targets. In simpler terms, the assets and liabilities of every company that merges into the Newco will be revalued and recorded at their fair market value on the Newco's books.

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On May 12, 2025, the FASB issued an ASU 2025-03 to improve the requirements in ASC 805 for identifying the accounting acquirer. The amendment provides guidance on determination of accounting acquirer in the acquisition transaction effected primarily by exchanging equity interests, wherein legal acquiree is a Variable Interest Entity (VIE) that meets the definition of business.

Key Highlights of amendments in ASU

- The amendment requires entities to consider the general factors in Topic 805 when the acquisition of a VIE is primarily effected by issuing equity for determination of accounting owner, rather than restricting the conclusion to primary beneficiary as per existing guidance.
- The amendment applies to the combinations that are primarily effected by issuing equity because reverse acquisitions are more prevalent for those types of transactions. This is because the former owners of the legal acquiree often become owners of the legal acquirer in the equity exchange and therefore several of the general factors above (e.g. relative voting rights, governance and management composition) could indicate the legal acquiree is the accounting acquirer (resulting in a reverse acquisition).



- The scope of the amendment is limited to an acquisition of a VIE that is a business. Therefore, if the legal acquiree is a VIE and not a business, the primary beneficiary would always be the accounting acquirer.
- The amendment is expected to improve comparability across the financial statements of entities that engage in acquisition transactions.

Effective date and transition

a. Effective date and transition

- The amendments in ASU are effective for annual reporting period beginning after December 15, 2026, and interim reporting periods² in fiscal years beginning after December 15, 2026. Early adoption is permitted in which financial statements have not yet been issued (or made available for issuance).
- The amendments will be applied prospectively to all business combinations with acquisition dates that occurs after the initial application date.

b. Applicability

The amendment shall apply to all entities, including private companies.

To learn more about amendment in ASU, refer to our recent publication titled, **Early Impressions "FASBs' Accounting Standard Update (ASU-2025-03) Business Combinations (Topic 805) and Consolidation (Topic 810)"**.

² Entities adopting ASU 2025-03 in an interim reporting period must adopt the ASU as of the beginning of that interim reporting period or the beginning of the annual reporting period that includes that interim reporting period.

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To provide investors with crucial financial insights into a company’s major activities, the SEC mandates that registrants disclose financial information about significant acquired or soon-to-be-acquired businesses, or real estate operations (the “acquiree”). This is required in specific filings per Regulation S-X, Rules 3-05 and 3-14. Audited financial statements of significant acquired businesses and equity method investments must be reported in Form 8-K

For example, an acquirer’s filing of a registration statement or a proxy statement could necessitate the inclusion of separate, pre-acquisition financial statements for the acquiree, alongside those of the registrant. This disclosure aids investors in evaluating the prospective impact of the acquiree on the registrant’s consolidated financial outcomes. Moreover, SEC Regulation S-X, Article 11, may require pro forma information for both completed and probable business acquisitions.

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COMPARISON WITH IFRS

Forward	ASC 805, Business Combination under U.S. Generally Accepted Accounting Principles (GAAP), and IFRS 3, Business Combination under International Financial Reporting Standards (IFRS), both the standards provide guidance on Business Combination accounting. While both accounting frameworks largely converge due to a joint project between the FASB and IASB, some key differences still exist in the accounting for business combinations.
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The following table summarizes the key differences:

Key Provision	ASC 805	IFRS 3
Definition of a Business: Screen/Concentration test	ASC 805 requires a mandatory “screen” test. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the acquired set is generally not considered a business.	IFRS 3 also includes a similar concentration test, but its use is optional.
Noncontrolling Interest (NCI) Measurement	Requires that the NCI in the acquiree be measured at fair value at the acquisition date. This is often referred to as the “full goodwill” method, as it implies recognizing goodwill attributable to both the parent and the NCI.	- Provides an election, on an acquisition-by-acquisition basis, to measure NCI in one of two ways: Fair value: Similar to ASC 805, this also results in “full goodwill.” Proportionate share of the acquiree’s identifiable net assets: This method only recognizes goodwill attributable to the parent’s ownership interest (sometimes called the “partial goodwill” method)
Pushdown accounting	- Provides an option for the acquiree to apply pushdown accounting in its separate financial statements. - This means the acquiree can recognize the acquirer’s basis of accounting (including goodwill) in its standalone financial statements.	Contains no explicit guidance on pushdown accounting, and its application is generally not permitted in practice under IFRS.
Revenue Contracts (Contract Assets and Liabilities)	- Requires entities to measure assets and liabilities arising from revenue contracts in accordance with ASC 606 (Revenue from Contracts with Customers). - This effectively means they are recognized as if the acquiree had already recognized them, rather than at their acquisition-date fair value under ASC 805.	Generally, requires contract assets and contract liabilities from customer contracts acquired in a business combination to be recognized and measured at their acquisition-date fair values

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Identifying the acquirer if the acquiree is a VIE

- In a business combination involving the acquisition of a variable interest entity (VIE), the primary beneficiary of that VIE is automatically identified as the acquirer.

Note: ASU-2025-03 provides an amendment to this principle, which is effective for annual reporting periods beginning after December 15, 2026. Refer to **Section FASBs' Accounting Standard Update (ASU-2025-03) above.**

- IFRS 3 does not include similar guidance because there is no VIE model under IFRS Accounting Standards.
- Therefore, the determination of the accounting acquirer follows the assessment of factors in IFRS 3.

Contingent Assets and Liabilities (Pre-acquisition Contingencies):

- Requires the acquirer to recognize contingent assets and contingent liabilities acquired in a business combination at their acquisition-date fair value if fair value can be reasonably determined during the measurement period.
- If fair value cannot be determined, then existing guidance for contingencies is applied, i.e., the entity will recognize a liability or asset (as the case may be) if both of the following conditions are met:
 - (1) information available before the end of the measurement period indicates that it is probable that a liability had been incurred, or an asset existed at the acquisition date," and
 - (2) The "amount of the liability or asset can be reasonably estimated.

- Contingent liability- An entity recognizes a liability arising from a contingency at fair value if it (1) is a present obligation that results from a past event and (2) can be measured reliably.
- An entity is not permitted to recognize a contingent asset in a business combination.

Measurement-period adjustments

- Any adjustments made to provisional amounts within the measurement period must be recognized in the financial statements of the period they are determined, rather than retrospectively.

- Any adjustments to provisional amounts made during the measurement period must be applied retrospectively, as if the business combination's accounting were finalized on the acquisition date.

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