

Statement of Financial Accounting Standards No. 141

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Business Combinations

June 2001



Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 141: Business Combinations

FAS 141 Summary

This Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. All business combinations in the scope of this Statement are to be accounted for using one method, the purchase method.

Reasons for Issuing This Statement

Under Opinion 16, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial statement results. Consequently:

- Analysts and other users of financial statements indicated that it was difficult to compare the financial results of entities because different methods of accounting for business combinations were used.
- Users of financial statements also indicated a need for better information about intangible assets because those assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes all intangible assets acquired in a business combination (either separately or as goodwill), only those intangible assets previously recorded by the acquired entity are recognized when the pooling method is used.
- Company managements indicated that the differences between the pooling and purchase methods of accounting for business combinations affected competition in markets for mergers and acquisitions.

Differences between This Statement and Opinion 16

The provisions of this Statement reflect a fundamentally different approach to accounting for business combinations than was taken in Opinion 16. The single-method approach used in this Statement reflects the conclusion that virtually all business combinations are acquisitions and, thus, all business combinations should be accounted for in the same way that other asset

acquisitions are accounted for—based on the values exchanged.

This Statement changes the accounting for business combinations in Opinion 16 in the following significant respects:

- This Statement requires that all business combinations be accounted for by a single method—the purchase method.
- In contrast to Opinion 16, which required separate recognition of intangible assets that can be identified and named, this Statement requires that they be recognized as assets apart from goodwill if they meet one of two criteria—the contractual-legal criterion or the separability criterion. To assist in identifying acquired intangible assets, this Statement also provides an illustrative list of intangible assets that meet either of those criteria.
- In addition to the disclosure requirements in Opinion 16, this Statement requires disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount of the purchase price assigned to each major intangible asset class.

This Statement does not change many of the provisions of Opinion 16 and Statement 38 related to the application of the purchase method. For example, this Statement does not fundamentally change the guidance for determining the cost of an acquired entity and allocating that cost to the assets acquired and liabilities assumed, the accounting for contingent consideration, and the accounting for preacquisition contingencies. That guidance is carried forward in this Statement (but was not reconsidered by the Board). Also, this Statement does not change the requirement to write off certain research and development assets acquired in a business combination as required by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*.

How the Changes in This Statement Improve Financial Reporting

The changes to accounting for business combinations required by this Statement improve financial reporting because the financial statements of entities that engage in business combinations will better reflect the underlying economics of those transactions. In particular, application of this Statement will result in financial statements that:

- *Better reflect the investment made in an acquired entity*—the purchase method records a business combination based on the values exchanged, thus users are provided information about the total purchase price paid to acquire another entity, which allows for more meaningful evaluation of the subsequent performance of that investment. Similar information is not provided when the pooling method is used.

- *Improve the comparability of reported financial information*—all business combinations are accounted for using a single method, thus, users are able to compare the financial results of entities that engage in business combinations on an apples-to-apples basis. That is because the assets acquired and liabilities assumed in all business combinations are recognized and measured in the same way regardless of the nature of the consideration exchanged for them.
- *Provide more complete financial information*—the explicit criteria for recognition of intangible assets apart from goodwill and the expanded disclosure requirements of this Statement provide more information about the assets acquired and liabilities assumed in business combinations. That additional information should, among other things, provide users with a better understanding of the resources acquired and improve their ability to assess future profitability and cash flows.

Requiring one method of accounting reduces the costs of accounting for business combinations. For example, it eliminates the costs incurred by entities in positioning themselves to meet the criteria for using the pooling method, such as the monetary and nonmonetary costs of taking actions they might not otherwise have taken or refraining from actions they might otherwise have taken.

How the Conclusions in This Statement Relate to the Conceptual Framework

The Board concluded that because virtually all business combinations are acquisitions, requiring one method of accounting for economically similar transactions is consistent with the concepts of representational faithfulness and comparability as discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. In developing this Statement, the Board also concluded that goodwill should be recognized as an asset because it meets the assets definition in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and the asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

The Board also noted that FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should provide information that helps in assessing the amounts, timing, and uncertainty of prospective net cash inflows to an entity. The Board noted that because the purchase method records the net assets acquired in a business combination at their fair values, the information provided by that method is more useful in assessing the cash-generating abilities of the net assets acquired than the information provided by the pooling method.

Some of the Board's constituents indicated that the pooling method should be retained for public policy reasons. For example, some argued that eliminating the pooling method would impede consolidation of certain industries, reduce the amount of capital flowing into certain industries, and slow the development of new technology. Concepts Statement 2 states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but rather, provide information about those combinations that is fair and evenhanded. The Board concluded that its public policy goal is to issue

accounting standards that result in neutral and representationally faithful financial information and that eliminating the pooling method is consistent with that goal.

The Effective Date of This Statement

The provisions of this Statement apply to all business combinations initiated after June 30, 2001. This Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later.

This Statement does not apply, however, to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises.

INTRODUCTION

1. This Statement addresses financial accounting and reporting for business combinations. This Statement supersedes APB Opinion No. 16, *Business Combinations*, and amends or supersedes a number of interpretations of that Opinion. However, this Statement carries forward without reconsideration the guidance in Opinion 16 and certain of its amendments and interpretations related to the application of the purchase method of accounting, including (a) guidance in Opinion 16 described as the principles of historical-cost accounting (refer to paragraphs 3–8), (b) determining the cost of an acquired entity (refer to paragraphs 20–34), (c) allocation of the cost of an acquired entity to assets acquired and liabilities assumed (refer to paragraphs 36–38), and (d) determining the date of acquisition (refer to paragraphs 48 and 49). This Statement also supersedes FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, but carries forward the guidance from that Statement without reconsideration (refer to paragraphs 40 and 41). The guidance carried forward from Opinion 16 and Statement 38 has been quoted, paraphrased, or rephrased as necessary so that it can be understood in the context of this Statement. The original source of that guidance has been noted parenthetically. The Board intends to reconsider some or all of that guidance (as well as related Emerging Issues Task Force [EITF] issues) in another project.

2. Appendix A to this Statement provides implementation guidance on the application of the purchase method of accounting for a business combination and is an integral part of the standards provided in this Statement. Appendix B provides background information and the basis for the Board's conclusions. Appendix C provides illustrations of some of the financial statement disclosures that this Statement requires. Appendix D carries forward without reconsideration certain provisions of Opinion 16 and its interpretations that have been deleted or superseded by this Statement but that continue to be relevant to past transactions that were accounted for using the **pooling-of-interests method**.¹ This Statement amends or supersedes other accounting pronouncements listed in Appendix E, but it does not change the status of the EITF Issues that provide guidance on applying the purchase method. Appendix F provides a glossary of terms as used in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Asset Acquisitions—General Concepts

3. The accounting for a business combination follows the concepts normally applicable to the initial recognition and measurement of assets acquired, liabilities assumed or incurred, and equity shares issued, as well as to the subsequent accounting for those items. Those concepts are set forth in paragraphs 4–8. The standards of accounting and reporting for a business combination by the purchase method, which are based on those concepts, are set forth in paragraphs 9–58 (Opinion 16, paragraph 66).

4. *Initial recognition.* Assets are commonly acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed. If the consideration given in exchange for the asset (or net assets) acquired is in the form of assets surrendered (such as cash), the assets surrendered are derecognized at the date of acquisition. If the consideration given is in the form of liabilities incurred or equity interests issued, the liabilities incurred and equity interests issued are initially recognized at the date of acquisition (Opinion 16, paragraph 67).

5. *Initial measurement.* Like other exchange transactions generally, acquisitions are measured on the basis of the **fair values** exchanged. In exchange transactions, the fair values of the net assets acquired and the consideration paid are assumed to be equal, absent evidence to the contrary. Thus, the “cost”² of an acquisition to the acquiring entity is equal to the fair values exchanged and no gain or loss is generally recognized. Exceptions to that general condition include (a) the gain or loss that is recognized if the fair value of noncash assets given as consideration differs from their carrying amounts on the acquiring entity’s books and (b) the extraordinary gain that is sometimes recognized by the acquiring entity if the fair value of the net assets acquired in a business combination exceeds the cost of the acquired entity (refer to paragraphs 45 and 46) (Opinion 16, paragraph 67).

6. Exchange transactions in which the consideration given is cash are measured by the amount of cash paid. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued), measurement is based on the fair value of the consideration given or the fair value of the asset (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable (Opinion 16, paragraph 67).

7. *Allocating cost.* Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets

and liabilities) that make up the group. The cost of such a group is determined using the concepts described in paragraphs 5 and 6. A portion of the cost of the group is then assigned to each individual asset (or individual assets and liabilities) acquired on the basis of its fair value. In a business combination, an excess of the cost of the group over the sum of the amounts assigned to the tangible assets, **financial assets**, and separately recognized **intangible assets** acquired less liabilities assumed is evidence of an unidentified intangible asset or assets (Opinion 16, paragraph 68).

8. *Accounting after acquisition.* The nature of an asset and not the manner of its acquisition determines an acquiring entity's subsequent accounting for the asset. The basis for measuring the asset acquired—whether the amount of cash paid, the fair value of an asset received or given up, the fair value of a liability incurred, or the fair value of equity shares issued—has no effect on the subsequent accounting for the asset (Opinion 16, paragraph 69).

Standards of Accounting for Business Combinations

Scope

9. For purposes of applying this Statement, a *business combination* occurs when an entity ³ acquires net assets that constitute a business ⁴ or acquires equity interests of one or more other entities and obtains control ⁵ 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. For purposes of this Statement, the formation of a joint venture is not a business combination. ⁶

10. This Statement applies to combinations involving either incorporated or unincorporated entities. The provisions of this Statement apply equally to a business combination in which (a) one or more entities are merged or become subsidiaries, (b) one entity transfers net assets or its owners transfer their equity interests to another, or (c) all entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity (some of which are referred to as roll-up or put-together transactions). All those transactions are business combinations regardless of whether the form of consideration given is cash, other assets, a business or a subsidiary of the entity, debt, common or preferred shares or other equity interests, or a combination of those forms and regardless of whether the former owners of one of the combining entities as a group retain or receive a majority of the voting rights of the combined entity. An exchange of a business for a business also is a business combination.

11. The acquisition of some or all of the noncontrolling interests in a subsidiary is not a business combination. However, paragraph 14 of this Statement specifies the method of accounting for those transactions. The term business combination as used in this Statement also excludes transfers of net assets or exchanges of equity interests between entities under common control. Paragraphs D11–D18 of Appendix D provide examples of those transactions and

accounting guidance for them.

12. 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. ⁷

Method of Accounting

13. All business combinations in the scope of this Statement shall be accounted for using the purchase method as described in this Statement and other pronouncements (refer to paragraph A3 of Appendix A).

14. The acquisition of some or all of the noncontrolling equity interests in a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—shall be accounted for using the purchase method. Paragraphs A5–A7 of Appendix A provide additional accounting guidance for those transactions. ⁸

Application of the Purchase Method

Identifying the Acquiring Entity

15. Application 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.

16. In 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.

17. 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. Thus, in 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—all 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.

- 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—all else being equal, 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.
- c. The composition of the governing body of the combined entity—all 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.
- d. The composition of the senior management of the combined entity—all 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.
- e. The terms of the exchange of equity securities—all 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. ⁹

18. Some 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.

19. If 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.

Determining the Cost of the Acquired Entity

20. The same accounting principles shall apply in determining the cost of assets acquired individually, those acquired in a group, and those acquired in a business combination. 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 or properties, and the fair values of liabilities incurred by an acquiring entity shall be used to measure the cost of an acquired entity (Opinion 16, paragraph 72).

21. 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 (Opinion 16, paragraph 73).

22. The 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. 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 (Opinion 16, paragraph 74).

23. If the quoted market price is not the fair value of the equity securities, either preferred or common, the consideration received shall be estimated even though measuring directly the fair values of net assets received is difficult. Both the net assets received, including **goodwill**, and the extent of the adjustment of the quoted market price of the shares issued shall be weighed to determine the amount to be recorded. All aspects of the acquisition, including the negotiations, shall be studied, and independent appraisals may be used as an aid in determining the fair value of securities issued. Consideration other than equity shares distributed to effect an acquisition may provide evidence of the total fair value received (Opinion 16, paragraph 75).

Costs of the business combination

24. The 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 (Opinion 16, paragraph 76).

Contingent consideration

25. 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. Some agreements provide that a portion of the consideration be placed in escrow to be distributed or returned to the transferor when specified events occur. Either debt or equity securities may be placed in escrow, and amounts equal to interest or dividends on the securities during the contingency period may be paid to the escrow agent or to the potential security holder (Opinion 16, paragraph 77).

26. Cash and other assets distributed, securities issued unconditionally, and amounts of contingent consideration that are determinable at the date of acquisition shall be included in determining the cost of an acquired entity and recorded at that date. Consideration 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 (Opinion 16, paragraph 78).

27. The contingent consideration usually should be recorded when the contingency is resolved and consideration is issued or becomes issuable. In general, the issuance of additional securities or distribution of other consideration at resolution of contingencies based on earnings shall result in an additional element of cost of an acquired entity. In contrast, the issuance of additional securities or distribution of other consideration at resolution of contingencies based on security prices shall not change the recorded cost of an acquired entity (Opinion 16, paragraph 79).

Contingency based on earnings

28. Additional 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 ¹⁰ (Opinion 16, paragraph 80).

Contingency based on security prices

29. 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 (Opinion 16, paragraph 81).

30. 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 (Opinion 16, paragraph 82).

31. 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. Similarly, 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 life of the assets ¹¹ (Opinion 16, paragraph 83).

Interest or dividends during contingency period

32. 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 (Opinion 16, paragraph 84).

Tax effect of imputed interest

33. A tax reduction resulting from imputed interest on contingently issuable shares reduces the fair value recorded for contingent consideration based on earnings and increases additional capital recorded for contingent consideration based on security prices (Opinion 16, paragraph 85).

Compensation in contingent agreements

34. If 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 (Opinion 16, paragraph 86).

Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed

35. Following the process described in paragraphs 36–46 (commonly referred to as the purchase price allocation), 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 (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.

36. Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed. The tax basis of an asset or liability shall not be a factor in determining its estimated fair value (Opinion 16, paragraph 87).

Assets acquired and liabilities assumed, except goodwill

37. The following is general guidance for assigning amounts to assets acquired and liabilities assumed, except goodwill:

- a. Marketable securities at fair values
- b. Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary
- c. Inventories
 - (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
 - (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
- d. Plant and equipment
 - (1) To be used, at the current replacement cost for similar capacity 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
- e. Intangible assets that meet the criteria in paragraph 39 at estimated fair values
- f. Other assets, including land, natural resources, and nonmarketable securities, at appraised values
- g. Accounts and notes payable, long-term debt, and other claims payable, at present values of amounts to be paid determined at appropriate current interest rates
- h. 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, at amounts determined in accordance with paragraph 74 of FASB Statement No. 87, *Employers' Accounting for Pensions*
- i. 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 at amounts determined in accordance with paragraphs 86–88 of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*
- j. Liabilities and accruals—such as accruals for warranties, vacation pay, and deferred compensation—at present values of amounts to be paid determined at appropriate current interest rates
- k. Other liabilities and commitments—such as unfavorable leases, contracts, and commitments and plant closing expense incident to the acquisition—at present values of amounts to be paid determined at appropriate current interest rates
- l. **Preacquisition contingencies** at amounts determined in accordance with paragraph 40 of this Statement (Opinion 16, paragraph 88).

38. An acquiring entity shall not recognize the goodwill previously recorded by an acquired entity, nor shall it recognize the deferred income taxes recorded by an acquired entity before its acquisition. 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* (Opinion 16, paragraph 88).

Intangible assets

39. An 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. Appendix A provides additional guidance relating to the recognition of acquired intangible assets apart from goodwill, including an illustrative list of intangible assets that meet the recognition criteria in this paragraph.

Preacquisition contingencies

40. 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) 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**, that preacquisition contingency shall be included in the allocation of the purchase price based on that fair value. 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 ¹⁵ (Statement 38, paragraph 5).

41. After the end of the allocation period, an adjustment that results from a preacquisition

contingency other than a loss carryforward **16** shall be included in the determination of net income in the period in which the adjustment is determined (Statement 38, paragraph 6).

Research and development assets

42. This 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.

Excess of cost over the fair value of acquired net assets (goodwill)

43. 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. An acquired intangible asset that does not meet the criteria in paragraph 39 shall be included in the amount recognized as goodwill.

Excess of fair value of acquired net assets over cost

44. 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 **17** except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, **18** (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets. **19**

45. If any excess 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 period, any subsequent adjustments to that extraordinary gain that result from changes to the purchase price allocation shall be recognized as an extraordinary item.

46. 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 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.

Accounting for Goodwill and Other Intangible Assets Acquired

47. After initial recognition, goodwill and other intangible assets acquired in a business combination shall be accounted for in accordance with the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*. **20**

Date of Acquisition

48. 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 (Opinion 16, paragraph 93).

49. 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 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 (Opinion 16, paragraph 94).

Documentation at Date of Acquisition

50. The 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.

Disclosures in Financial Statements

51. 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
- 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.

52. 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: **21**
 - (1) The total amount assigned and the amount assigned to any major **intangible asset class**
 - (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, **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. **23**

An example of the disclosure requirements in this paragraph and paragraph 51 is provided in illustration 1 in Appendix C.

53. 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 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.

An example of those disclosure requirements is provided in illustration 2 in Appendix C.

54. 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
- 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.

55. At a minimum, the supplemental pro forma information shall display revenue, income before extraordinary items and the cumulative effect of accounting changes, 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.

56. In the period in which an extraordinary gain is recognized related to a business combination (paragraphs 45 and 46), the notes to the financial statements shall disclose the information required by paragraph 11 of Opinion 30.

57. The notes to the financial statements also shall disclose the information required by paragraphs 51 and 52 if a material business combination is completed after the balance sheet date but before the financial statements are issued (unless not practicable).

Disclosures in Interim Financial Information

58. 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 paragraph 51(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 (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.

Effective Date and Transition

59. Except for combinations between two or more mutual enterprises, this Statement shall be effective as follows:

- a. The provisions of this Statement shall apply to all business combinations initiated after June 30, 2001. Use of the pooling-of-interests method for those business combinations is prohibited.
- b. The provisions of this Statement also shall apply to all business combinations accounted for by the purchase method for which the date of acquisition is July 1, 2001, or later.

The following definition of *initiated* from paragraph 46 of Opinion 16 shall be used in determining the effective date of this Statement:

A plan of combination is initiated on the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer. Therefore, a plan of combination is

often initiated even though consummation is subject to the approval of stockholders and others.

Paragraphs D4–D8 of Appendix D provide additional guidance relating to that definition. Any alteration in the terms of the exchange in a plan of combination constitutes initiation of a new plan of combination. Therefore, if the terms of the exchange in a plan of combination initiated on or before June 30, 2001, and in process on June 30, 2001, are altered after that date, the combination shall be accounted for by the purchase method in accordance with this Statement.

60. 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. ²⁴

61. The following transition provisions apply to business combinations for which the acquisition date was before July 1, 2001, that were accounted for using the purchase method:

- a. The carrying amount of acquired intangible assets that do not meet the criteria in paragraph 39 for recognition apart from goodwill (and any related deferred tax liabilities if the intangible asset is nondeductible for tax purposes) shall be reclassified as goodwill as of the date Statement 142 is initially applied in its entirety.
- b. The carrying amount of (1) any recognized intangible assets that meet the recognition criteria in paragraph 39 or (2) any unidentifiable intangible assets recognized in accordance with paragraph 5 of FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, that have been included in the amount reported as goodwill (or as goodwill and intangible assets) shall be reclassified and accounted for as an asset apart from goodwill as of the date Statement 142 is initially applied in its entirety. ²⁵
- c. Other than as set forth in (a) and (b), an entity shall not change the amount of the purchase price assigned to the assets acquired and liabilities assumed in a business combination for which the acquisition date was before July 1, 2001. ²⁶

62. As of the earlier of the first day of the fiscal year beginning after December 15, 2001, or the date Statement 142 is initially applied in its entirety, the amount of any unamortized deferred credit related to an excess over cost arising from (a) a business combination for which the acquisition date was before July 1, 2001, or (b) an investment accounted for by the equity method acquired before July 1, 2001, shall be written off and recognized as the effect of a change in accounting principle. The effect of the accounting change and related income tax effects shall be presented in the income statement between the captions *extraordinary items* and *net income*. The per-share information presented in the income statement shall include the per-share effect of the accounting change.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the unanimous vote of the six members of the Financial Accounting Standards Board:

Edmund L. Jenkins, *Chairman*
G. Michael Crooch
John M. Foster
Gaylen N. Larson
Gerhard G. Mueller
Edward W. Trott

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

A1. This appendix provides guidance to assist entities in the application of certain provisions of this Statement and is therefore an integral part of the standards provided in this Statement. This appendix discusses generalized situations. The facts and circumstances of each business combination should be considered carefully in applying this Statement.

A2. This Statement requires that all business combinations be accounted for using the purchase method. As stated in paragraph 1, this Statement carries forward without reconsideration portions of APB Opinion No. 16, *Business Combinations*, that provide guidance related to the application of the purchase method. While this Statement supersedes all of the AICPA Accounting Interpretations of Opinion 16, guidance in several of those interpretations continues to be relevant in applying certain of the provisions of Opinion 16 that are carried forward in this Statement. Therefore, the guidance in those interpretations has been carried forward without reconsideration in paragraphs A5–A9 of this appendix. Because that guidance has been quoted, paraphrased, or rephrased so that it can be understood in the context of this Statement, the original source of the guidance has been noted parenthetically. The Board intends to reconsider some of that guidance in another of its business combinations projects.

A3. This Statement does not supersede other pronouncements that provide guidance on accounting for a business combination using the purchase method. Guidance in those pronouncements, which are listed below, shall be considered when applying the provisions of this Statement.

- a. FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*
- b. FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*

- c. FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*
- d. FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*
- e. FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation* (paragraphs 83–85)
- f. FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*.

A4. This Statement requires that intangible assets that meet the criteria in paragraph 39 be recognized as assets apart from goodwill. Paragraphs A10–A13 provide examples that illustrate how the guidance in paragraph 39 should be applied to certain generalized situations. Paragraph A14 includes a non-inclusive list of intangible assets that meet the criteria for recognition apart from goodwill. ²⁷ Paragraphs A15–A28 describe some of the intangible assets included on that list and explain how the criteria in paragraph 39 generally apply to them.

Application of Paragraph 14—Accounting for the Acquisition of Some or All of the Noncontrolling Equity Interests in a Subsidiary

A5. Paragraph 14 continues the practice established by Opinion 16 of accounting for the acquisition of noncontrolling equity interests of a subsidiary (commonly referred to as a minority interest) using the purchase method. Several interpretations of Opinion 16 provide guidance on the accounting for those transactions, and that guidance has been carried forward in paragraphs A6 and A7. The interpretative guidance in Technical Bulletin 85-5 also shall be considered when accounting for those transactions.

A6. 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.

A7. 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 (AICPA Accounting Interpretation 26, "Acquisition of Minority Interest," of Opinion 16).

Application of Paragraph 24—Costs of the Business Combination

A8. Paragraph 24 states that the cost of an acquired entity includes the direct costs of the business combination. 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 (AICPA Accounting Interpretation 33, "Costs of Maintaining an 'Acquisitions' Department," of Opinion 16).

A9. Paragraph 24 also states that costs 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 (AICPA Accounting Interpretation 35, "Registration Costs in a Purchase," of Opinion 16).

Application of Paragraph 39—Recognition of Intangible Assets Apart from Goodwill

A10. Paragraph 39 states that an acquired intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (the contractual-legal criterion). Intangible assets that meet that criterion shall be recognized apart from goodwill even if the asset is not transferable or separable from the acquired entity or from other rights and obligations. For example:

- a. An acquired entity leases a manufacturing facility under an operating lease that has terms that are favorable relative to market prices. ²⁸ The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The value arising from that operating lease contract is an intangible asset that meets the contractual-legal criterion for recognition apart from goodwill, even though the lease contract cannot be sold or otherwise transferred.
- b. An acquired entity owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition apart from goodwill, even if it cannot be sold or transferred apart from the acquired power

plant. This Statement does not preclude an acquiring entity from recognizing the fair value of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

- c. An acquired entity owns a technology patent. It has licensed that patent to others for their exclusive use outside the United States in exchange for which the entity receives a specified percentage of future non-U.S. revenue. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition apart from goodwill even if it would not be practical to sell or exchange the patent and the related license agreement apart from one another.

A11. If an acquired intangible asset does *not* arise from contractual or other legal rights, paragraph 39 requires that it 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 (the separability criterion). Exchange transactions provide evidence that an intangible asset is separable from the acquired entity and might provide information that can be used to estimate its fair value. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type (even if those exchange transactions are infrequent and regardless of whether the acquiring entity is involved in them). For example, customer and subscriber lists are frequently leased and thus meet the separability criterion. Even if an entity believes its customer lists have different characteristics than other customer lists, the fact that customer lists are frequently leased generally means that the acquired entity’s customer list meets the separability criterion. Title plant assets also are bought and sold in exchange transactions (either in whole or in part) or are leased, although less frequently than customer lists. Title plant assets also would meet the separability criterion.

A12. An intangible asset that meets the separability criterion shall be recognized apart from goodwill even if the acquiring entity does not intend to sell, lease, or otherwise exchange that asset. The separability criterion is met because the asset is capable of being separated from the acquired entity and sold, transferred, licensed, rented, or otherwise exchanged for something else of value. For example, because an acquired customer list is generally capable of being rented, it meets the separability criterion regardless of whether the acquiring entity intends to rent it.

A13. As stated in paragraph 39, an intangible asset that is not separable from the entity individually still meets the separability criterion if it is separable from the acquired entity in combination with a related contract, asset, or liability. For example:

- a. Deposit liabilities and related depositor relationship intangible assets are exchanged in observable exchange transactions. Therefore, the depositor relationship intangible asset shall be recognized apart from goodwill.
- b. An acquired entity owns a registered trademark, a related secret formula, and unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark in the United States, the owner is also required to transfer everything else

necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the entity and sold if the related trademark is sold, it meets the separability criterion.

Examples of Intangible Assets That Meet the Criteria for Recognition Apart from Goodwill

A14. The following are examples of intangible assets that meet the criteria for recognition as an asset apart from goodwill. 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. ²⁹ Assets designated by the symbol (▲) 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)[†]
 - (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[†]
- (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.[†]

Marketing-Related Intangible Assets

A15. Marketing-related intangible assets are those assets that are primarily used in the marketing or promotion of products or services. Trademarks are words, names, symbols, or other devices used in trade to indicate the source of the product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks are used to identify the goods or services of members of a group, and certification marks are used to certify the geographic origin or other characteristics of a good or service. In the United States and other countries, trademarks, service marks, collective marks, and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce, or by other means. If registered or otherwise provided legal protection, a trademark or other mark is an intangible asset that meets the contractual-legal criterion for recognition apart from goodwill. Otherwise, a trademark or other mark shall be recognized apart from goodwill only if the separability criterion is met, which would normally be the case.

A16. The terms *brand* and *brand name* often are used as synonyms for trademarks and tradenames. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as the trademark (or service mark) and its related tradename, formulas, recipes, and technological expertise (which may or may not be patented). This Statement does not preclude an entity from recognizing, as a single asset apart from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

A17. An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name associates the name with a designated computer on the Internet for the period the registration is in effect. Those registrations are renewable. Registered domain names shall be recognized as an intangible asset apart from goodwill because they meet the contractual-legal criterion.

Customer-Related Intangible Assets

Customer lists

A18. 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.

Order or production backlog

A19. If 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).

Customer contracts and related customer relationships

A20. 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.

Noncontractual customer relationships

A21. 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.

Artistic-Related Intangible Assets

A22. Artistic-related intangible assets meet the criteria for recognition apart from goodwill if the assets arise from contractual rights or legal rights such as those provided by copyright. In the United States for example, copyrights are granted by the government for the life of the creator plus 50 years. Copyrights can be transferred either in whole through assignments or in part through licensing agreements. In determining the fair value of an intangible asset protected by copyright, consideration shall be given to the existence of any assignments or licenses of the acquired copyrights. This Statement does not preclude an acquiring entity from recognizing a copyright intangible asset and any related assignments or license agreements as a single intangible asset for financial reporting purposes if their useful lives are similar.

Contract-Based Intangible Assets

A23. Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts (refer to paragraph A20) are one particular type of contract-based intangible asset. Contracts to service financial assets are another. While servicing is inherent in all financial assets, it becomes a distinct asset or liability only when (a) contractually separated from the underlying financial assets by sale or securitization of the assets with servicing retained or (b) through the separate purchase and assumption of the servicing. If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with servicing retained, this Statement does not require recognition of the inherent servicing rights as an intangible asset because the fair value of the servicing intangible asset is considered in the measurement of the fair value of the acquired financial asset. However, a contract representing an acquired **servicing asset** is an intangible asset that shall be recognized apart from goodwill.

A24. If 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.

Technology-Based Intangible Assets

A25. Technology-based intangible assets relate to innovations or technological advances. As stated in paragraphs A26–A28, the future economic benefits of those assets are often protected through contractual or other legal rights. Thus, many technology-based intangible assets meet the contractual-legal criterion for recognition apart from goodwill.

Computer software and mask works

A26. If computer software and program formats are protected legally such as by patent or copyright, they meet the contractual-legal criterion for recognition apart from goodwill. Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may be provided legal protection; for example, in the United States mask works qualify for protection under the Semiconductor Chip Protection Act of 1984. Acquired mask works protected under the provisions of that Act or other similar laws or regulations also meet the contractual-legal criterion for recognition apart from goodwill.

Databases, including title plants

A27. Databases are collections of information, often stored in electronic form (such as on computer disks or files). An acquired database that includes original works of authorship is entitled to copyright protection and, if so protected, meets the contractual-legal criterion for recognition apart from goodwill. However, a database often includes information created as a consequence of an entity's normal operations, such as a customer list or specialized information

such as a title plant, scientific data, and credit information. Databases that are not protected by copyright can be (and often are) exchanged in their entirety or in part. Alternatively, they can be (and often are) licensed or leased to others. Thus, even if the future economic benefit of a database does not arise from legal rights, it meets the separability criterion for recognition as an asset apart from goodwill.

Trade secrets, such as secret formulas, processes, recipes

A28. A trade secret is “information, including a formula, pattern, compilation, program, device, method, technique, or process, that (1) derives independent economic value, actual or potential, from not being generally known . . . and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”³⁰ If the future economic benefit of an acquired trade secret is protected legally, such as by the Uniform Trade Secrets Act or other laws and regulations, that asset meets the contractual-legal criterion for recognition as an asset apart from goodwill. Otherwise, a trade secret would be recognized as an asset apart from goodwill only if the separability criterion was met, which is likely to be the case.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others. It also summarizes the considerations that were deemed significant in reaching the conclusions in FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. Those conclusions and considerations are carried forward in this Statement without reconsideration.

Background Information

B2. Prior to the issuance of this Statement, the guidance on accounting for business combinations was provided by APB Opinion No. 16, *Business Combinations*, which the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued in 1970. Opinion 16 provided for two methods of accounting for business combinations, the pooling-of-interests method (pooling method) and the purchase method. Those methods were not alternatives or substitutes for one another. Opinion 16 required that the pooling method be used if a business combination met 12 specified conditions; otherwise, the purchase method was to be used.

B3. During the 1970s, the FASB had an active project on its agenda to reconsider the accounting for business combinations and purchased intangible assets. However, the Board later decided to defer consideration of the issues in that project until after it had completed development of its conceptual framework for accounting and reporting. In 1981, the Board removed the inactive business combinations project from its agenda to focus on higher priority projects.

B4. In August 1996, the Board added the current project on accounting for business combinations to its agenda. The objective of this project was to improve the transparency of accounting and reporting of business combinations including the accounting for goodwill and other intangible assets by reconsidering the requirements of Opinion 16 and APB Opinion No. 17, *Intangible Assets* (which also was issued in 1970). In 1999, the Board decided that that objective would best be achieved through several projects focused on specific issues. In the first of those projects, which ended with the concurrent issuance of this Statement and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, the Board reconsidered the methods

of accounting for business combinations and the accounting for goodwill and other intangible assets. Another project will address issues associated with the accounting for combinations between not-for-profit organizations, the acquisition of a for-profit entity by a not-for-profit organization, and combinations between mutual enterprises. The Board intends to consider issues related to the accounting for the formation of joint ventures and other new entities, push-down accounting (including spinoffs), and common control transactions in another project. In still another project the Board intends to consider issues related to the provisions of Opinion 16 and Statement 38 that are carried forward in this Statement without reconsideration and other issues related to the application of the purchase method, such as the accounting for step acquisitions. **31**

Reasons the FASB Took on the Project

B5. A principal reason for taking on this project in 1996 was the increase in merger and acquisition activity that brought greater attention to the fact that two transactions that are economically similar may be accounted for by different methods that produce dramatically different financial statement results. Consequently, both the representational faithfulness and the comparability of those financial statements suffer.

B6. Another reason that the Board decided to undertake this project was that many perceived the differences in the pooling and purchase methods to have affected competition in markets for mergers and acquisitions. Entities that could not meet all of the conditions for applying the pooling method believed that they faced an unlevel playing field in competing for targets with entities that could apply that method. That perception and the resulting attempts to expand the application of the pooling method placed considerable tension on the interpretation and application of the provisions of Opinion 16. The volume of inquiries fielded by the staffs of the FASB and Securities and Exchange Commission (SEC) and the auditing profession was evidence of that tension.

B7. The unlevel playing field that was perceived to stem from the application of the pooling and purchase methods extended internationally as well. Cross-border differences in accounting standards for business combinations and the rapidly accelerating movement of capital flows globally heightened the need for accounting standards to be comparable internationally. Promoting international comparability in accounting standards is part of the Board's mission, and many members of the Financial Accounting Standards Advisory Council (FASAC) cited the opportunity to promote greater international comparability in the standards for business combinations as a reason for adding this project to the Board's agenda. (FASAC had consistently ranked a possible project on business combinations as a high priority for a number of years.)

International Cooperation

B8. Largely because of concerns about the perception of an unlevel cross-border playing field with the United States in the accounting standards for business combinations, the Accounting

Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) conducted a business combinations project concurrently with the FASB's project. The goal of that concurrent effort was to establish common standards on business combinations and intangible assets.

B9. The FASB also worked with other members of an international organization of standard-setting bodies with the aim of achieving convergence internationally with respect to the methods of accounting for business combinations. That organization, known as the "Group of 4 plus 1" (G4+1), consisted of the Australian Accounting Standards Board (AASB), the New Zealand Financial Reporting Standards Board (FRSB), the United Kingdom Accounting Standards Board (UK ASB), the AcSB, the FASB, and an observer, the International Accounting Standards Committee (IASC).

Conduct of the FASB's Project

B10. The Board formed a business combinations task force comprising individuals from a number of organizations representing a wide range of the Board's constituents. The first meeting of that task force was held in February 1997. Relevant academic research was reviewed, and the meeting discussion centered on a background paper that addressed the project's scope, the direction the project should take, and how the project should be conducted.

B11. The June 1997 FASB Special Report, *Issues Associated with the FASB Project on Business Combinations*, was based on that background paper and indicated some of the Board's initial decisions about the project's scope, direction, and conduct. The 54 comment letters received in response to that Special Report generally expressed agreement with those decisions.

B12. In 1998, the FASB participated in the development of a G4+1 Position Paper, *Recommendations for Achieving Convergence on the Methods of Accounting for Business Combinations*. That Position Paper considered the pooling method, the purchase method, and the fresh-start method, ³² and concluded that only the purchase method should be used to account for business combinations.

B13. The Board issued the Position Paper as an FASB Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, in December 1998, the same date on which other G4+1 member organizations issued similar documents for comment. The FASB received 148 comment letters, the AcSB received 40 letters, the UK ASB received 35 letters, the IASC received 35 letters, the AASB received 5 letters, and the FRSB received 4 letters.

B14. After considering the recommendations of the G4+1 and the responses to the Invitation to Comment, the Board decided that only the purchase method should be used to account for business combinations. The Board also decided that certain changes should be made in how the purchase method should be applied, particularly in the accounting for and financial statement

presentation of goodwill and other intangible assets. Those changes were proposed in the September 1999 FASB Exposure Draft, *Business Combinations and Intangible Assets* (1999 Exposure Draft). The Board received 210 comment letters in response to the 1999 Exposure Draft. In February 2000, the Board held 4 days of public hearings, 2 days in San Francisco and 2 days in New York City, at which 43 individuals or organizations presented their views on the 1999 Exposure Draft.

B15. In redeliberating the proposals in the 1999 Exposure Draft, the Board considered changes suggested by various constituents, in particular those related to the accounting for goodwill. During October and November 2000, Board and staff members explored the suggested changes to the accounting for goodwill in field visits with 14 companies. The Board's deliberations resulted in significant changes to the proposed requirements related to goodwill but not to other issues addressed in the 1999 Exposure Draft. In particular, the Board decided that goodwill should no longer be amortized and should be tested for impairment in a manner different from how other assets are tested for impairment. The Board also affirmed the proposal that only the purchase method should be used to account for business combinations. In February 2001, the Board issued a revised Exposure Draft, *Business Combinations and Intangible Assets—Accounting for Goodwill* (2001 Exposure Draft), that proposed changes to the 1999 Exposure Draft with regard to the accounting for goodwill and the initial recognition of intangible assets other than goodwill. The Board received 211 comment letters on the 2001 Exposure Draft.

B16. The Board decided to separate the guidance for business combinations from that for goodwill and other intangible assets and issue that guidance in two final documents, this Statement and Statement 142. Those two Statements parallel and supersede Opinions 16 and 17, respectively. Statement 142 was issued concurrently with this Statement.

B17. The Board also decided that this Statement should supersede Opinion 16 and Statement 38 and carry forward without reconsideration portions of the guidance in that Opinion 16 and that Statement related to the application of the purchase method.

Basis for Conclusions

Definition and Scope

B18. In developing the 1999 Exposure Draft, the Board concluded that because this project is primarily focused on the methods of accounting for business combinations, this Statement should generally retain the definition and scope of Opinion 16. The Board affirmed that conclusion in its redeliberations of the 1999 Exposure Draft.

B19. The 1999 Exposure Draft proposed certain changes to the Opinion 16 definition of a business combination to reflect the Board's conclusion that all two-party business combinations

and virtually all other business combinations (other than joint venture formations) are acquisitions. Specifically, the 1999 Exposure Draft proposed that a *business combination* be defined as occurring when one entity acquires all or a portion of the net assets that constitutes a business or equity interests of one or more entities and obtains control over the entity or entities.

B20. Respondents to the 1999 Exposure Draft were asked to comment on that proposed definition, in particular whether it would appear to include or exclude business combinations that were not similarly covered by the Opinion 16 definition. The principal concern expressed by respondents that commented on that issue related to the proposal that a business combination be defined as occurring when one entity acquires equity interests of another entity and obtains control over that entity. Many of those respondents said that that definition would exclude certain transactions covered by Opinion 16 from the scope of the 1999 Exposure Draft, in particular, transactions in which none of the former shareholder groups of the combining entities obtain control over the combined entity (such as roll-ups, put-togethers, and so-called mergers of equals). During its redeliberations of the 1999 Exposure Draft, the Board concluded that those transactions should be included in the definition of a business combination and in the scope of this Statement. Therefore, paragraph 10 explicitly states that the provisions of this Statement also apply to business combinations in 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. However, the Board acknowledges that some of those business combinations might not be acquisitions, and it intends to consider in another project whether business combinations that are not acquisitions should be accounted for using the fresh-start method rather than the purchase method.

B21. Respondents to the 1999 Exposure Draft suggested that because joint venture formations were to be excluded from the scope of that proposed Statement, the Board should define *joint venture*. 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 No. Opinion 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. The Board intends to develop a definition of joint venture as part of its project on accounting for joint venture and other new entity formations.

B22. Respondents to the 1999 Exposure Draft also said that the Board should define the term *business*. The Board observed that in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” the EITF reached a consensus on guidance for determining whether a business has been received in an exchange transaction. That guidance discusses the characteristics of a business. The Board concluded that while it was not necessary to define *business* for purposes of this Statement, this Statement should refer to the guidance provided in Issue 98-3.

B23. 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. That treatment is consistent with the practice for accounting for step acquisitions, in which a parent obtains control of a subsidiary through two or more purchases of the investee-subsidiary's stock. In addition, this 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.

B24. The 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 or joint venture and other new entity formations and transactions between entities under common control. Those are among the issues that the Board intends to consider in another project.

Methods of Accounting for Business Combinations

B25. In deliberating the methods of accounting for business combinations, the Board carefully considered the analyses of the issues in the G4+1 Position Paper, as well as the conclusions and recommendations that were based on those analyses. The Board also carefully considered the views expressed by respondents to the Invitation to Comment, as well as those of respondents to the corresponding documents of other G4+1 member organizations. In later redeliberating the proposals made in the 1999 Exposure Draft, the Board also carefully considered the views expressed by respondents to that Exposure Draft, most of which reiterated views expressed by respondents to the Invitation to Comment.

B26. Like the G4+1, the Board considered three possible methods of accounting for business combinations—the pooling method, the purchase method, and the fresh-start method. Also like the G4+1, the Board observed that neither the pooling method nor the fresh-start method could be appropriately used for all business combinations.

B27. In assessing those methods, the Board was mindful of the disadvantages of having more than one method of accounting for business combinations, as evidenced by the experience with Opinion 16 over the past three decades. Among those disadvantages are the incentives for accounting arbitrage that inevitably exist when different methods produce dramatically different financial statement results for economically similar transactions. Another disadvantage is the

difficulty in drawing unambiguous and nonarbitrary boundaries between the transactions to which the different accounting methods would apply. Still others include the difficulties and costs associated with applying, auditing, and enforcing the resulting standards. Yet others relate to difficulties with analyzing the information provided by different methods because users commonly do not have the means available to convert from the information provided by one method to that provided by another.

B28. The Board concluded that having more than one method could be justified only if the alternative method (or methods) could be demonstrated to produce information that is more decision useful and if unambiguous and nonarbitrary boundaries could be established that unequivocally distinguish when one method is to be applied rather than another.

Reasons for Adopting the Purchase Method

B29. The Board concluded that the purchase method is the appropriate method of accounting for all business combinations that are acquisitions, as did the G4+1. The purchase method is consistent with how the historical-cost accounting model generally accounts for transactions in which assets are acquired and liabilities are assumed or incurred, and it therefore produces information that is comparable to other accounting information. Under the purchase method, one of the combining entities is viewed as surviving the transaction and is considered the acquiring entity. The other combining entities that do not survive the combination as independent entities are considered the acquired entities. The purchase method recognizes and measures assets and liabilities in the same way regardless of the nature of the consideration that is exchanged for them. Consequently, users of financial statements are better able to assess the initial costs of the investments made and the subsequent performance of those investments and compare them with the performance of other entities. Moreover, the purchase method is familiar to preparers, auditors, regulators, and users of financial statements.

B30. Respondents to both the Invitation to Comment and the 1999 Exposure Draft generally agreed that most business combinations are acquisitions, and many stated that all combinations involving only two entities are acquisitions. Respondents also agreed that the purchase method is the appropriate method of accounting for business combinations that are acquisitions. However, some qualified their support for the purchase method contingent upon the Board's decisions about certain aspects of applying that method, particularly the accounting for goodwill.

B31. Because the purchase method is the only appropriate method of accounting for business combinations that are acquisitions, the question considered by the Board was whether any combinations are not acquisitions and, if so, whether the pooling method or the fresh-start method should be used to account for them. The Board generally agreed with the analyses and conclusions in the G4+1 Position Paper and concluded that all two-party business combinations other than joint venture formations are acquisitions. Accordingly, the Board decided that one method, the purchase method, should be used to account for all two-party business combinations except joint venture formations.

B32. The Board also concluded that most business combinations involving three or more entities (multi-party combinations) are acquisitions. The Board acknowledged that some multi-party combinations (in particular, those that are commonly referred to as roll-up or put-together transactions) might not be acquisitions; however, it noted that presently those transactions are generally accounted for by the purchase method. The Board decided not to change that practice at this time. Consequently, this Statement requires that the purchase method be used to account for all multi-party combinations, including those that some might not consider to be acquisitions. As discussed in paragraph B4, however, the Board intends to consider whether joint venture formations and multi-party business combinations that are not acquisitions should be accounted for by the fresh-start method rather than the purchase method.

B33. The Board noted that requiring the use of the purchase method will bring the accounting for business combinations in the United States more in step with how those combinations are accounted for in other jurisdictions because that method is widely or exclusively used in those jurisdictions.

B34. The Board also concluded that identifying the acquiring entity is practicable in all cases, although doing so may be difficult in some instances. In that regard, some respondents to the 1999 Exposure Draft noted that even though identifying an acquirer might sometimes be difficult, an acquirer nonetheless must be identified for U.S. federal income tax purposes.

B35. Paragraphs B36–B85 discuss the bases for the Board’s decision to reaffirm its proposal in the 1999 Exposure Draft to reject the pooling method and fresh-start method in favor of the purchase method.

Reasons for Rejecting the Pooling Method

Mergers and acquisitions are similar economically

B36. Many respondents to the Invitation to Comment and the 1999 Exposure Draft argued that mergers (business combinations in which the consideration is in the form of equity interests) should be accounted for differently than acquisitions. They stated that, in mergers, ownership interests are completely or substantially continued, no new capital is invested and no assets are distributed, postcombination ownership interests are proportional to those prior to the combination, and the intention is to have a uniting of commercial strategies going forward. Moreover, no change in control of the entity’s assets or liabilities occurs and no earnings process culminates. Those respondents said that a merger should be accounted for in terms of the carrying amounts of the assets and liabilities of the combining entities because unlike acquisitions, in which only the acquiring entity survives the combination, all of the combining entities effectively survive a merger.

B37. A few respondents urged that the pooling method be applied to all business combinations, regardless of the nature of the consideration, and a few others urged that it be applied to all

mergers. The Board is not aware of any jurisdiction in which *all* business combinations are or may be accounted for by the pooling method. In most jurisdictions, use of that method has been limited to mergers. The Board also is not aware of any jurisdiction in which all *mergers* are accounted for by the pooling method. In most jurisdictions that permit use of the pooling method for mergers, many mergers are accounted for by the purchase method. Thus, adoption of the suggestions to broaden the application of the pooling method would move away from rather than toward greater convergence of accounting standards internationally for business combinations. Furthermore, the Board does not believe that the nature of the consideration tendered—equity interests in the case of mergers—should dictate how the net assets acquired should be recorded.

B38. Most respondents that favored retaining the pooling method urged that its application be limited. Some stated that application of the pooling method should be limited to those combinations that meet certain conditions, either the same as those in Opinion 16 or a simpler set. However, many stated that its application should be more restricted than under Opinion 16. They generally urged that its application be limited to “true mergers” or “mergers of equals,” which they described as combinations of entities of approximately equal size or those in which an acquirer could not be readily identified. Some added that the combining businesses should be complementary in nature and that the risks and rewards associated with the assets obtained should be similar to those associated with assets given up. Several respondents stated that true mergers or mergers of equals might be accounted for by either the pooling method or the fresh-start method but did not suggest which of those methods might be more appropriate or what the criteria should be for determining which method to apply.

B39. The Board noted that mergers are not transactions between owners as asserted by proponents of the pooling method, but rather that the combining entities themselves are deeply involved in those transactions. The issuance of shares is an investment by owners from the issuing entity’s perspective. The net assets of one entity are transferred to another, which issues its shares in exchange, and that transaction should be accounted for on the same basis that would be used to record an investment by owners in the form of cash—that is, on a fair value basis. From the perspective of the acquired entity’s shareholders, that transaction is an exchange transaction, a sale on their part and a purchase on the part of the surviving entity. In that regard, the Board observed that the shareholders of the acquired entity typically receive a premium for their shares, which is consistent with being sellers. Furthermore, the acquired entity shareholders often become relatively more liquid following the exchange by virtue of receiving shares that are more widely and deeply traded than those they gave up (particularly if their shares had been privately held or closely held), which also is consistent with the usual outcome for sellers.

B40. Many respondents agreed with the Board’s conclusion that although ownership interests are continued in a merger, they are not the same interests as before the combination. That is because control over precombination assets is reduced by sharing, and shared control over other assets is gained. Thus, not only does control change but also what is controlled changes.

Furthermore, the risks and rewards associated with the assets obtained may or may not be similar to those given up, and the combination itself may have either increased or decreased risks and the potential for rewards. Finally, even though “intent” in the form of a uniting of commercial strategies going forward is sometimes cited as a feature of mergers, the Board believes that all business combinations entail some bringing together of commercial strategies and, thus, that feature is not unique to mergers.

B41. Some respondents stated that mergers are virtually identical to acquisitions economically, making them in-substance acquisitions. In that regard, some noted that shares could have been issued for cash and that cash then used to effect the combination, with the end result being the same economically as if shares had been used to effect the combination.

B42. The Board concluded that “true mergers” or “mergers of equals” are nonexistent or so rare as to be virtually nonexistent, and many respondents agreed. Other respondents stated that even if a true merger or merger of equals did occur, it would be so rare that a separate accounting treatment is not warranted. They also stated that developing the criteria necessary to identify those transactions simply would be a continuation of the same problems and potential for abuse evidenced by Opinion 16. The Board agreed, observing that even in those standards set by others that restrict use of the pooling method to true mergers or mergers of equals (such as the AcSB, the UK ASB, and the IASC), there are differences not only in the criteria themselves but in how they are interpreted and applied. The Board further observed that respondents and other constituents were unable to suggest an unambiguous and nonarbitrary boundary for distinguishing true mergers or mergers of equals from other two-party business combinations and concluded that developing such an operational boundary would not be feasible. Moreover, even if those mergers could feasibly be distinguished from other combinations, the Board concluded that it does not follow that such combinations should be accounted for on a carry-over basis. If they were to be accounted for using a method other than the purchase method, the Board believes that a better method would be the fresh-start method.

Information provided is not decision useful

B43. Some proponents of the pooling method argued that the information it provides for some business combinations is more decision useful. They argued that the information is more reliable, in particular, more representationally faithful, than the information that the purchase method would provide if it were applied to those combinations. However, other respondents countered, stating that the information provided by the purchase method is more revealing than that provided by the pooling method. Respondents also noted that the pooling method does not hold management accountable for the investment made and the subsequent performance of that investment. In contrast, the accountability that results from applying the purchase method forces management to examine business combination deals carefully to see that they make sense economically.

B44. The Board observed that an important facet of decision-useful information is information about cash-generating abilities and cash flows generated. As FASB Concepts Statement No. 1,

Objectives of Financial Reporting by Business Enterprises, states, “. . . financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise” (paragraph 37; footnote reference omitted). The Board noted that neither the cash-generating abilities of the combined entity nor its future cash flows generally are affected by the method used to account for the combination. However, fair values reflect the expected cash flows associated with acquired assets and assumed liabilities. Because the pooling method records the net assets acquired at their carrying amounts rather than at their fair values, the information that the pooling method provides about the cash-generating abilities of those net assets is less useful than that provided by other methods.

B45. The Board also concluded that the information provided by the pooling method is less relevant in terms of completeness, predictive value, and feedback value than the information that is provided by other methods. It also is less reliable because, for example, by recording assets and liabilities at the carrying amounts of predecessor entities, postcombination revenues may be overstated (and expenses understated) as the result of embedded gains that were generated by predecessor entities but not recognized by them. Furthermore, because of variations in when the pooling method is applied, similar combinations may be accounted for by different methods, adversely affecting both representational faithfulness and comparability.

B46. Comparability is another important facet of information that is decision useful. As FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states, “The purpose of comparison is to detect and explain similarities and differences” (paragraph 113). It also notes that “the difficulty in making financial comparisons among enterprises because of the use of different accounting methods has been accepted for many years as the principal reason for the development of accounting standards” (paragraph 112).

B47. Most of the respondents to the Invitation to Comment agreed that differences in the methods of accounting for business combinations and when they are applied make it difficult to compare financial statements.

B48. Respondents to the 1999 Exposure Draft expressed mixed views. Some proponents of the pooling method argued that eliminating it would hinder comparability, describing the purchase method as an “apples and oranges approach” because it measures the net assets of the acquired entity at fair value and those of the acquiring entity at historical cost. However, opponents of the pooling method stated that the purchase method produces results that are comparable with those of entities that grow by acquiring similar assets in a number of smaller purchases that are not business combinations. The Board agreed with those who stated that the purchase method is consistent with how other asset acquisitions are accounted for, and it disagreed with those who described it as an apples-and-oranges approach.

B49. Proponents of the pooling method also argued that the pooling method enhances the comparability of the financial statements of entities that grow through acquisition (a “buy

strategy”) with those of entities that grow internally (a “build strategy”). They asserted that the pooling method enhances comparability because it avoids recognizing assets on the statement of financial position and related charges to the income statement that the purchase method requires. The Board concluded that comparability between entities that “buy” and those that “build” is a false comparability because the outlays that are made for the assets in question are never accounted for under the pooling method, whereas they are accounted for when the assets are developed internally.

B50. Opponents of the pooling method stated that eliminating that method would enhance the comparability of financial statements of entities that grow by means of acquisitions. After considering all of the views expressed by respondents, the Board agreed with those that stated that comparability of financial information reported by entities that engage in business combinations would be enhanced by eliminating the pooling method.

Inconsistencies across jurisdictions and over time

B51. The Board observed that there are inconsistencies internationally with regard to whether and when the pooling method is applied. In some jurisdictions, its use is prohibited, and in those jurisdictions where its use is not prohibited, it is applied to some—but not all—business combinations in which the consideration is in the form of equity interests, with the particulars varying from jurisdiction to jurisdiction.

B52. The Board also observed that because accounting standards for business combinations in the United States have changed over time, there has been variation over time as to which business combinations qualify for application of the pooling method. For example, Opinion 16 was designed to narrow the application of the pooling method to only those combinations that met 12 stated conditions.

B53. The Board noted that if the pooling method were based on a sound underlying conceptual foundation, there would not be inconsistencies in how that method is applied internationally, nor would there have been changes over time in the transactions that qualify for use of that method in the United States.

B54. The Board observed that the pooling method is used today to account for transactions that are quite different from those it was originally intended to account for. As discussed in the Invitation to Comment’s appendix entitled “The History of the Pooling-of-Interests Method in the Jurisdictions of G4+1 Member Organizations,” the pooling method in the United States

... has its roots in an approach developed for combinations in which a strong degree of affiliation existed between the combining companies prior to the combination. That approach was gradually extended to a quite different set of combinations, namely those in which the combining companies had not been part of the same “family” and whose existing relationships—if any—had simply been incident to normal business activities, such as those with suppliers or customers.
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B55. The Board also observed that early uses of the pooling method occurred in certain regulated industries in which the rates that regulated entities could charge their customers were based on the cost of their assets. Rather than permit those entities to charge higher rates as a result of business combinations, particularly between entities that had been so closely related that the presence of arm's-length bargaining was open to question, regulators held that no new values should be assigned to the assets being combined. That was because no change in substance had occurred from the rate payers' perspective—the net assets being employed before and after the combination were the same. Accordingly, rate regulation issues expanded the use of the pooling method, even to combinations in which the consideration was not in the form of stock.

B56. Although use of the pooling method has spread considerably in the years since its inception, the Board observed that the criteria for its application today bear little or no resemblance to those that would be consistent with its roots.

Inconsistent with historical-cost accounting model

B57. The Board observed that the pooling method is an exception to the general concept that exchange transactions are accounted for in terms of the fair values of the items exchanged. Because the pooling method records the combination in terms of the carrying amounts of the parties to the transaction, it fails to record the investment made in the combination and fails to hold management accountable for that investment and its subsequent performance.

B58. Some proponents of the pooling method asserted that use of that method is consistent with the historical-cost model and that eliminating it would be another step down the road toward a fair value model. They argued that before eliminating the pooling method, the Board should resolve the broad issue of whether to adopt a fair value model in place of the historical-cost model. In the Board's view, regardless of the merits of a fair value model, the pooling method is an aberration that is inconsistent with the historical-cost model. The reason relates to the fundamental role of transactions in accounting.

B59. The Board observed that although the historical-cost model is frequently described as being "transaction based," the fair value model also records all transactions. In both models, the transactions are recorded at the same amounts. The main difference between those models does not relate to whether transactions that the entity engages in are recorded; it lies in what is recorded between transactions.

B60. Under the fair value model, a "truing up" takes place between transactions that involves recognizing nontransactional events and circumstances that affect the entity's assets and liabilities. That "truing up" also involves making end-of-period adjustments that are needed to update the fair values of those assets and liabilities in order to prepare financial statements.

B61. In contrast, under the historical-cost model, entries that are recorded between transactions are not generally aimed at truing-up the measures of the entity's assets and liabilities but rather at allocating or assigning costs to particular accounting periods. To the extent that any truing-up takes place, it generally is limited to recognizing such events as calamities, decreases in the market value of inventories below their cost, and impairments of long-lived assets. Thus, the truing-up is largely left to subsequent transactions that the entity engages in. Therefore, those transactions provide the "reality check" that is needed to validate the historical-cost model, without which its outputs would be suspect. Stated another way, transactions are the essential part of the historical-cost model that provide the reckoning that otherwise might not occur.

B62. The pooling method effectively sidesteps the reckoning that comes with business combination transactions by assuming that those transactions are exchanges between the owners of the combining entities rather than between the entities themselves. That method does not recognize the values exchanged in the records of the combined entity, only the carrying amounts of the predecessor entities. The failure to record those values can adversely affect the reliability of the combined entity's financial statements for years—and even decades—to come. For those reasons, the Board concluded that the pooling method is inconsistent with the historical-cost model.

Consistency with other standards

B63. A few respondents noted that FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, precludes sale accounting for transfers of financial assets when there is continuing involvement of the transferor (such as retaining an ownership interest in the asset purported to be sold). Those respondents argued that if owners of both combining entities in a business combination have a significant degree of continuing involvement in the combined entity, neither owner has "sold" their entity. Therefore, the use of the purchase method for all business combinations may be inconsistent with accounting for certain securitization transactions as set forth in Statement 140. The Board observed, however, that Statement 140 addresses transfers of financial assets and that those transactions are fundamentally different from business combinations. Moreover, the provisions of Statement 140 preclude recognition of a transfer of assets as a sale if the transferor does not surrender control over those assets. In contrast, in a business combination that is effected by cash, control over the net assets of the acquired entity *is* transferred, and in those affected by stock, control over precombination net assets *is* reduced and shared.

Disclosure not an adequate response

B64. In urging that the pooling method be retained, a few respondents to the Invitation to Comment and the 1999 Exposure Draft stated that any perceived problems with having two methods of accounting could be addressed by enhanced disclosures in the notes to the financial statements. However, they generally did not specify what those disclosures should be and how they would help overcome the comparability problems that inevitably result from having two methods.

B65. In developing the 1999 Exposure Draft, the Board considered the matter of enhanced disclosures but doubted the usefulness of almost any disclosures short of disclosing what the results would have been had the purchase method been used to account for the business combination. Even so, providing disclosures that would enable users of financial statements to determine what the results would have been had the transaction been accounted for by the purchase method would be a costly solution that begs the question of why the purchase method was not used to account for the transaction in the first place. Since the respondents to the 1999 Exposure Draft that raised that issue did not provide any information that the Board had not already considered, the Board rejected the addition of enhanced disclosures as a viable alternative.

Not cost beneficial

B66. Some respondents cited cost-benefit considerations as a reason for retaining the pooling method. They argued that the pooling method is a quicker and less expensive way to account for a business combination because it does not require an entity to hire outside appraisers to value assets for accounting purposes.

B67. Other respondents favored eliminating the pooling method for cost-benefit reasons. Some argued that the pooling method causes preparers of financial statements, auditors, regulators, and others to spend unproductive time dealing with what they described as the detailed and somewhat illogical criteria required by Opinion 16 in attempts to have certain business combinations qualify for application of the pooling method. Others noted that using the purchase method of accounting for all business combinations would eliminate the enormous amount of interpretive guidance necessary to accommodate the pooling method. They also stated that the benefits derived from the purchase method as the only method of accounting for business combinations would significantly outweigh any issues that might arise from accounting for the very rare true merger or merger of equals by the purchase method.

B68. The Board addressed cost-benefit considerations in developing the 1999 Exposure Draft and concluded that a single method of accounting is preferable in light of those considerations because having more than one method would lead to higher costs associated with applying, auditing, enforcing, and analyzing the information produced by them. Cost-benefit considerations were thoroughly analyzed at that time and are discussed in paragraphs B225–B234. The Board concluded that those that favor retaining the pooling method on the basis of cost-benefit considerations did not provide any additional information that the Board did not consider previously.

Public policy not served by retention

B69. A number of respondents to the Invitation to Comment and the 1999 Exposure Draft argued that public policy considerations should dominate the Board's decisions. Some argued that eliminating the pooling method would require some investors to adjust to different measures

of performance, potentially affecting market valuations adversely in certain industries during the transition period. Others argued that it would impede desirable consolidation in certain industries, reduce the amount of capital flowing into those industries, slow the development of new technology, and adversely affect entrepreneurial culture. Still others argued that eliminating the pooling method would remove a competitive advantage that U.S. companies have in competing with foreign companies for acquisitions and could impose a competitive disadvantage on them. Yet others argued that it would reduce the options available to certain regulatory agencies and possibly require regulated entities to maintain a second set of books. A few argued that elimination of the pooling method, by imposing an accounting hurdle on business combinations, would hinder obtaining the economic advantages afforded by the recently enacted Financial Services Reform Act in the United States that reforms the Glass-Steagall Act of 1933.

B70. Other respondents did not share those views. Some stated that because business combinations are driven by their underlying economics and not accounting considerations, economically sound deals would be completed regardless of the method used to account for them. Others noted that the financial community values business combinations in terms of their fair values rather than book values and, therefore, those transactions should initially be recognized in the financial statements at fair value.

B71. The Board has long held that accounting standards should not be slanted to favor one set of economic interests over another. For example, if accounting standards result in information that favors sellers in capital markets, those standards simultaneously disfavor buyers in those markets. If accounting standards were slanted, they would not be neutral, and the information that they produce would not be neutral. Consequently, financial reporting would not be fair and evenhanded and thus would lose its credibility.

B72. The Board noted that Concepts Statement 2 states that “neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest” (paragraph 98). It goes on to explain that:

Neutrality does not mean “without purpose,” nor does it mean that accounting should be without influence on human behavior. Accounting information cannot avoid affecting behavior, nor should it. If it were otherwise, the information would be valueless—by definition, irrelevant—and the effort to produce it would be futile. It is, above all, the predetermination of a desired result, and the consequential selection of information to induce that result, that is the negation of neutrality in accounting. To be neutral, accounting information must report economic activity as faithfully as possible, without coloring the image it communicates for the purpose of influencing behavior in *some particular direction*. [Paragraph 100, emphasis in original.]

B73. Concepts Statement 2 acknowledges the argument that has been made against neutrality in accounting standards—that it may inhibit the FASB from working toward achieving public

policy goals. However, the Board noted that that argument raises several issues. One is that there would have to be agreement on what those goals should be. Another is that since goals change with changes in government, questions would arise about the desirability or feasibility of changing accounting standards every time public policy changes. Moreover, to the extent that accounting standards become a means of facilitating or implementing public policy, the ability of those standards to help guide policy and measure its results is unavoidably diminished. For those reasons, the Board concluded that accounting standards should be neutral.

B74. Neutrality is also an essential component of the precepts that the Board follows in the conduct of its activities. One of those precepts, as stated in the FASB's mission statement, is as follows:

To be objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction. [FASB Rules of Procedure, page 3]

B75. In the final analysis, the Board concluded that the accounting standards for business combinations should not seek to encourage or discourage business combinations. Instead, those standards should produce information about those combinations that is fair and evenhanded to those having opposing economic interests. The Board also concluded that those who argue for the pooling method on the basis that they believe that it fosters more combinations are not seeking to have neutral, evenhanded information disseminated.

B76. The Board carefully studied the responses to the 1999 Exposure Draft including those of respondents that favored retaining the pooling method on the basis of what they asserted to be public policy reasons. The information provided by those respondents did not cause the Board to change its view that its public policy goal is to issue accounting standards that result in neutral and representationally faithful financial information and that eliminating the pooling method is consistent with that goal.

Purchase method flaws remedied

B77. A number of respondents to the Invitation to Comment and the 1999 Exposure Draft indicated that the pooling method should be retained because of problems associated with the purchase method, particularly the requirement to recognize goodwill and subsequently amortize it in determining net income. Some argued that goodwill is not an asset and should not be recognized (and thus not amortized). Others argued that goodwill is an asset but not a wasting asset and thus should not be amortized. Still others argued that goodwill may be a wasting asset but that estimates of its useful life are inherently subjective. They argued that goodwill should be written off immediately in determining net income, other comprehensive income, or equity or, alternatively, that it should be assigned an arbitrary life that is both short and uniform and then amortized in determining net income, other comprehensive income, or equity. Yet others noted

that reported earnings might be drastically affected by additional noncash charges for depreciation, depletion, and amortization that result from accounting for a business combination by the purchase method. However, most focused on the effects of goodwill amortization.

B78. The Board concluded that the concerns cited about the purchase method did not justify retaining the pooling method, as some had urged, and it affirmed its decision that the pooling method was so fundamentally flawed as to not warrant retention.

B79. For the reasons cited in paragraphs B36–B78, the Board concluded that the pooling method should not be used to account for any business combination.

Reasons for Rejecting the Fresh-Start Method

B80. Few of the respondents to the Invitation to Comment and the 1999 Exposure Draft that commented on the fresh-start method supported its use to account for any business combination. And, as noted previously, several respondents to that Exposure Draft stated that mergers of equals could be accounted for by either the pooling method or the fresh-start method but did not indicate which would be more appropriate or suggest criteria for making that determination.

B81. The Board acknowledged that a case can be made for using the fresh-start method to account for business combinations that are not acquisitions, which might be defined as transactions in which an acquiring entity cannot be identified or one in which the acquiring entity is substantially modified by the transaction. Under the fresh-start method, none of the combining entities are viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them, and the history of that new entity, by definition, begins with the combination.

B82. The Board noted that under the fresh-start method, the new entity has no history against which to compare itself and it is difficult to compare the results of the new entity with those of its predecessors for periods before the combination. Furthermore, new accounting guidance would have to be developed for implementing the method, and many unsettled aspects (such as whether goodwill should be recognized and how it should be measured) would have to be addressed before it could be applied.

B83. The Board noted that if the fresh-start method were to be applied only to those two-party combinations in which an acquiring entity cannot be identified or the combining entities were equal in all respects, such combinations would be so rare—if they occurred at all—as to not justify the need for a new and separate method. The Board also noted that if the method also were to be applied to two-party combinations in which the acquiring entity is substantially modified, *substantially modified* would have to be defined, which would likely prove to be difficult to do in an unambiguous and nonarbitrary way. Moreover, those two-party combinations would be relatively few in number. Furthermore, the method may offer the potential for accounting arbitrage because the financial statement results it produces are apt to

differ significantly from those that the purchase method produces.

B84. The Board concluded that the advantages of using the fresh-start method for two-party combinations such as those discussed in paragraph B81 (primarily enhanced representational faithfulness) were outweighed by the disadvantages of having two methods of accounting (particularly the potential for accounting arbitrage but also the difficulties of drawing unambiguous and nonarbitrary boundaries between the methods). The Board further concluded that an alternative to the purchase method of accounting for those combinations was not needed because it is possible to apply the purchase method to them.

B85. The Board observed that the fresh-start method might be appropriate for certain multi-party combinations. However, as discussed in paragraph B32, the Board noted that those transactions are generally accounted for by the purchase method and it decided not to change that practice at this time. Also as discussed in paragraph B32, the Board intends to consider whether joint venture formations and multi-party business combinations that are not acquisitions should be accounted for by the fresh-start method rather than by the purchase method.

Acquisition of Noncontrolling Interests in a Subsidiary

B86. As it did prior to issuing the 1999 Exposure Draft, the Board concluded that this Statement should continue the practice established in Opinion 16 of accounting for the acquisition of noncontrolling interests in a subsidiary (commonly referred to as minority interests) using the purchase method. The Board intends to consider the accounting for those transactions in another project. The Board also noted that those deliberations might be affected by conclusions reached in its liabilities and equity project. In the development of the October 2000 FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, the Board concluded that (a) noncontrolling interests in a subsidiary should be reported in consolidated financial statements as a separate component of equity and (b) distributions to holders of instruments that are classified as equity should be recognized as equity distributions. If the Board affirms those provisions in its redeliberations of that Exposure Draft, it will consider whether the acquisition of a minority interest should be accounted for as an equity distribution rather than by the purchase method.

Application of the Purchase Method

Accounting for Asset Acquisitions—General Concepts

B87. In reaching the conclusion that the purchase method should be used to account for all business combinations, the Board affirmed the basic principles of historical-cost accounting included in paragraphs 66–69 of Opinion 16. Specifically, the Board affirmed that an asset acquisition should be measured on the basis of the values exchanged and that measurement of the values exchanged should be based on the fair value of the consideration given or the fair value of the net assets acquired, whichever is more reliably measurable. The Board also affirmed that when groups of assets are acquired, the value of the asset (or net asset) group as a

whole should be allocated to the individual assets (or assets and liabilities) that make up the group on the basis of their fair values. Accordingly, this Statement carries forward from Opinion 16 those general principles; however, those principles have been rephrased as general concepts so that they can be understood in the context of this Statement.

Identifying the Acquiring Entity

B88. The Board's decision that all business combinations in the scope of this Statement should be accounted for by the purchase method means that the acquiring entity must be identified in every business combination. One of the issues raised in the Invitation to Comment focused on situations in which identifying the acquiring entity is difficult. Most of the respondents that commented on that issue suggested that the Board develop additional criteria for identifying the acquiring entity.

B89. In developing the 1999 Exposure Draft, the Board affirmed the guidance in Opinion 16 that states that in 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 assumes or incurs liabilities is the acquiring entity. The Board considered a variety of suggestions made by respondents to the Invitation to Comment on factors that should be considered in applying the purchase method to situations in which the acquiring entity cannot be readily identified. The guidance proposed in the 1999 Exposure Draft reflected the Board's conclusion that all pertinent facts and circumstances should be considered when identifying the acquiring entity, particularly the relative voting rights in the combined entity after the combination. That proposed guidance stated that in determining which shareholder group retained or received the larger portion of the voting rights in the combined entity, the existence of any unusual or special voting arrangements, and options, warrants, or convertible securities should be considered. The proposed guidance also reflected the Board's conclusion that consideration also should be given to factors related to the composition of the board of directors and senior management of the combined entity and that those factors should be weighted equally with the factors related to voting rights.

B90. The respondents to the 1999 Exposure Draft that commented on the proposed criteria for identifying the acquiring entity generally agreed that they were appropriate. Some of those respondents said that the guidance proposed in that Exposure Draft was an improvement over Opinion 16 because it provided additional factors to consider in determining which shareholder group retained or received the larger share of the voting rights in the combined entity. However, many of the respondents suggested improvements to the proposed criteria and some suggested that the Board consider other criteria.

B91. Several respondents to the 1999 Exposure Draft suggested that the Board retain the presumptive approach in Opinion 16 for identifying the acquiring entity in transactions effected through an exchange of equity interests. That approach presumes that absent evidence to the contrary, the acquiring entity is the combining entity whose owners as a group retain or receive the larger share of the voting rights in the combined entity. Other respondents suggested that the

factors to be considered in identifying the acquiring entity should be provided in the form of a hierarchy. Some of those respondents also suggested that the Board provide additional guidance explaining how factors relating to voting rights (unusual special voting arrangements and options, warrants, or convertible securities) would affect the determination of the acquiring entity.

B92. The Board carefully considered those suggestions. However, the Board observed, as it did in developing the 1999 Exposure Draft, that each business combination is unique and, therefore, the facts and circumstances relevant to identifying the acquiring entity in one combination may be less relevant in another. The Board affirmed its conclusion that this Statement should not retain the presumptive approach in Opinion 16 nor provide hierarchical guidance. The Board concluded that doing so would imply that some factors are more important in identifying the acquiring entity than others. However, as suggested by respondents, the Board decided to modify the guidance proposed in the 1999 Exposure Draft to explain how some of the factors influence the identification of the acquiring entity.

B93. In developing the 1999 Exposure Draft, the Board decided not to require consideration of the payment of a premium over the market value of the equity securities acquired as evidence of the identity of the acquiring entity. The Board observed that while that criterion would be a useful indicator, it would be difficult to evaluate when quoted market prices are not available for the equity securities exchanged. A number of respondents to the 1999 Exposure Draft said that the payment of a premium is a strong indicator of the identity of the acquirer. Upon reconsideration, the Board decided that this Statement would include the payment of a premium as a criterion to be considered in identifying the acquirer, but only when the equity securities exchanged in a business combination are traded in a public market.

B94. Some respondents to the Invitation to Comment and the 1999 Exposure Draft suggested that the relative market capitalizations and relative net asset sizes of the combining entities also should be considered when identifying the acquiring entity. The Board noted, however, that entities could engage in various transactions in contemplation of a business combination, such as asset dispositions and treasury stock transactions. Those transactions would result in different market capitalizations and net asset sizes than those that existed before the combination was contemplated. The Board also noted that assessing relative net assets on the basis of precombination carrying amounts would be inappropriate, while assessing them on the basis of fair values could entail significant cost. Thus, although those factors may in some cases provide evidence as to which entity is the acquiring entity, the Board concluded that consideration of those factors should not be required in all combinations.

B95. In developing the 1999 Exposure Draft, the Board observed that identifying the acquirer might be difficult in some multi-party business combinations, particularly those combinations that might not be acquisitions but are to be accounted for as such under this Statement. In the basis for conclusions to that Exposure Draft, the Board noted that in those circumstances it might be helpful to consider additional factors such as which of the entities initiated the combination

and whether the reported amounts of assets, revenues, and earnings of one of the combining entities significantly exceed those of the others. In response to suggestions made by respondents to the 1999 Exposure Draft, the Board decided to include that guidance in the standards section of this Statement.

B96. In addition, as suggested by respondents, the Board decided that this Statement should explicitly state that in some business combinations, such as those described as “reverse acquisitions,” the entity that issues the equity interests may not be the acquiring entity for financial reporting purposes.

Determining the Cost of the Acquired Entity and Date of Acquisition

B97. The Board decided that this Statement would carry forward without reconsideration the provisions of Opinion 16 related to determining the cost of the acquired entity and the date of acquisition. The Board intends to reconsider some or all of that guidance in its separate project focused on issues related to the application of the purchase method.

B98. 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 the 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 interest 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,” 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.” 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.

Allocating the Cost of the Acquired Entity

B99. In developing this Statement, the Board affirmed the basic principle set forth in Opinion 16 that the cost of an asset group should be allocated to the individual assets (or assets and liabilities) that make up the group on the basis of their fair values. However, the Board decided that this project would reconsider several aspects of the Opinion 16 guidance related to the allocation of the cost of an acquired entity in a business combination. As described in paragraphs B101–B146, the Board affirmed the requirement in Opinion 16 that the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities

assumed should be recognized as an asset referred to as goodwill. The Board decided to change the requirements in Opinion 16 for determining whether an acquired intangible asset should be recognized as an asset apart from goodwill (refer to paragraphs B147–B170). The Board also reconsidered and decided to change the guidance in Opinion 16 related to the accounting for the excess of the fair value of net assets acquired over the cost of an acquired entity (commonly referred to as negative goodwill) (refer to paragraphs B187–B193).

B100. The 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 (paragraph 88 of that Opinion). The Board recognizes that some of that guidance may be inconsistent with the term *fair value* as defined in this Statement. For example, uncertainties about the collectibility of accounts or loans receivable would affect their fair value. If accounts or loans receivable were assigned an amount equal to their fair value, there would be no need to separately recognize an allowance for uncollectible accounts as stated in paragraph 37(b). The Board decided, however, that it would consider those inconsistencies in a separate project on issues related to the application of the purchase method.

Excess of cost over the fair value of acquired net assets (goodwill)

B101. For the reasons described in paragraphs B102–B139, the Board affirmed the conclusion expressed in both the 1999 Exposure Draft and the 2001 Exposure Draft that goodwill meets the assets definition in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and the asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Most respondents to those Exposure Drafts agreed with that conclusion. Generally, those in agreement said that goodwill is an asset because future benefits are expected from it in conjunction with the future benefits expected from other assets and that the consideration paid is evidence of the existence of that asset. Many of those respondents referred to goodwill as a special type of asset—one that cannot be separated from the other net assets of an entity.

The nature of goodwill

B102. As described in the 1999 Exposure Draft and the 2001 Exposure Draft, the amount that in practice has been recognized as goodwill includes the following six components:

- Component 1—The excess of the fair values over the book values of the acquired entity’s net assets at the date of acquisition.
- Component 2—The fair values of other net assets that had not been recognized by the acquired entity at the date of acquisition. They may not have been recognized because they failed to meet the recognition criteria (perhaps because of measurement difficulties), because of a requirement that prohibited their recognition, or because the entity concluded that the costs of recognizing them separately were not justified by the benefits.
- Component 3—The fair value of the “going-concern” element of the acquired entity’s existing business. The going-concern element represents the ability of the established

business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry—either legal or because of transaction costs—by potential competitors).

- Component 4—The fair value of the expected synergies and other benefits from combining the acquiring entity's and acquired entity's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.
- Component 5—Overvaluation of the consideration paid by the acquiring entity stemming from errors in valuing the consideration tendered. Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said of a transaction involving the acquiring entity's equity interests. For example, if the number of common shares being traded daily is small relative to the number of shares issued in the combination, imputing the current market price to all of the shares issued to effect the combination may produce a higher value than those shares would produce if they were sold for cash and the cash then used to effect the combination.
- Component 6—Overpayment or underpayment by the acquiring entity. Overpayment might occur, for example, if the price is driven up in the course of bidding for the acquired entity, while underpayment may occur in the case of a distress sale or fire sale.

B103. The Board continues to believe that the following analysis of those components is useful in understanding the nature of goodwill. The first two components, both of which relate to the acquired entity, conceptually are not part of goodwill. The first component is not an asset in and of itself but instead reflects gains that were not recognized by the acquired entity on its net assets. As such, that component is part of those assets rather than part of goodwill. The second component also is not part of goodwill conceptually; it primarily reflects intangible assets that might be recognized as individual assets.

B104. The fifth and sixth components, both of which relate to the acquiring entity, also are not conceptually part of goodwill. The fifth component is not an asset in and of itself or even part of an asset but, rather, is a measurement error. The sixth component also is not an asset; conceptually it represents a loss (in the case of overpayment) or a gain (in the case of underpayment) to the acquiring entity. Thus, neither of those components is conceptually part of goodwill.

B105. As the Board noted in both the 1999 Exposure Draft and the 2001 Exposure Draft, the third and fourth components *are* conceptually part of goodwill. The third component relates to the acquired entity and reflects the excess assembled value of the acquired entity's net assets. It represents the preexisting goodwill that was either internally generated by the acquired entity or acquired by it in prior business combinations. The fourth component relates to the acquired entity and acquiring entity jointly and reflects the excess assembled value that is created by the combination—the synergies that are expected from combining those businesses. The Board

described the third and fourth components collectively as “core goodwill.”

B106. Consistent with both the 1999 Exposure Draft and the 2001 Exposure Draft, this Statement calls for efforts to avoid subsuming the first, second, and fifth components of goodwill into the amount initially recognized as goodwill. Specifically, an acquiring entity is required to make every effort to (a) measure the purchase consideration accurately (eliminating or reducing component 5), (b) record the net assets acquired at their fair values rather than their carrying amounts (eliminating or reducing component 1), and (c) recognize all acquired intangible assets meeting the criteria in paragraph 39 of this Statement so that they are not subsumed into the amount initially recognized as goodwill (reducing component 2).

Whether goodwill meet the assets definition

B107. Opinion 16 defined goodwill as the “excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed” (paragraph 87). That definition describes how the cost of goodwill should be calculated rather than explaining what goodwill is or what it represents. As such, it confuses the substance of goodwill with how goodwill is to be measured.

B108. Opinion 16 was adopted in August 1970, at a time when the APB was developing its own definition of assets. However, that definition has been replaced by the FASB’s definition, which is the benchmark against which goodwill should be judged.

B109. According to Concepts Statement 6:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Paragraph 25; footnote reference omitted.]

The footnote to that paragraph points out that “*probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. . . .”

B110. Concepts Statement 6 further explains that:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. [paragraph 26]

Because the question of whether goodwill meets the assets definition depends on whether core

goodwill possesses each of those three essential characteristics, the Board considered it in the context of each of those characteristics.

Future economic benefit

B111. Concepts Statement 6 states that:

Future economic benefit is the essence of an asset. . . . An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities. [paragraph 172]

The Board noted that goodwill cannot be exchanged for something else of value to the entity, nor can it be used to settle the entity's liabilities. Goodwill also lacks the capacity singly to produce future net cash inflows, although it can—in combination with other assets—produce cash flows. As a result, the future benefit associated with goodwill generally is more nebulous and may be less certain than the benefit that is associated with most other assets.

B112. Concepts Statement 6 states that “the most obvious evidence of future economic benefit is a market price” (paragraph 173). Because goodwill does not have the capacity to contribute directly to future net cash inflows, it is not priced separately in the marketplace, but rather is priced in combination with other assets with which it produces future net cash inflows. That capacity is reflected by the premium that an entity as a whole commands in comparison to the sum of the fair values of its component parts.

B113. The Board concluded that although goodwill is not priced separately, that does not preclude it from having future economic benefit. In that regard, Concepts Statement 6 states that “anything that is commonly bought and sold has future economic benefit, including the individual items that a buyer obtains and is willing to pay for in a ‘basket purchase’ of several items or in a business combination” (paragraph 173).

B114. The Board observed that the premium associated with goodwill may be reflected in several ways. One way is based on the market capitalization of the acquired entity as a stand-alone entity, with the premium over the sum of the fair values of the identifiable net assets reflecting the “going concern” element of the business. Another way is by the takeover premium, the price that the acquired entity as a whole commands as a target, which often is considerably higher than its market capitalization on a stand-alone basis, and reflects the synergies arising out of the combination.

Control

B115. In addition to having future economic benefit, there must be control over that benefit if goodwill is to meet the definition of assets. The Board concluded that control is provided by means of the acquiring enterprise's ability to direct the policies and management of the acquired entity.

Past transaction or event

B116. The control over future economic benefit must also result from a past transaction or event if goodwill is to meet the definition of assets. The Board concluded that the past transaction or event is the transaction in which the controlling interest was obtained by the acquiring entity.

Opposing views

B117. Some respondents to the 1999 Exposure Draft and the 2001 Exposure Draft expressed opposing views about whether goodwill meets the assets definition. Some argued that goodwill is not an asset because that conclusion would equate costs with assets. Concepts Statement 6 states that “although an entity normally incurs costs to acquire or use assets, costs incurred are not themselves assets. The essence of an asset is its future economic benefit rather than whether or not it was acquired at a cost” (paragraph 179). It further states that “. . . since an entity commonly obtains assets by incurring costs, incurrence of a cost may be evidence that an entity has acquired one or more assets, but it is not conclusive evidence. . . . The ultimate evidence of the existence of assets is the future economic benefit, not the costs incurred” (paragraph 180). Thus, the Board rejected that argument because it concluded that goodwill has future economic benefit.

B118. Other respondents argued that goodwill does not meet the assets definition because it cannot be sold apart from the business. Under that view, assets that are not cash or contractual claims to cash or services must be capable of being sold separately for cash, and thus exchangeability is an essential characteristic. In that regard, the Board noted that Concepts Statement 6 expressly considers the matter of exchangeability, noting that, in addition to the three essential characteristics described above:

Assets commonly have other features that help identify them—for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item’s qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or distributing other goods or services. [Paragraph 26; footnote reference omitted.]

B119. Concepts Statement 6 noted that absence of exchangeability of an asset may create recognition and measurement problems, “but it in no way negates future economic benefit that can be obtained . . .” (footnote 62). Thus, exchangeability is expressly ruled out as an element of the assets definition, and so the Board rejected that argument.

Initial Recognition of Goodwill as an Asset

B120. Paragraph 63 of Concepts Statement 5, contains four fundamental recognition criteria that apply to all recognition decisions:

- a. Definitions—The item meets the definition of an element of financial statements.
- b. Measurability—It has a relevant attribute measurable with sufficient reliability.
- c. Relevance—The information about it has the potential to make a difference in user decisions.
- d. Reliability—The information is representationally faithful, verifiable, and neutral.

An item meeting those criteria should be recognized in the financial statements, subject to a cost-benefit constraint and a materiality threshold.

Definition

B121. Based on its analysis, the Board concluded that core goodwill meets the assets definition in Concepts Statement 6, thereby leaving the criteria of measurability, relevance, and reliability to be considered.

Measurability

B122. Because the scope of the business combinations project focuses only on goodwill that is acquired in conjunction with a business combination, the Board noted that the cost incurred in the combination transaction provides the basis for initially measuring goodwill.

B123. The Board questioned whether goodwill should be initially recognized as an asset because of concerns about its measurability, since it is not exchangeable separate from other assets of the entity. The Board's concerns focused on the ability to measure goodwill both initially, based on the combination transaction, and subsequent to that transaction. However, the Board acknowledged that exchangeability is not a criterion of the assets definition in Concepts Statement 6 and that even though assets like goodwill may be more difficult to measure than other assets, measurement would be possible.

B124. The Board also noted that the measurement of goodwill is complicated by the potential that some or all of components 1, 2, 5, or 6 (identified in paragraph B102) might be included. However, the Board concluded that including those components in the measurement of goodwill is preferable to not recording goodwill at all.

B125. The Board further noted that measuring goodwill subsequent to its initial recognition is complicated by difficulties in determining its consumption or decline in value. However, the Board concluded that such difficulties are not unique to goodwill.

B126. The Board concluded that the measurability criterion is met, although not as readily as with many other assets, particularly with respect to measurement after initial recognition.

Relevance

B127. In assessing whether information about goodwill is relevant, the Board considered the

views of users as reported by the AICPA Special Committee ³³ and as expressed by the Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR) in its 1993 position paper, *Financial Reporting in the 1990s and Beyond*. The Board observed that users have mixed views about whether goodwill should be recognized as an asset. While some are troubled by the lack of comparability between internally generated goodwill and acquired goodwill that results under present standards, others do not appear to be particularly bothered by it. However, users appear to be reluctant to give up information about the cost of goodwill that is acquired in conjunction with a business combination and measured as part of the transaction price. In the view of the AICPA Special Committee, users want to retain the option of being able to use that information. Similarly, the FAPC stated that the amount paid for goodwill should be reported.

B128. The Board also considered the growing use of “economic value added” (EVA) ³⁴ and similar measures, which increasingly are being employed as means of assessing performance. The Board observed that such measures commonly incorporate goodwill, and in the case of business combinations that are accounted for by the pooling method, an adjustment is commonly made to incorporate a measure of the goodwill that would not be recognized under that method. As a result, the aggregate amount of goodwill is included in the base that is subject to a capital charge that is part of the EVA measure, and management is held accountable for the total investment in the acquired entities.

B129. The Board also considered evidence about the relevance of goodwill that has been provided by a number of recent research studies that empirically examined the relationship between goodwill and the market value of business entities.³⁵ Those studies generally found a positive relationship between the reported goodwill of entities and their market values, thereby indicating that investors in the markets behave as if they view goodwill as an asset. For those reasons, the Board concluded that the relevance criterion is met.

Reliability

B130. According to Concepts Statement 2, to be reliable, information about an item must be representationally faithful, verifiable, and neutral. It must also be sufficiently faithful in its representation of the underlying resource and sufficiently free of error and bias to be useful to investors, creditors, and others in making decisions. Thus, for an asset to be recognized, information about the existence and amount of an asset must be reliable.

B131. Concepts Statement 2 states that “representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent” (paragraph 63). Thus, to the extent that recorded goodwill consists of the excess of fair values over book values of the acquired entity’s net assets (component 1) or the fair values of unrecorded net assets of the acquired entity (component 2), it is not representationally faithful. However, the Board observed that this Statement contains guidance aimed at minimizing the inclusion of those components in the amount recorded for goodwill. Moreover, any problem that

would result from their inclusion is limited to mislabeling items that are all assets of some kind, which is not as serious as labeling expenses or losses as assets, in which case the amount reported for total assets would not be representationally faithful.

B132. Alternatively, recorded goodwill might include overvaluation of the consideration paid by the acquiring entity (component 5) or overpayment by the acquiring entity (component 6). To the extent that goodwill includes those components, it is including items that are not assets at all. Thus, including them in the asset described as goodwill would not be representationally faithful, nor would the amount reported for total assets be representationally faithful because it would include amounts that are not assets. The Board noted that that would constitute a more serious breach of representational faithfulness than would including components 1 or 2.

B133. However, the Board observed that it may be difficult to determine the cost attributable to each item in a basket purchase and that the acquisition cost may be difficult to determine if equity interests were used to acquire the basket of assets. The problem thus is not unique to the accounting for goodwill in conjunction with business combinations, but arises in many other situations as well. That indicates that representational faithfulness or reliability of measurement in accounting is often not an absolute, but rather one of degree.

B134. While there may be difficulties of representational faithfulness in recognizing most or all of an acquisition premium as an asset labeled goodwill for the reasons cited above, the Board observed that there are corresponding difficulties in the alternative of writing it off immediately as an expense or loss. That is because, to the extent that recorded goodwill consists of what conceptually is goodwill (components 3 and 4) and other assets (components 1 and 2), depicting those assets as expenses or losses is not representationally faithful either.

B135. Indeed, to the extent that recorded goodwill consists primarily of core goodwill and other assets, the Board observed that writing it off as an expense or loss would be less representationally faithful than recognizing it as an asset, particularly at the date of the business combination. Treating an item that primarily is an asset as an expense or loss may be said to reflect bias, which Concepts Statement 2 described as “the tendency of a measure to fall more often on one side than the other of what it represents instead of being equally likely to fall on either side. Bias in accounting measures means a tendency to be consistently too high or too low” (paragraph 77). Accordingly, the Board concluded that the reliability criterion is met.

Opposing views

B136. Some of the respondents to the 1999 Exposure Draft and the 2001 Exposure Draft argued that goodwill should be written off immediately to earnings, other comprehensive income, or equity on the basis that goodwill does not meet the assets definition or the other criteria for initial recognition. Others argued that writing goodwill off immediately would eliminate much of the difference between the financial statements of entities that grow by acquisitions and those that grow internally and would be preferable to the alternative of capitalizing internally generated goodwill. The Board observed those views in reaching its tentative decision that

goodwill should be recognized as an asset and again in certain of the responses to the Invitation to Comment that expressed disagreement with that tentative decision.

B137. In its redeliberations of the 1999 Exposure Draft, the Board affirmed its observation that goodwill does meet the assets definition and the other criteria for initial recognition and, therefore, writing it off immediately to earnings or other comprehensive income would not be representationally faithful. The Board also affirmed its observation that charging it off to equity directly without flowing through earnings or other comprehensive income could only be interpreted conceptually as a distribution to owners.

B138. The Board acknowledged that recognizing only goodwill acquired in a business combination and not goodwill that is generated internally results in differences in financial statements that make comparison more difficult. However, as it did in developing the 1999 Exposure Draft and the 2001 Exposure Draft, the Board concluded that the differences in accounting between acquired goodwill and internally generated goodwill are not unique as they also arise between other assets that are acquired and those that are internally generated.

B139. The Board also observed the potential for accounting arbitrage that might accompany a requirement that goodwill be written off immediately while other components of the acquisition premium could not be similarly written off. That sharply different treatment would provide incentives for entities to allocate more of the premium to goodwill and less to other assets in order to enhance future earnings by avoiding the future charges against earnings related to those assets.

Initial Measurement of Goodwill

B140. In developing the 1999 Exposure Draft, the Board observed that because goodwill cannot be purchased separately but only as part of business combination transactions, those transactions are necessarily the basis for initially measuring it. As such, difficulties associated with measuring the acquisition cost in those transactions can have a direct effect on the measurement of goodwill.

B141. Difficulties in measuring acquisition costs in a business combination relate largely to the nature of the consideration tendered. Concepts Statement 2 acknowledged that, stating, “The acquisition cost may also be difficult to determine if assets are acquired . . . by issuing stock . . .” (paragraph 65). Although the acquisition costs in all-cash transactions are not difficult to measure, the Board noted the potential for overvaluation (component 5) when the consideration consists wholly or partially of shares of the acquiring entity’s stock.

B142. The Board also noted that that difficulty is not unique to the measurement of goodwill, however, and extends to all the net assets acquired in a business combination in which the consideration involves equity interests of the acquiring entity. It also is not unique to business combinations and extends to any transaction in which assets or groups of assets are acquired in exchange for equity interests of the acquiring entity. However, the Board acknowledged that the

effects of those difficulties would be more pronounced for goodwill than for other assets and liabilities, since it is measured as a residual of the acquisition cost incurred.

B143. The Board also observed that even if the acquisition cost can be measured without difficulty, difficulties may arise in assigning that cost to the individual net assets acquired in the “basket purchase,” including goodwill. Although measuring some items acquired in a basket purchase is less difficult than measuring other items, particularly if they are exchangeable and traded regularly in the marketplace (or otherwise routinely obtained in transactions other than a business combination), that is not the case with goodwill, since it is not exchangeable. However, many other assets acquired in a business combination—especially many intangible assets—are not traded regularly or otherwise routinely obtained in other transactions. As a result, assigning a portion of the cost of the acquisition to goodwill is not necessarily more difficult than it is for those other assets.

B144. Despite those difficulties, the Board believes that knowledgeable users of financial statements can and do understand the limitations inherent in accounting for goodwill. The Board also believes that users are generally familiar with and understand the present requirements in Opinion 16 for initially measuring purchased goodwill.

B145. The Board therefore concluded that the approach to initial measurement of goodwill that is taken in Opinion 16 is appropriate and that no other alternative identified would be a significant improvement. The Board expressed concern about measuring goodwill as a residual but acknowledged that there is no other real measurement alternative, since goodwill is not separable from the entity or exchangeable.

B146. Accordingly, the 1999 Exposure Draft and 2001 Exposure Draft proposed that goodwill should be measured initially as the excess of the cost of the acquired entity over the fair value of the net assets acquired, consistent with the requirements of Opinion 16. In that regard, the Board noted that acquiring entities should make every effort (a) to measure the purchase consideration accurately, (b) to record the fair values rather than the book values of net assets acquired, and (c) to ensure that all intangible assets not previously recorded are recorded so that those items are not included in what is recognized as goodwill. Few respondents to those Exposure Drafts commented on that requirement or suggested alternative measurement approaches. The Board affirmed that requirement in its redeliberations.

Initial recognition and measurement of intangible assets other than goodwill

Definition of intangible assets

B147. In the deliberations that led to the 1999 Exposure Draft, the Board concluded that the characteristics that distinguish intangible assets from other assets are that they are (a) without physical substance, (b) not financial instruments, and (c) not current assets. The 1999 Exposure Draft defined intangible assets in terms of those characteristics. Several respondents to that

Exposure Draft noted that some intangible assets (such as order or production backlogs) are current assets. They observed that some might interpret the proposed definition in the 1999 Exposure Draft as prohibiting recognition of those intangible assets apart from goodwill, which they believed was not the Board's intent. The Board agreed with those respondents and decided that this Statement should define intangible assets more broadly, that is, as assets (not including financial assets) that lack physical substance.

Distinguishing intangible assets from goodwill

B148. At the inception of this project, the Board observed that intangible assets make up an increasing proportion of the assets of many (if not most) entities. The Board also observed that intangible assets acquired in a business combination often were included in the amount recognized as goodwill, despite the provisions in Opinion 16 that required they be recognized apart from goodwill.

B149. For two primary reasons, the Board concluded that this Statement should provide explicit criteria for determining whether an acquired intangible asset should be recognized apart from goodwill. First, the Board affirmed the conclusion it reached prior to issuance of the 1999 Exposure Draft that the decision usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill. As stated in Concepts Statement 5:

Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogenous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar. [paragraph 20]

B150. Second, for several Board members, having explicit criteria that determine whether an acquired intangible asset should be recognized apart from goodwill was important to their decision that goodwill is an indefinite-lived asset that should no longer be amortized. Absent such criteria, many more finite-lived intangible assets would be included in the amount recognized as goodwill.

B151. In developing the 1999 Exposure Draft, the Board considered various characteristics that might distinguish other intangible assets from goodwill. Based on the Board's conclusion that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill, the 1999 Exposure Draft proposed that intangible assets that are identifiable and reliably measurable should be recognized as assets apart from goodwill. Most respondents to the 1999 Exposure Draft agreed that many intangible assets are identifiable and that various

intangible assets are reliably measurable. Many of those respondents generally agreed that the proposed recognition criteria would improve the transparency of financial reporting for business combinations—a primary objective of this project. However, respondents' views on the proposed recognition criteria varied. Many of those respondents suggested alternative recognition criteria and many urged the Board to clarify the term *reliably measurable*.

B152. The Board considered those suggestions and decided to modify the proposed recognition criteria to provide a clearer distinction between intangible assets that should be recognized apart from goodwill and those that should be subsumed into goodwill. The 2001 Exposure Draft reflected the Board's conclusion that an intangible asset should be recognized apart from goodwill if it meets the asset recognition criteria in Concepts Statement 5 and if either (a) control over the future economic benefits of the asset results from contractual or other legal rights (the contractual-legal criterion) or (b) the intangible asset is capable of being separated or divided and sold, transferred, licensed, rented, or exchanged (either separately or as part of a group of assets) (the separability criterion). The Board concluded that sufficient information should exist to reliably measure the fair value of that asset if an asset has an underlying contractual or legal basis or if it is capable of being separated from the entity. Thus, the change in the recognition criteria eliminated the need to explicitly include reliably measurable as a recognition criterion or to clarify the meaning of that term.

B153. In developing those recognition criteria, the Board acknowledged that they would result in some finite-lived intangible assets being subsumed into the amount initially recognized as goodwill. The Board concluded, however, that the advantages of the revised criteria (in particular, greater consistency in their application) outweighed the disadvantages of recognizing some finite-lived intangible assets as part of goodwill.

B154. Most of the respondents to the 2001 Exposure Draft that commented on the revised recognition criteria agreed that they were an improvement over the recognition criteria proposed in the 1999 Exposure Draft. However, some of those respondents suggested alternative recognition criteria or made other suggestions. Many of those alternative recognition criteria were similar to the suggestions made by respondents to the 1999 Exposure Draft. Paragraphs B155–B164 describe the Board's reasons for accepting some suggestions made by respondents and rejecting others.

B155. The 2001 Exposure Draft proposed that an intangible asset would need to meet the asset recognition criteria in Concepts Statement 5 in order to be recognized apart from goodwill. Several respondents to that Exposure Draft said that inclusion of that criterion was inconsistent with the Board's stated presumption that an intangible asset that meets the contractual-legal criterion or the separability criterion also would meet the asset recognition criteria. The Board agreed with those respondents that it was not necessary to explicitly state that an intangible asset that meets the recognition criteria in paragraph 39 also meets the asset recognition criteria in Statement 5.

Reasons for the contractual-legal criterion

B156. In considering alternative recognition criteria, the Board observed that in contrast to goodwill, the values of many intangible assets arise from rights conveyed legally by contract, statute, or similar means. For example, franchises are granted to automobile dealers, fast-food outlets, and professional sports teams. Trademarks and service marks may be registered with the government. Contracts are often negotiated contracts with customers or suppliers. Technological innovations are often protected by patents. In contrast, the value of goodwill arises from the collection of assembled assets that make up an acquired entity or the value created by assembling a collection of assets through a business combination, such as the synergies that are expected to result from combining one or more businesses. In developing the 2001 Exposure Draft, the Board concluded that the fact that an intangible asset arises from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill and, therefore, acquired intangible assets with that characteristic should be recognized as an asset apart from goodwill. The Board affirmed that conclusion in its redeliberations of the 2001 Exposure Draft.

Reasons for the separability criterion

B157. In reconsidering the recognition criteria proposed in the 1999 Exposure Draft, the Board also noted that although some intangible assets do not arise from rights conveyed by contract or other legal means, they are nonetheless capable of being separated from the acquired entity and exchanged for something else of value. Others, like goodwill, cannot be separated from an entity and sold or otherwise transferred. The Board concluded that separability is another important characteristic that distinguishes many intangible assets from goodwill and, therefore, acquired intangible assets with that characteristic should be recognized as assets apart from goodwill. The Board affirmed that conclusion in its redeliberations of the revised Exposure Draft.

B158. The 2001 Exposure Draft proposed that an intangible asset that was not separable individually would meet the separability criterion if it could be sold, transferred, licensed, rented, or exchanged along with a group of related assets or liabilities. Some respondents to that Exposure Draft suggested that the Board eliminate that requirement, arguing that unless the asset is separable individually it should be included in the amount recognized as goodwill. Others suggested the Board clarify the meaning of the term *group of related assets*, noting that even goodwill can be separated from the acquired entity if the asset group sold constitutes a business.

B159. As it did prior to issuing the 2001 Exposure Draft, the Board noted that some intangible assets are so closely related to another asset or liability that they are usually sold as a “package” (as is the case with deposit liabilities and the related depositor relationship intangible asset). The Board concluded that if those intangible assets were subsumed into goodwill, gains might be inappropriately recognized if the intangible asset was later sold along with the related asset or obligation. However, the Board agreed that the proposed requirement to recognize an intangible asset separately from goodwill if it could be sold or transferred as part of an asset group was a

broader criterion than it had intended. For those reasons, this Statement states that an intangible asset that is not separable individually meets the separability criterion if it can be separated and divided from the entity and sold, transferred, licensed, rented, or exchanged in combination with a related contract, other asset, or liability.

B160. At the suggestion of some respondents to the 2001 Exposure Draft, the Board considered explicitly limiting the separability criterion to intangible assets that are separable *and* that trade in observable exchange transactions. While the Board agreed that exchange transactions provide evidence of an asset's separability, it concluded that those transactions were not necessarily the only evidence of separability. Therefore, the Board concluded that it should not limit the recognition of intangible assets that meet the separability criterion to only those that are traded in observable exchange transactions.

B161. Several respondents to the 2001 Exposure Draft suggested that the separability criterion be modified to require recognition of an intangible asset apart from goodwill only if management of the entity *intends* to sell, lease, or otherwise exchange the asset. The Board rejected that suggestion because it does not believe that the intent to sell or otherwise exchange the asset is the relevant factor that distinguishes some intangible assets from goodwill. Rather, it is the asset's *capability* of being separated from the entity and exchanged for something else of value that is the distinction requiring that it be accounted for separately from goodwill.

Reasons for rejecting other suggested recognition criteria

B162. Some respondents to both the 1999 Exposure Draft and the 2001 Exposure Draft suggested that the Board eliminate the requirement to recognize intangible assets apart from goodwill. Others suggested that all intangible assets with characteristics similar to goodwill should be included in the amount recorded as goodwill. The Board rejected those suggestions because they would diminish rather than improve the decision usefulness of reported financial information.

B163. Some respondents to the 1999 Exposure Draft and the 2001 Exposure Draft doubted their ability to reliably measure the fair values of many intangible assets. They suggested, therefore, that the only intangible assets that should be recognized apart from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The Board rejected that suggestion. The Board noted that in a business combination, the fair value of the asset acquired—the acquired entity—is established through a bargained exchange transaction. This Statement requires allocation of that fair value to individual assets acquired, including financial assets, tangible assets, and intangible assets based on their fair values. During redeliberations of the 2001 Exposure Draft, the Board affirmed its belief that the fair value estimates for intangible assets that meet the recognition criteria in this Statement will be sufficiently reliable for the purpose of that purchase price allocation. The Board acknowledged that the fair value estimates for some intangible assets that meet the recognition criteria might lack the precision of the fair value measurements for other assets. However, the Board also concluded that the financial information that will be provided by recognizing intangible assets at

their estimated fair values is more representationally faithful than that which would be provided if those intangible assets were subsumed into goodwill on the basis of measurement difficulties. Moreover, including finite-lived intangible assets in goodwill that is not being amortized would further diminish the representational faithfulness of financial statements.

B164. Some of the Board's constituents believe that an item is not an asset if it is not separable. As it did prior to issuance of the 1999 Exposure Draft and the 2001 Exposure Draft, the Board noted that the assets definition in Concepts Statement 6 does not include separability as a necessary characteristic. Thus, although certain intangible assets meeting the contractual-legal criterion might not be separable, they do meet the assets definition.

Illustrative list of intangible assets

B165. Appendix A of the 1999 Exposure Draft included an illustrative list of identifiable intangible assets that might be acquired in a business combination (some of which did not meet the recognition criteria proposed in the 1999 Exposure Draft). The Board agreed with the respondents to the 2001 Exposure Draft that urged the Board to retain such a list in this Statement. However, because the Board changed the criteria for recognizing intangible assets apart from goodwill and decided to include on the list intangible assets meeting the recognition criteria in this Statement, the list of intangible assets in Appendix A of this Statement differs from the proposed list in the 1999 Exposure Draft. For example, the list in the Exposure Draft included customer base as an identifiable intangible asset. The Board views a customer base as a group of customers that are not known or identifiable to the entity (such as customers of a fast-food franchise). The Board concluded that a customer base does not meet the criteria for recognition apart from goodwill and, therefore, customer base is not included on the list in paragraph A14. The Board similarly concluded that other intangible assets listed in Appendix A of the 1999 Exposure Draft would not generally meet the recognition criteria in this Statement and, thus, those assets also have been excluded from the list in paragraph A14. Examples of those intangible assets include 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, and favorable government relations.

B166. The Board also removed some of the items included on the proposed list in the 1999 Exposure Draft because they represent asset categories that might include both tangible and intangible assets. For example, many different types of assets might be included in the broad category of research and development assets. Whether a specific research and development asset is an intangible asset depends on the nature of the asset.

B167. The Board noted that the list in paragraph A14 is not all-inclusive. The fact that an intangible asset that was included on the proposed list in the 1999 Exposure Draft is not listed in paragraph A14 does not mean that the intangible asset does not meet the recognition criteria in paragraph 39. The nature of each acquired intangible asset needs to be considered in determining whether the recognition criteria of this Statement are met.

Exceptions to the recognition criteria

Assembled workforce

B168. The Board recognizes that the intellectual capital of an assembled workforce is an important resource of many entities. The Board therefore decided that this Statement should address whether an assembled workforce of at-will employees should be recognized as an intangible asset apart from goodwill.

B169. Some constituents believe there are circumstances under which an assembled workforce could be viewed as meeting either the contractual-legal criterion or the separability criterion for recognition as an asset apart from goodwill. However, the Board decided not to explicitly consider whether and in what circumstances an assembled workforce would meet those criteria. The Board observed that even if an assembled workforce met the criteria for recognition as an intangible asset apart from goodwill, the technique often used to measure the fair value of that asset is replacement cost—the cost to hire and train a comparable assembled workforce. The Board believes that replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination. The 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.

Acquired research and development assets

B170. The Board also considered whether this Statement should address issues related to the accounting for research and development assets acquired in business combinations. During development of the 1999 Exposure Draft, the Board noted that some of the issues associated with acquired research and development assets are unique to those assets and not directly related to other business combinations issues. The Board concluded that it was not possible to address those issues without considering the issues associated with accounting for research and development costs generally. Consequently, the Board decided not to address them in this Statement. Therefore, neither the 1999 Exposure Draft nor the 2001 Exposure Draft proposed any change to 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* be charged to expense at the acquisition date. A few respondents to the 2001 Exposure Draft suggested that the amount of acquired research and development assets be subsumed into the amount recognized as goodwill. In its redeliberations, the Board affirmed its conclusion not to reconsider the guidance in Interpretation 4 at this time. The Board concluded that intangible assets in the scope of that Interpretation should be charged to expense at the acquisition date regardless of whether they meet the criteria

in paragraph 39 for recognition apart from goodwill.

Initial measurement of intangible assets

B171. As proposed in the 1999 Exposure Draft and consistent with the requirements of Opinion 16, intangible assets acquired in a business combination and recognized in accordance with paragraph 39 of this Statement should initially be assigned an amount based on their fair values. As noted in paragraph 7 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, in recent years the Board has identified fair value as the objective for most measurements at initial recognition. None of the respondents to the 1999 Exposure Draft suggested alternative measurement approaches.

B172. The Board noted that an intangible asset arising from a contractual or other legal rights represents the future cash flows that are expected to result from ownership of that contract or legal right. Its fair value represents the amount at which it could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. For example, the fair value of an order backlog would represent the amount a buyer would be willing to pay to acquire the future cash flows expected to arise from that order backlog.

B173. 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.

B174. Several respondents 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. The Board also noted that while many contracts or other rights (including customer contracts) are fixed in duration, past history (and industry practice) often provides evidence that the contracts or rights are generally renewed without substantial cost and effort. For example, although contracts to manage investments of mutual funds are often short-term contracts (one year or less), the Board has been informed that in many (if not most) cases those contracts are continuously renewed. The Board has also been informed that while some legal rights such as trademarks and broadcast licenses have finite legal lives, those rights are renewable and are often renewed without challenge. In cases such as those, the Board believes that estimates of future cash flows used in measuring the fair value of the acquired intangible asset likely would reflect cash flows for periods that extend beyond the remaining term of the acquired contract or legal right. The Board noted that Concepts Statement 7 discusses the essential elements of a present value measurement (paragraph 23), provides examples of circumstances in which an entity's expected cash flows might differ from the market expected cash flows (paragraph 32), and discusses the use of present value techniques in measuring the fair value of an asset or liability (paragraphs 39–54 and 75–88).

Preacquisition Contingencies

B175. This Statement carries forward without reconsideration the provisions in Statement 38, as amended, that relate to the accounting for preacquisition contingencies of purchased entities. Specifically, paragraph 40 of this Statement carries forward the requirement in paragraph 5 of Statement 38 that the amount paid for the contingent asset or liability be estimated. Paragraph 41 of this Statement carries forward the requirement in paragraph 6 that after the end of the allocation period, an adjustment that results from a preacquisition contingency other than an income tax loss carryforward should be included in the determination of net income in the period in which the adjustment is determined. Paragraphs 19–21 of the basis for conclusions of Statement 38 explain the approach the Board used in developing that guidance:

This Statement distinguishes between (a) an amount deemed to have been paid for an item that includes an element of risk and (b) the gain or loss that results from the risk assumed.

Paragraph 5 [carried forward in paragraph 40 of this Statement] requires that the amount paid for the contingent asset or liability be estimated. If its fair value can be determined, that fair value is used as the basis for recording the asset or liability. Otherwise, an amount determined on the basis of criteria drawn from Statement 5 is used as the best available estimate of fair value. In accordance with the rationale of Opinion 16 (which requires that all assets and liabilities of the acquired enterprise, whether recorded or unrecorded, be identified and recorded by the acquiring enterprise and that only the residual purchase price that cannot be allocated to specific assets and liabilities be allocated to goodwill) this Statement allows a period of time (the “allocation period”) for discovery and quantification of preacquisition contingencies.

Paragraph 6 [carried forward in paragraph 41 of this Statement] requires that subsequent adjustments of the amounts recorded as a part of the purchase allocation be included in the determination of net income in the period in which the adjustments are determined. In contrast to the amounts deemed paid for the asset or liability, those subsequent adjustments are gains or losses that result from the uncertainties and related risks assumed in the purchase.

B176. Paragraph 22 of the basis for conclusions of Statement 38 also explains the differences between the accounting for contingent consideration and the accounting for preacquisition contingencies, as follows.

The following examples illustrate the relationship of the accounting for contingent consideration to the nature of the agreement and contrast the nature of each agreement with the nature of a preacquisition contingency:

- a. If the contingent consideration is based on subsequent earnings, the additional consideration, when determinable, increases the purchase price because the increased value that was purchased has been demonstrated. Additional goodwill was proven to exist by the achievement of the specified level of earnings. In contrast, when an enterprise changes its estimate of a preacquisition contingent liability, there is nothing to indicate that additional value has been created. A payment is expected to be required, but the payment does not demonstrate that an asset exists or is more valuable than before the payment was anticipated.
- b. If the contingent consideration represents payment of amounts withheld to insure against the existence of contingencies, neither the payment of the contingent consideration nor the payment of a liability that results from the contingency with the funds withheld affects the acquiring enterprise's accounting for the business combination. The escrow is a way of protecting the buyer against risk. The buyer has agreed to pay the amount either to the seller or to a third-party claimant; and thus, the only uncertainty to the buyer is the identity of the payee. The amount of the agreed consideration that is withheld would be recorded as part of the purchase price in the original allocation. In contrast, a change in an estimate of a preacquisition contingency for which the acquiring enterprise assumed responsibility represents a change in the total amount that will be paid out or received by the acquiring enterprise. The buyer assumed the risk and is subject to the results of that risk.

B177. In developing Statement 38, the Board concluded that the provisions of that Statement should not be applied to contingencies that arise from the acquisition and that did not exist prior to the acquisition (such as contingencies related to litigation over the acquisition and the tax effect of the purchase). Paragraph 23 of Statement 38 explains the basis for that conclusion:

A number of respondents to the Exposure Draft questioned whether this Statement should be applied to contingencies that arise from the acquisition and that did not exist prior to the acquisition. Examples provided included litigation over the acquisition and the tax effect of the purchase. The Board concluded that such contingencies are the acquiring enterprise's contingencies, rather than preacquisition contingencies of the acquired enterprise. Accordingly, Statement 16 applies to those contingencies after the initial purchase allocation.

B178. Also 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. As was explained in paragraphs 24 and 25 of Statement 38:

Some believe that a distinction should be made based on whether contingencies were known to the acquiring enterprise at the date of the purchase. In their opinion, the initial recorded estimate for contingencies that were identified at the date of the purchase should be an adjustment of the purchase price and its allocation regardless of when that estimate becomes determinable. The acquiring enterprise agreed to assume those identified contingencies as a condition of the purchase, and presumably that assessment was considered directly in arriving at the purchase price; accordingly, they should be accounted for as part of the purchase. On the other hand, the discovery of contingent assets or liabilities that were *not* identified at the date of the purchase should not affect the allocation of a purchase price because unknown contingencies could not enter directly in the determination of the purchase price and discovery of unexpected assets or liabilities should not affect cost assigned to the other assets and liabilities acquired.

The Board rejected the approach outlined in paragraph 24 for a number of reasons, including the following:

- a. An approach that would base the allocation of the purchase price on whether an item was known to the acquiring enterprise at the date of the purchase would conflict with the requirements of Opinion 16 for allocation of the cost of an enterprise accounted for by the purchase method. Paragraph 87 of Opinion 16 [carried forward without reconsideration in paragraph 36 of this Statement] requires the acquiring enterprise to assign "a portion of the cost of the acquired company" to "all identifiable assets acquired . . . and liabilities assumed . . . , whether or not shown in the financial statements of the acquired company." The reference to "identifiable" does not indicate an intent to limit the allocation to items that were known at the date of the purchase.
- b. A distinction based on whether contingencies were known to the acquiring enterprise at the date of the purchase could be viewed as only partially reflecting the economics of many purchase combinations. Many factors affect the purchase

price in a business combination. Known contingencies would be one of those factors. Other factors might include amounts of earnings, demonstrated growth in earnings, and unknown preacquisition contingencies, the potential existence of which would nevertheless enter into an assessment of risk and affect the purchase price.

c. If all preacquisition contingencies that result from a cause that was identified at the date of the purchase were considered part of the purchase consideration, the distinction between an identified contingency and one that was not identified would be vague.

d. A requirement that initial recorded estimates for some contingencies be recorded as adjustments of the purchase allocation could discourage an enterprise from recording timely estimates.

B179. In Statement 38, the Board also considered and rejected an approach that would exclude from income of the acquiring entity all adjustments that result from preacquisition contingencies. Paragraph 27 of Statement 38 cited the following as the Board's reasons for rejecting that approach:

a. The usual practice in the current accounting environment is for irregularly occurring costs that result from risks assumed by the enterprise to be reflected in income when they occur. The Board did not believe that it should differentiate between risks assumed by purchase and other business risks.

b. The distinction between an adjustment related to a preacquisition contingency and an adjustment that results from current events is not always clear. For example, an enterprise may settle litigation because the cost of a successful defense would exceed the cost of the settlement. The opinion of counsel may be that the case can be successfully defended. In that case, whether the cost of the settlement relates to the preacquisition event that is the stated cause of the litigation or to the current litigious environment is not clear.

B180. As was explained in paragraph 28 of Statement 38, the Board also considered whether all adjustments related to preacquisition contingencies should be included in income of the acquired entity in the period in which the adjustments are determined:

[Some] note that Statement 16 requires accruals of estimated losses from loss contingencies to be included in income in the period in which they are determined, and they believe that contingencies assumed through purchase should be accounted for the same as other contingencies. Although the Board generally agreed, it concluded that an "allocation period" was needed to permit adequate time to make reasonable estimates for the purchase allocation required by Opinion 16.

Criteria for amount to be included in purchase allocation

B181. In developing Statement 38, the Board noted that a requirement to recognize contingent assets in the allocation of the purchase price could be viewed as inconsistent with the practice described in paragraph 17(a) of Statement 5 that "contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." As discussed in paragraph 30 of Statement 38, "The Board concluded that this usual practice is not applicable to a purchase allocation because revenue does not result from such an allocation; rather, the question is whether to allocate amounts paid to identifiable assets that have value or to goodwill."

B182. During the development of Statement 38, the Board considered comments made by constituents that the fair value of a preacquisition contingency can sometimes be determined and that that fair value might not equal the amount determined in accordance with the criteria in Statement 5. As explained in paragraphs 32 and 33 of Statement 38, the Board decided to permit recording a preacquisition contingency based on its fair value if that fair value can be determined:

The Board did not intend to modify the general requirement of paragraph 87 of Opinion 16 . . . that the purchase allocation be based on the fair value of the assets acquired and the liabilities assumed. Rather, the criteria were provided because fair value of a preacquisition contingency usually would not be determinable. Accordingly, the Board added paragraph 5(a) to this Statement, to permit recording a preacquisition contingency based on its fair value if that fair value can be determined. Otherwise, paragraph 5(b) requires that the amount recorded be based on the criteria included in the Exposure Draft.

Some respondents to the Exposure Draft inquired whether it would be appropriate to base the amount recorded on the present value of the amount determined in accordance with the criteria in paragraph 5(b) because the nature of the resulting amount would be a monetary asset or liability. The Board concluded that it should not specify such a requirement because the timing of payment or receipt of a contingent item seldom would be sufficiently determinable to permit the use of a present value technique on a reasonable basis. However, this Statement does not prohibit the use of a present value if appropriate.

Allocation period

B183. Paragraphs 34–38 of Statement 38 explain the Board's reasons for specifying a time period, referred to as the allocation period, during which estimates of preacquisition contingencies could be included in the purchase price allocation:

Opinion 16 provides the general principles of accounting for a business combination by the purchase method. The acquiring enterprise determines the value of the consideration given to the sellers, the present value of the liabilities assumed, and the value of the assets acquired. The total value of the consideration given and the liabilities assumed is then allocated among the

identifiable assets acquired based on their value; and the balance, if any, is allocated to "goodwill."

The Board recognizes that completion of the allocation process that is required by Opinion 16 may sometimes require an extended period of time. For example, appraisals might be required to determine replacement cost of plant and equipment acquired, a discovery period may be needed to identify and value intangible assets acquired, and an actuarial determination may be required to determine the pension liability to be accrued.

If a business combination is consummated toward the end of an acquiring enterprise's fiscal year or the acquired enterprise is very large or unusually complex, the acquiring enterprise may not be able to obtain some of the data required to complete the allocation of the cost of the purchased enterprise for inclusion in its next annual financial report. In that case, a tentative allocation might be made using the values that have been determined and preliminary estimates of the values that have not yet been determined. The portions of the allocation that relate to the data that were not available subsequently are adjusted to reflect the finally determined amounts, usually by adjusting the preliminary amount with a corresponding adjustment of goodwill.

The Board considered specifying a time period during which estimates of preacquisition contingencies could be recorded as part of the purchase allocation. The Board concluded that it should relate the recording of preacquisition contingencies in the purchase allocation to the nature and process of the allocation, rather than to an arbitrary time limit. However, to indicate the Board's intent that the defined "allocation period" should not be unreasonably extended, paragraph 4(b) notes that the existence of a preacquisition contingency for which an amount cannot be estimated does not, of itself, extend the "allocation period." For example, the existence of litigation for which no estimate can be made in advance of the disposition by a court does not extend the "allocation period." That paragraph also notes that the "allocation period" should usually not exceed one year from the consummation date.

The "allocation period" is intended to differentiate between amounts that are determined as a result of the identification and valuation process required by Opinion 16 for all assets acquired and liabilities assumed and amounts that are determined because information that was not previously obtainable becomes obtainable. Thus, the "allocation period" would continue while the acquiring enterprise's counsel was making an evaluation of a claim, but it would not continue if the counsel's evaluation were complete and resulted in the conclusion that no estimate could be made pending further negotiations with the claimant.

Preacquisition net operating loss carryforwards

B184. Also during development of Statement 38, the Board noted the similarity of preacquisition net operating tax loss carryforwards to the other types of preacquisition

contingencies. The Board decided that the accounting for net operating loss carryforwards should not be conformed to the accounting for preacquisition contingencies for those contingencies in the scope of Statement 38.

Recognition of Deferred Taxes

B185. As proposed in the 2001 Exposure Draft, Statement 142 does not permit amortization of either goodwill or intangible assets with indefinite useful lives. Several respondents to the 2001 Exposure Draft suggested that the Board consider permitting nonrecognition of deferred taxes for the differences between the carrying amount and the tax bases of goodwill and intangible assets that are not amortized (whether those differences exist at the date the assets are initially recognized or arise in future periods). Some of those respondents noted that if goodwill or other intangible assets are not amortized, the indefinite useful deferred tax liability will remain on the balance sheet until the asset is sold, completely impaired, or otherwise disposed of. In that case, settlement of that deferred tax liability could take an extremely long time. Others argued that the proposed nonrecognition of deferred tax liabilities related to goodwill and intangible assets with indefinite useful lives is analogous to two exceptions to the comprehensive recognition of deferred taxes required by FASB Statement No. 109, *Accounting for Income Taxes*—nonrecognition of deferred U.S. tax liabilities for foreign unremitted earnings and nonrecognition of a deferred tax liability for nondeductible goodwill.

B186. The Board acknowledged that its decision not to amortize goodwill and certain intangible assets creates a situation that did not exist when the Board deliberated Statement 109. However, the same arguments made by respondents to the 2001 Exposure Draft for nonrecognition of deferred tax liabilities related to goodwill and intangible assets with indefinite useful lives also were made at the time Statement 109 was developed. Those arguments were extensively studied and debated, and in the end the Board decided that Statement 109 would require comprehensive recognition of deferred taxes subject only to the limited number of exceptions identified in paragraph 9 of that Statement. In its redeliberations of the 2001 Exposure Draft, the Board concluded that this Statement should not amend Statement 109 to provide more exceptions to comprehensive recognition of deferred taxes.

Excess of the Fair Value of Acquired Net Assets over Cost

B187. In some business combinations, the amounts assigned to the acquired net assets exceed their cost. That excess (commonly referred to as negative goodwill) is referred to herein as the *excess over cost* or *excess*. The Board affirmed its belief expressed in both the 1999 Exposure Draft and the 2001 Exposure Draft that substantially all business combinations are exchange transactions in which each party receives and sacrifices commensurate value. Accordingly, an excess rarely would remain if the valuations inherent in the purchase price allocation process were properly performed. The Board affirmed the requirement proposed in both the 1999 Exposure Draft and the 2001 Exposure Draft that if an excess 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.

B188. As expressed in both the 1999 Exposure Draft and the 2001 Exposure Draft, Board members believe that, in most cases, the excess is due to measurement errors in the purchase price allocation. Therefore, the Board affirmed its conclusion that the excess should be used to adjust the amounts initially assigned to certain assets. Based on suggestions made by respondents to the 1999 Exposure Draft and the 2001 Exposure Draft, the Board concluded that the excess should be allocated on a pro rata basis to all acquired assets *except* financial assets other than investments accounted for by the equity method, assets to be disposed of by sale, deferred tax assets, prepaid assets relating to pension or other postretirement benefit plans, and any other current assets. The Board concluded that those assets should be excluded from the allocation of the excess because (with the exception of equity method investments and deferred tax assets) their fair values are generally more certain than those of other assets. The Board also observed that not excluding those assets potentially would result in ordinary gain recognition in the near term as those assets are realized.

B189. As it did prior to issuing the 1999 Exposure Draft and the 2001 Exposure Draft, the Board concluded that any excess remaining after those assets had been reduced to zero should be recognized as an extraordinary gain.

B190. Respondents to both the 1999 Exposure Draft and the 2001 Exposure Draft offered little support for the proposed treatment of the excess—particularly the requirement to record an extraordinary gain (if an excess remained after reducing the amount assigned to certain assets to zero). Respondents asserted that recognizing any gain on a purchase transaction cannot be justified conceptually. They generally favored recognizing the remaining excess as a deferred credit that would be amortized in some manner—as is done in current practice.

B191. A number of respondents also disagreed with the proposed requirement to allocate the excess to specified acquired assets—especially given the emphasis in both Exposure Drafts on initially recording assets and liabilities at their fair value. Most of those respondents suggested that the entire excess should be recognized as a deferred credit. However, a few respondents suggested that the excess should be recognized as a component of equity or as a contingent liability.

B192. While the Board acknowledged the views expressed by those respondents, it affirmed its conclusion that accounting for the excess as an unrecognizable obligation would require recognition of a credit balance that does not meet the definition of a liability in Concepts Statement 6. Moreover, if that credit balance was treated as if it was a liability, that credit balance would be reduced only when, if ever, it was determined that the related outlays had been incurred. Because of the inherent difficulties in making those determinations and because entities would not be permitted to recognize such obligations in other circumstances, the Board affirmed its conclusion that the only practical approach would be to recognize the excess as an

extraordinary gain. The Board noted that extraordinary treatment is appropriate to highlight the fact that an excess exists and to reflect the unusual nature and infrequent occurrence of the item. The Board also noted that regardless of how the excess is accounted for, it results in recognition of a gain as a result of the purchase transaction. The only issue is when that gain is recognized—immediately or in future periods.

B193. In developing the 2001 Exposure Draft the Board decided that recognition of the excess as a reduction in the amounts that would otherwise have been assigned to the assets acquired or as an extraordinary gain should be delayed in combinations involving contingent consideration. That is because, while the initial purchase price (excluding the contingent amount) could be below the fair value of the net assets acquired prior to resolution of the contingency (giving rise to an excess over cost), resolution resulting in additional consideration could significantly change that result. Thus, recognizing an extraordinary gain related to that excess when the business combination is recognized initially could result in recognition of an extraordinary gain that perhaps should not have been recognized and that may be reversed (partially or fully) if and when the contingent consideration is paid or issued. None of the respondents to the 2001 Exposure Draft specifically objected to that view and the Board affirmed it during redeliberations. Thus, this Statement requires that if a business combination involves a consideration contingency that might result in additional cost of the acquired entity, an amount equal to the lesser of the excess or the maximum amount of contingent consideration is to be recognized as if it was a liability until the consideration contingency is resolved.

Documentation at Date of Acquisition

B194. Statement 142 requires that acquiring entities assign acquired assets (including goodwill) and liabilities to reporting units. In developing the 2001 Exposure Draft, the Board concluded that entities should be required to document certain facts and circumstances surrounding the business combination for use in making those assignments. The proposed documentation requirements included the basis for and method of determining the purchase price and other information such as the reasons for the acquisition and management's expectations related to dilution, synergies, and other financial measurements. None of the respondents to that Exposure Draft commented on those requirements. The Board concluded that those documentation requirements should be retained in this Statement.

Disclosures in Financial Statements

B195. Because 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. Accordingly, the Board decided that as part of this project, it would assess the usefulness of the disclosure requirements in Opinion 16 for entities that apply the purchase method. As part of that assessment, the Board solicited input from analysts and other users of financial statements on ways to improve the disclosure requirements in Opinion 16. As it did prior to issuing the 1999 Exposure Draft, the Board concluded that the disclosure requirements in Opinion 16 should

be retained. The Board then considered whether other information should be disclosed to supplement the information provided under the disclosure requirements in Opinion 16.

B196. In developing the 1999 Exposure Draft the Board concluded that additional disclosures should be required to provide decision-useful information about the net assets acquired in a business combination. Specifically, the Board concluded that additional information should be provided relating to (a) the allocation of the purchase price to assets acquired and liabilities assumed, (b) the nature and amount of intangible assets acquired, and (c) the amount of goodwill recognized.

Disclosure of Information about the Purchase Price Allocation and Pro Forma Sales and Earnings

B197. In developing the 1999 Exposure Draft, the Board decided to require disclosure of information about the purchase price allocation, specifically, information about the amount of the step-up in assets acquired and liabilities assumed. That Exposure Draft would have required tabular disclosure of the fair values allocated to each of the major balance sheet captions and the related carrying amounts as recognized in the statement of financial position of the acquired entity immediately before its acquisition. Based on input received from analysts, the Board concluded that that information would provide users with a powerful tool for assessing the postacquisition earnings and cash flows of acquiring entities. That input also led the Board to conclude that information about the step-up in the basis of assets acquired and liabilities assumed would be more useful in assessing those postacquisition earnings and cash flows than the pro forma sales and earnings disclosures required by Opinion 16. Consequently, the 1999 Exposure Draft proposed that the pro forma disclosure requirement in Opinion 16 be eliminated.

B198. Respondents' views on the proposed requirement to disclose information about the purchase price allocation were mixed. About half of the respondents that commented on that proposed requirement agreed that the information it would provide would be useful in assessing postacquisition earnings and cash flow of the acquiring entity. The respondents that disagreed with that proposed requirement were primarily opposed to disclosure of information about the carrying amounts of assets acquired and liabilities assumed. They questioned the usefulness of that information, particularly if the financial statements of the acquired entity were not audited or if they were prepared on a basis other than U.S. generally accepted accounting principles. After considering those views, the Board affirmed its conclusion that information about the allocation of the purchase price to major balance sheet captions would be useful in assessing the amount and timing of future cash flows. However, it agreed with those respondents that information about the related carrying amounts might be of limited usefulness. Thus, this Statement requires disclosure of information about the allocation of the purchase price to each major balance sheet caption of the acquired entity but not their related carrying amounts.

B199. Respondents also expressed mixed views about the proposal to eliminate the pro forma sales and earnings disclosures required by Opinion 16. Many of the respondents supported elimination of those disclosure requirements. Those respondents said that the information

provided has little value because it is based on hypothetical assumptions and mechanical computations. Respondents that favored retaining those disclosures said that the pro forma information is useful for measuring growth and in assessing whether the synergies expected to result from the combination have been achieved. After considering respondents' views, the Board concluded that the pro forma disclosure requirements in Opinion 16 should be retained in this Statement.

B200. Several users suggested that the Board require disclosure of pro forma sales and earnings information at the reportable segment level because that information would be useful in assessing the amount and timing of future goodwill impairment losses. The Board rejected that suggestion because it concluded that the costs of preparing and disclosing that information would exceed the benefits derived from its use.

B201. The Board noted that FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*, exempts nonpublic entities from the Opinion 16 requirement to disclose supplemental pro forma information. Preparers and attestors of financial statements of nonpublic entities urged the Board to continue that exemption, arguing that the costs of preparing the pro forma information exceed the benefit of providing it. After considering those views, the Board concluded that nonpublic entities should continue to be exempt from the pro forma disclosure requirements of this Statement.

Disclosures Related to Goodwill

B202. The 1999 Exposure Draft proposed that in the year of acquisition, the notes to financial statements should include a description of the elements that underlie goodwill, the useful life of goodwill and how it was determined, and the amortization method. As a consequence of its decision that goodwill should not be amortized, the Board decided to eliminate the requirement to disclose the useful life of goodwill and the amortization method because they are not applicable under a nonamortization approach. The Board also decided to eliminate the requirement to disclose a description of the elements that underlie goodwill because its purpose was to provide a basis for assessing the appropriateness of the goodwill amortization period.

B203. The Board concluded, however, that information about the amount of goodwill, in particular the amount of goodwill by reportable segment, would be useful in assessing the amount and timing of potential goodwill impairment charges. After considering input from analysts and other users of financial statements, the Board decided that for each material business combination, the notes to the financial statements should disclose (a) the reasons for the acquisition including a description of the factors that led to the payment of a purchase price that resulted in goodwill and (b) the amount of goodwill assigned to each reportable segment.

B204. The Board acknowledged, however, that information about the amount of goodwill by reportable segment is only useful if users also are provided information about performance at that level. The Board decided, therefore, that the requirement to disclose the amount of goodwill by reportable segment should be limited to those entities that are within the scope of FASB

Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

B205. Based on input received from analysts and other users, the Board also concluded that information about the amount of goodwill that is expected to be deducted for tax purposes is useful in assessing the amount and timing of future cash flows of the combined entity. The Board therefore decided to require disclosure of that amount if the goodwill initially recognized in a material business combination is significant in relation to the total cost of the acquired entity.

B206. Several respondents to the 2001 Exposure Draft commented on the proposed requirement to disclose goodwill by reportable segment. Half of those respondents agreed with the requirement and half suggested it be eliminated. The Board affirmed its conclusion that disclosure of that information is useful in estimating the amount and timing of future impairment losses and, thus, concluded that the disclosure requirement should be retained.

B207. Several respondents to the 2001 Exposure Draft suggested that entities be required to provide information about the methods and key assumptions that would be used in measuring the fair value of a reporting unit and the types of events that would likely give rise to a goodwill impairment test. They argued that that information is needed to make informed judgments about the timing and amount of potential future impairment losses. The Board considered similar suggestions during development of the 2001 Exposure Draft. The Board concluded that without access to management's cash flow projections and its methods of estimating those future cash flows, and information about past cash flows or earnings at the reporting unit level, the suggested disclosures would be of little benefit to users in making those judgments. In addition, the Board noted that information about methods and assumptions could be useful only if changes to those methods and assumptions are disclosed almost continuously. The Board affirmed its initial conclusions in its redeliberations of the 2001 Exposure Draft and, therefore, this Statement does not require disclosure of that information.

Disclosure of Information about Intangible Assets Other Than Goodwill

B208. The 1999 Exposure Draft proposed that certain information be disclosed in the notes to the financial statements for each major intangible asset class. The information that would have been required to be disclosed included (a) a description of the assets and the amounts assigned to them at the acquisition date, (b) the key assumptions and methodologies used to determine those amounts, (c) a description of the amortization method, and (d) the weighted-average amortization period. Many respondents to that Exposure Draft commented on the proposed disclosure requirements. Most agreed that additional information about intangible assets acquired would be useful, but many urged the Board to consider reducing the extent of the disclosure requirements. They argued that the cost of providing the information, particularly for entities that complete multiple acquisitions in a single period, would exceed the benefits derived from that information.

B209. After considering the suggestions made by those respondents, the Board affirmed its

conclusion that financial statements should provide additional information about acquired intangible assets other than goodwill. However, in view of the changes made to the proposed accounting for intangible assets and the comments made by respondents, the Board revised the disclosure requirements related to acquired intangible assets.

B210. The Board concluded that if the amount assigned to intangible assets is significant in relation to the total cost of an acquired entity, the following information should be disclosed because it is useful in assessing the amount and timing of future cash flows: (a) the total amount assigned to intangible assets subject to amortization and the total amount assigned to those that are not subject to amortization, (b) the amount assigned to each major intangible asset class, and (c) for intangible assets subject to amortization, the weighted-average amortization period in total and for each major intangible asset class. The Board also concluded that disclosure should be made, both in total and for each major intangible asset class, of the amount of any significant residual value assumed.

B211. Although not proposed in the 1999 Exposure Draft, at the suggestion of respondents the Board also decided to require disclosure of the amount of research and development assets acquired and written off at the date of acquisition in accordance with Interpretation 4, as well as the line item in which those write-offs are aggregated.

Other Disclosure Requirements

B212. The 1999 Exposure Draft proposed disclosure of certain information (as provided for in paragraph 53) if a series of immaterial business combinations were completed in a reporting period that are material in the aggregate. The Board affirmed that requirement, noting that it is consistent with Opinion 16.

B213. In addition, the 1999 Exposure Draft proposed that the information required to be disclosed for a completed business combination would also be disclosed for a material business combination completed after the balance sheet date but before the financial statements are issued (unless disclosure of such information is not practicable). The Board concluded that that disclosure requirement should be retained in this Statement, noting that none of the respondents to the 1999 Exposure Draft commented on that disclosure requirement and that the requirement is consistent with subsequent-events literature within the auditing standards.

Disclosures in Interim Financial Information

B214. Several analysts and other users recommended that the Board consider requiring disclosure of supplemental pro forma sales and earnings information in interim financial information. They argued that that information would be more useful if it was available on a timelier basis. Board members noted that APB Opinion No. 28, *Interim Financial Reporting*, requires disclosures about completed business combinations but does not specify what those disclosures should be. The Board agreed with the suggestion that it amend Opinion 28 to require disclosure of pro forma sales and earnings information in interim financial information.

Effective Date and Transition

Method of Accounting for Business Combinations

B215. The 1999 Exposure Draft proposed that the requirements of this Statement would be effective for business combinations initiated after the date this Statement is issued. A number of respondents to that Exposure Draft suggested the Board consider deferring the effective date for three to six months after issuance to provide time for analysis, interpretation, and implementation of this Statement. The Board affirmed its conclusion that deferral of the effective date would not be necessary because its constituents will have had sufficient time to consider the implications of the Board's decision on planned transactions and because application of the purchase method to all business combinations will not create significant new implementation issues. Thus, the Board concluded that the requirements of this Statement should be applied to business combinations initiated after June 30, 2001. As with the 1999 Exposure Draft, this Statement uses the Opinion 16 definition of initiation date. According to that definition, a business combination is initiated on the earlier of (a) the date that the major terms of a plan are announced publicly or otherwise formally made known or (b) the date that stockholders of a combining entity are notified in writing of an exchange offer.

B216. In reaching its decision on the effective date, the Board noted that business combinations generally are undertaken for strategic and economic considerations that are largely independent of accounting standards. However, the effect of the proposed transaction on postcombination reported earnings commonly is considered by entities in planning and negotiating those transactions. Prospective application for transactions initiated after this Statement is issued therefore avoids situations in which transactions are planned using one accounting standard and accounted for using another.

B217. In developing the 1999 Exposure Draft, the Board concluded that business combinations recorded prior to the issuance of this Statement and business combinations in process when this Statement is issued should be "grandfathered" under Opinion 16. The Board noted that retroactive application of the purchase method to business combinations previously accounted for by the pooling method would have resulted in more comparable financial statements. However, retroactive application would be impractical or burdensome for many entities because the information needed to apply the purchase method may not exist or may no longer be obtainable. Respondents to the 1999 Exposure Draft that addressed that issue supported that decision, and the Board affirmed it in the course of its redeliberations. Several respondents to the 1999 Exposure Draft raised questions related to how the purchase method should be applied to combinations between mutual enterprises. The Board decided to defer the effective date of this Statement with respect to those transactions until interpretative guidance addressing those questions is issued.

Provisions Related to the Application of the Purchase Method

B218. This Statement changes certain requirements in Opinion 16 related to the application of the purchase method. Under the transition provisions included in the 1999 Exposure Draft, similar proposed changes would have been effective for business combinations *initiated* after the date that a final Statement was issued. Because amortization of all goodwill will cease upon initial application of Statement 142, Board members concluded that the effective date for the provisions of this Statement related to the application of the purchase method, in particular the criteria for recognition of intangible assets apart from goodwill, should be changed. Therefore, the Board concluded that this Statement should be effective for all business combinations accounted for by the purchase method for which the date of acquisition is July 1, 2001, or later.

Transition

Excess of the fair value of acquired net assets over cost

B219. In developing the 1999 Exposure Draft, the Board concluded that the provisions related to the excess of the fair values of acquired net assets over cost should be applied on a prospective basis because of the operational difficulties that retroactive application would present. The Board reconsidered that decision in developing the 2001 Exposure Draft and decided that as of the beginning of the first fiscal quarter after the date the final Statement is issued, the amount of such excess that is recorded in the statement of financial position as a deferred credit as required by Opinion 16 should be recognized as an extraordinary gain. As suggested by respondents to the 2001 Exposure Draft, the Board concluded that the amount of any excess over cost that is recorded in the statement of financial position as a deferred credit as required by Opinion 16 should be recognized as the effect of a change in accounting principle as of the earlier of either the first day of the fiscal year beginning after December 15, 2001, or the date that Statement 142 is initially applied in its entirety.

Goodwill and other intangible assets

B220. Because this Statement changes the criteria for recognizing intangible assets apart from goodwill, the Board considered whether entities should be required to reassess the intangible assets currently recognized separately in the statement of financial position and possibly reclassify intangible assets that do not meet the new recognition criteria as goodwill and vice versa. For example, some entities may have an assembled workforce recognized as a separate intangible asset, which is not permitted by this Statement. Conversely, some entities may have subsumed into goodwill acquired intangible assets that would be recognized separately under the criteria in this Statement.³⁶ The Board noted that it would be fairly straightforward to determine whether recognized intangible assets meet the new criteria for recognition apart from goodwill but that it would not be so straightforward to identify intangible assets that meet those criteria that were previously subsumed in goodwill. In developing the 2001 Exposure Draft, the Board concluded that it would not be appropriate to require the reassessment in one direction but not the other.

B221. Several respondents to the 2001 Exposure Draft urged the Board to reconsider those

proposed transition provisions, in particular the prohibition against reclassification as goodwill those recognized intangible assets that do not meet the recognition criteria in this Statement. They argued that permitting such reclassifications would improve the comparability of financial statements.

B222. The basis for conclusions to the 2001 Exposure Draft stated that if an entity had aggregated goodwill and intangible assets as one amount for reporting purposes and information exists on how the purchase price was initially allocated between goodwill and other intangible assets, that entity would be required to disaggregate existing intangible assets that meet the recognition criteria in paragraph 39 and report them separately in subsequent statements of financial position. The Board agreed that it should not require disaggregation of that type while prohibiting reclassification of recognized intangible assets that do not meet the criteria for recognition apart from goodwill. Accordingly, the Board decided to retain the disaggregation requirement proposed in the 2001 Exposure Draft and require that entities reclassify as goodwill any recognized intangible assets that do not meet the recognition criteria in paragraph 39.

B223. The Board considered whether the requirement to disaggregate existing intangible assets that meet the recognition criteria from the amount reported as goodwill would affect the recorded deferred tax balances. The Board noted that Statement 109 requires that deferred taxes be provided for differences between the book and tax bases of intangible assets acquired in a business combination. Only goodwill that is not deductible for tax purposes is exempt from that requirement. The Board concluded that the requirement to disaggregate existing intangible assets that were previously included in the amount reported as goodwill would not affect the amount of recorded deferred tax balances, as deferred taxes would have been provided for any differences between the book and tax bases of those assets.

B224. The Board then considered the consequences of reclassifying existing intangible assets as goodwill on recorded deferred tax balances. The Board concluded that when an existing intangible asset is reclassified as goodwill (because it does not meet the recognition criteria in this Statement), it should be considered goodwill for purposes of accounting for income taxes. Thus, if an intangible asset reclassified as goodwill is an asset for which amortization is not deductible for tax purposes, that asset should be considered as nondeductible goodwill that Statement 109 exempts from the requirements for deferred tax recognition. The Board concluded that any deferred tax liabilities associated with those intangible assets should be eliminated through a corresponding reduction in the carrying amount of goodwill. The Board concluded that if an intangible asset that is deductible for tax purposes is reclassified as goodwill under the transition provisions of this Statement, it should be deemed to be deductible goodwill for which recognition of deferred taxes is required. Thus, reclassification of that asset as goodwill would not affect the recorded deferred tax balances.

Benefits and Costs

B225. The mission of the FASB is to establish and improve standards of financial accounting

and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—as well as others benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B226. The Board believes that this Statement will remedy certain significant deficiencies and fill certain significant voids in financial reporting. The requirement to account for all business combinations by the purchase method will provide users of financial statements with information about the cost of those transactions that the pooling method does not provide because that method does not reflect the values exchanged in the business combination transaction. Therefore, users of financial statements will be better able to assess the initial costs of those investments. They also will be better able to assess the subsequent performance of those investments.

B227. Information about assets and liabilities also will be more complete and comparable. Assets acquired and liabilities assumed that were not previously recorded by predecessor entities will be recorded, as they would be if they had been obtained outside a business combination. Moreover, assets and liabilities that are acquired in a business combination will be measured in the same way as those assets and liabilities that are acquired by other means, either individually or in groups. Consequently, financial statement comparability will be enhanced.

B228. The Board observed that intangible assets constitute a growing share of assets for entities generally and are, in fact, most of the assets of some individual entities. However, information about the intangible assets owned by those entities is often incomplete and inadequate. The Board believes that the changes in the criteria for initial recognition of goodwill and other intangible assets acquired in business combinations will result in more information about those assets than was the case previously.

B229. This Statement also will bring the accounting for business combinations in the United States more in step with how those combinations are accounted for outside the United States. The Board observed that widespread use of the pooling method is largely a phenomenon in the United States and that use of that method in other countries around the world is rare in many jurisdictions and prohibited in others. Consequently, investors will be better able to compare the financial statements of U.S. entities that enter business combinations with those of foreign entities that have engaged in business combinations. Furthermore, this Statement will be an important step in the process of achieving greater convergence of cross-border accounting requirements generally, consistent with the Board's mission statement. That, in turn, will reduce costs now borne by preparers, auditors, and users of financial statements alike, as well as facilitate the efficient allocation of capital globally.

B230. The Board believes that preparers and auditors of financial statements domestically also will benefit from this Statement. The existence of two methods of accounting for similar business combinations that produce such dramatically different financial statement results often puts preparers of financial statements under pressure to obtain the accounting treatment that is deemed to have the more favorable effect on the earnings that are reported postcombination. As a result, the Board has been informed that the ability or inability to use the pooling method is perceived by many to affect competition for mergers and acquisitions, including whether those transactions are entered into and the prices that are negotiated for them. However, there are often uncertainties about whether entities can qualify to use the favored method, and those uncertainties can lead to conflicts between preparers, auditors, and regulators in interpreting and applying those qualifying criteria. This Statement removes those uncertainties.

B231. The Board observed that business entities often incur significant costs in seeking to use the pooling method. Those costs are both monetary and nonmonetary as entities try to position themselves to meet the criteria to qualify for use of that method and sometimes take actions that those entities might not otherwise take or refrain from taking actions that they might otherwise take. This Statement removes the need to incur those costs.

B232. The Board believes that the guidance in this Statement is not overly complex. Indeed, it eliminates guidance that many have found to be complex, costly, and arbitrary, and that has been the source of considerable uncertainties and costs in the marketplace. Moreover, this Statement does not introduce a new method of accounting but rather expands the use of an existing method that is familiar, has been widely used, and for which there is a substantial base of experience.

B233. Some argue that the pooling method is less costly to apply than the purchase method and thus a requirement to use only the purchase method will impose costs on preparers. However, as noted above, preparers of financial statements often incur significant costs in attempting to qualify to use the pooling method, and those costs may be greater than the costs incurred in applying the purchase method. Moreover, the use of two methods that produce such dramatically different financial statement outcomes makes it difficult or impossible for users to compare the financial statements of entities that have accounted for their business combinations by different methods. Use of the pooling method also makes it difficult or impossible for users to compare the financial statements of entities that acquire their assets in business combinations accounted for by that method with the financial statements of entities that purchase their assets individually or in groups rather than by means of business combinations. Therefore, the Board believes that this Statement will not impose aggregate costs greater than those that have been borne previously and instead should reduce some costs significantly.

B234. The Board has sought to reduce the costs of applying this Statement and facilitate transition to its requirements by making its provisions with respect to the method to be used to account for business combinations prospective rather than retroactive.

Appendix C: ILLUSTRATIONS

Introduction

C1. This appendix provides illustrations of some of the disclosure requirements of this Statement. The information is presented for illustrative purposes only and, therefore, may not be representative of actual transactions.

Illustration 1—Disclosure of a Material Business Combination in the Year of Acquisition

C2. The following illustrates the disclosures required if a material business combination is completed during the reporting period (paragraphs 51 and 52).

Footnote C: Acquisitions (dollars in thousands)

On June 30, 20X2, Alpha acquired 100 percent of the outstanding common shares of Beta. The results of Beta's operations have been included in the consolidated financial statements since that date. Beta is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, Alpha is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.

The aggregate purchase price was \$9,400, including \$7,000 of cash and common stock valued at \$2,400. The value of the 100,000 common shares issued was determined based on the average market price of Alpha's common shares over the 2-day period before and after the terms of the acquisition were agreed to and announced.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. Alpha is in the process of obtaining third-party valuations of certain intangible assets; thus, the allocation of the purchase price is subject to refinement.

At June 30, 20X2	
(\$000s)	
Current assets	\$ 2,400
Property, plant, and equipment	1,500
Intangible assets	4,900
Goodwill	<u>2,200</u>

Total assets acquired	<u>11,000</u>
Current liabilities	(500)
Long-term debt	<u>(1,100)</u>
Total liabilities assumed	<u>(1,600)</u>
Net assets acquired	<u>\$ 9,400</u>

Of the \$4,900 of acquired intangible assets, \$1,400 was assigned to registered trademarks that are not subject to amortization and \$1,000 was assigned to research and development assets that were written off at the date of acquisition in accordance with FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*. Those write-offs are included in general and administrative expenses. The remaining \$2,500 of acquired intangible assets have a weighted-average useful life of approximately 4 years. The intangible assets that make up that amount include computer software of \$1,500 (3-year weighted-average useful life), patents of \$800 (7-year weighted-average useful life), and other assets of \$200 (5-year weighted-average useful life).

The \$2,200 of goodwill was assigned to the technology and communications segments in the amounts of \$1,300 and \$900, respectively. Of that total amount, \$250 is expected to be deductible for tax purposes.

Illustration 2—Disclosures in Year of Acquisition of Several Individually Immaterial Business Combinations That Are Material in the Aggregate

C3. The following illustrates the disclosures required if a series of individually immaterial business combinations are completed during a period that are material in the aggregate (paragraph 53). The illustration assumes that Alpha completed four business combinations, one during each quarter of its fiscal year ending December 31, 20X3.

Footnote C: Acquisitions (dollars in thousands)

In 20X3, Alpha acquired the following 4 entities for a total cost of \$1,000, which was paid primarily in cash:

- Omega Consulting, based in Zurich, Switzerland, a leading provider of telecommunications consulting services
- Nittany Systems, based in Toronto, Canada, a producer of digital networking technology
- Sherman Communications, Inc., based in Portland, Oregon, a start-up data networking company
- Blue and White Networks, Inc., based in Atlanta, Georgia, a designer and

manufacturer of wireless communications networks.

Goodwill recognized in those transactions amounted to \$300, and that amount is expected to be fully deductible for tax purposes. Goodwill was assigned to the communication and technology segments in the amounts of \$120 and \$180, respectively.

Appendix D: CONTINUING AUTHORITATIVE GUIDANCE

Introduction

D1. APB Opinion No. 16, *Business Combinations*, required that the pooling-of-interests method (pooling method) be used if a business combination met certain criteria. This Statement prohibits the use of the pooling method for business combinations initiated after June 30, 2001. This Statement supersedes Opinion 16 and the AICPA Accounting Interpretations of that Opinion that provide guidance on applying the pooling method. This appendix carries forward, without reconsideration, guidance in Opinion 16 and its interpretations that may be helpful in applying the transition provisions of this Statement and in accounting for past transactions to which the pooling method was applied (paragraphs D4–D10).

D2. Consistent with the provisions of Opinion 16, the provisions of this Statement do not apply to transfers of net assets or exchanges of shares between entities under common control. Guidance in Opinion 16 and an interpretation of that Opinion that has been used in past practice to account for those transactions also is carried forward without reconsideration in this appendix (paragraphs D11–D18).

D3. The following guidance has been quoted, paraphrased, or modified as necessary so that it can be understood in the context of this Statement. The original source of the guidance is noted parenthetically or otherwise. Some of that guidance may be reconsidered by the Board in another project.

Initiation Date of a Business Combination

D4. Paragraph 59 of this Statement carries forward the Opinion 16 definition of *initiated* as it relates to a business combination. Paragraphs D5–D8 carry forward without reconsideration the interpretations of Opinion 16 that provide guidance relating to that definition. That guidance should be considered in applying the transition provisions of this Statement.

D5. A business combination is not initiated until the major terms are set and announced publicly or formally communicated to the shareholders who will tender their shares to the issuing corporation. A corporation may communicate to its own shareholders its intent to make a tender

offer or to negotiate the terms of a proposed business combination with another company. However, intent to tender or to negotiate does not constitute "initiation." A business combination is not initiated until the major terms are "set" and announced publicly or formally communicated to shareholders. Paragraph 59 of this Statement defines initiation in terms of two dates. The first date is for the announcement of an exchange offer negotiated between representatives of two (or more) corporations. The second date is for a tender offer made by a corporation directly or by newspaper advertisement to the shareholders of another company. In the second date specified for initiation, a *combining company* refers to the company whose shareholders will tender their shares to the issuing corporation. An *exchange offer* refers to the major terms of a plan including the ratio of exchange (or formula to determine that ratio). A corporation may communicate to its *own* shareholders its intent to make a tender offer or to negotiate the terms of a proposed business combination with another company. However, intent to tender or to negotiate does not constitute initiation (AICPA Accounting Interpretation 2, "Notification to Stockholders," of Opinion 16).

D6. To constitute initiation of a business combination, the actual exchange ratio (1 for 1, 2 for 1, and so forth) of shares need not be known provided that the ratio of exchange is absolutely determinable by objective means in the future. A formula would usually provide such a determination. A formula to determine the exchange ratio might include factors such as earnings for a period of time, market prices of shares at a particular date, average market prices for a period of time, and appraised valuations. The formula may include upper limits, lower limits, or both for the exchange ratio, and the limits may provide for adjustments based on appraised valuations, audits of the financial statements, and so forth. However, to constitute initiation of a business combination, the formula must be announced or communicated to shareholders. Any subsequent changes in the terms of a formula used to initiate a business combination constitute a new plan of combination. That new plan of combination would be accounted for in accordance with the provisions of this Statement (AICPA Accounting Interpretation 1, "Ratio of Exchange," of Opinion 16).

D7. A business combination also may be initiated at the date the shareholders of a closely held company grant an option to exchange shares at a future date to another company. The terms of the grant must require unilateral performance by either party or bilateral performance by both parties in order to constitute initiation of a business combination. Thus, if one company is required to issue shares upon the tendering of shares by the shareholders of another company, or if the shareholders are required to tender their shares upon demand, the date the option is granted is the initiation date. However, an agreement that grants only the right of first refusal *does not* constitute initiation of a business combination. For example, if the shareholders of a closely held company decide to consider entering into a business combination in the future and the shareholders agree to negotiate with one company before negotiating with any other company, a business combination has not been initiated. Neither party may be obligated to perform or to pay damages in the absence of performance (AICPA Accounting Interpretation 29, "Option May Initiate Combination," of Opinion 16).

D8. Termination of a plan of combination prior to shareholder approval has an effect on the initiation date of a business combination. If negotiations of a plan of combination are formally terminated and then are subsequently resumed, the subsequent resumption always constitutes a new plan. Formal announcement of the major terms of the new plan constitutes a new initiation date, even if the terms are the same as the terms of the previously terminated plan. In such circumstances, if the new initiation date falls after June 30, 2001, that combination should be accounted for in accordance with the provisions of this Statement (AICPA Accounting Interpretation 10, "Effect of Termination," of Opinion 16).

Disposition of Assets after a Combination Accounted for Using the Pooling Method

D9. Following a business combination accounted for by the pooling method, the combined entity might dispose of assets of the previously separate entities. Unless those disposals are part of customary business activities of the combined entity, any gain or loss recognized resulting from that disposition might require recognition as an extraordinary item. Recognition as an extraordinary item is warranted because the pooling method of accounting would have been inappropriate if the combined entity had made a commitment or had planned to dispose of a significant part of the assets of one of the combining entities.

D10. The combined entity should recognize the gain or loss resulting from the disposal of a significant part of the assets or a separable segment of the previously separate entities, less applicable income tax effect, as an extraordinary item if (a) the gain or loss is material in relation to the net income of the combined entity and (b) the disposition is within two years after the combination is consummated (Opinion 16, paragraph 60).

Transactions between Entities under Common Control

D11. Consistent with the provisions of Opinion 16, paragraph 11 of this Statement states that the term *business combination* excludes transfers of net assets or exchanges of shares between entities under common control. The following are examples of those types of transactions:

- a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.
- b. A parent 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.

D12. When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.

D13. The purchase method of accounting shall be applied if the effect of the transfer or exchange described in paragraph D11 is the acquisition of all or a part of the noncontrolling equity interests in a subsidiary (refer to paragraph 14).

Procedural Guidance

D14. Some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. In practice, the method that many entities have used to account for those transactions is similar to the pooling method. Certain provisions in Opinion 16 relating to application of the pooling method provide a source of continuing guidance on the accounting for transactions between entities under common control. Paragraphs D15–D18 provide procedural guidance that should be considered when preparing financial statements and related disclosures for the entity that receives the net assets.

D15. In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying values of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would otherwise have been appropriate. Any such change in accounting method should be applied retroactively, and financial statements presented for prior periods should be restated (Opinion 16, paragraph 52).

D16. The financial statements of the receiving entity should report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intercompany transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intercompany transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible. The nature of and effects on earnings per share of nonrecurring intercompany transactions involving long-term assets and liabilities need not be eliminated but should be disclosed (Opinion 16, paragraph 56).

D17. Similarly, the receiving entity should present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had

been transferred at that date. Financial statements and financial information presented for prior years should also be restated to furnish comparative information. All restated financial statements and financial summaries should indicate clearly that financial data of previously separate entities are combined (Opinion 16, paragraph 57).

D18. Notes to financial statements of the receiving entity should disclose the following for the period in which the transfer of assets and liabilities or exchange of equity interests occurred:

- a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests
- b. The method of accounting for the transfer of net assets or exchange of equity interests.

Appendix E: AMENDMENTS TO EXISTING PRONOUNCEMENTS

E1. This Statement supersedes the following pronouncements:

- a. APB Opinion No. 16, *Business Combinations*
- b. All of the AICPA Accounting Interpretations of Opinion 16
- c. FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations*
- d. FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*
- e. FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*.

E2. APB Opinion No. 20, *Accounting Changes*, is amended as follows:

- a. The last sentence of paragraph 12 is deleted.
- b. In the last sentence of paragraph 35, *Paragraphs 56 to 65 and 93 to 96 of APB Opinion No. 16, Business Combinations* is replaced by *Paragraphs 51–58 of FASB Statement No. 141, Business Combinations*.

E3. The fourth sentence of paragraph 21 of APB Opinion No. 28, *Interim Financial Reporting*, is amended as follows:

- a. The phrase , *business combinations treated for accounting purposes as poolings of interests and acquisition of a significant business* is replaced by *and business combinations*.
- b. The following footnote is added to the end of that sentence:

*Disclosures required in interim financial information related to a business combination are set forth in paragraph 58 of FASB Statement No. 141, *Business Combinations*.

E4. In paragraph 4(a) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, the phrase *APB Opinion No. 16, Business Combinations*, is replaced by *FASB Statement No. 141*,

Business Combinations, and the following footnote is added to the end of that paragraph:

*Paragraph 10 of Statement 141 states that an exchange of a business for a business is a business combination.

E5. 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*, is amended as follows:

- a. In the third sentence of paragraph 7, *or of APB Opinion No. 16, Business Combinations, paragraph 60*, is deleted.
- b. The following sentence is added at the end of paragraph 20:

However, the following items shall be recognized as extraordinary items regardless of whether those criteria are met:

- (1) Classifications of gains or losses from extinguishment of debt pursuant to paragraph 8 of FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*
- (2) The net effect of discontinuing the application of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, pursuant to paragraph 6 of FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*
- (3) The remaining excess of fair value of acquired net assets over cost pursuant to paragraphs 45 and 46 of FASB Statement No. 141, *Business Combinations*.

E6. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, is amended as follows:

- a. In footnote 5 to paragraph 13, *(See paragraph 67 of APB Opinion No. 16, “Business Combinations.”)* is replaced by *(See paragraph 6 of FASB Statement No. 141, Business Combinations.)*.
- b. In footnote 6 to paragraph 13, *paragraphs 88 and 89 of APB Opinion No. 16* is replaced by *paragraphs 37 and 38 of Statement 141*.
- c. In footnote 16 to paragraph 28, *(See paragraph 67 of APB Opinion No. 16.)* is replaced by *(See paragraph 6 of Statement 141.)*.

E7. In the first sentence of footnote 6 to paragraph 12 of FASB Statement No. 16, *Prior Period Adjustments*, the phrase *a change in accounting method permitted by paragraph 52 of APB Opinion No. 16*, is deleted.

E8. In the first sentence of paragraph 4 of FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers*, the following footnote is added after *APB Opinion No. 16, Business Combinations*:

*FASB Statement No. 141, *Business Combinations*, supersedes Opinion 16. However, the guidance from paragraph 88 of Opinion 16 is carried forward in paragraphs 37 and 38 of Statement 141.

E9. Paragraph 19 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, is amended as follows:

- a. In the first sentence, *APB Opinion No. 16, Business Combinations*, is replaced by *FASB Statement No. 141, Business Combinations*.
- b. The second and third sentences are deleted.

E10. In the first sentence of footnote 3 to paragraph 11 of FASB Statement No. 68, *Research and Development Arrangements*, the phrase accounted for by the purchase method is deleted.

E11. FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, is amended as follows:

- a. The first sentence of paragraph 4 is replaced by the following:

In a business combination involving the acquisition of a banking or thrift institution, intangible assets acquired that meet the criteria in paragraph 39 of FASB Statement No. 141, *Business Combinations*, shall be recognized as assets apart from goodwill.

- b. In the second sentence of paragraph 8, (*paragraphs 87 and 88 of Opinion 16*) is replaced by (*paragraphs 35–39 of Statement 141*).
- c. In the first sentence of paragraph 9, *accounted for by the purchase method* is deleted.

E12. FASB Statement No. 87, *Employers' Accounting for Pensions*, is amended as follows:

- a. In the first sentence of paragraph 74, *that is accounted for by the purchase method under Opinion 16* is deleted.
- b. In the first sentence of Illustration 7—Accounting for a Business Combination, in paragraph 261, *accounted for as a purchase* is deleted.

E13. Paragraph 134(g) of FASB Statement No. 95, *Statement of Cash Flows*, is amended as

follows:

- a. At the end of the first sentence, *in a business combination* is added.
- b. The second sentence is deleted.

E14. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, is amended as follows:

- a. In the first sentence of paragraph 86, *that is accounted for by the purchase method under Opinion 16* is deleted.
- b. In the first sentence of paragraph 444, *and accounts for the business combination as a purchase pursuant to APB Opinion No. 16, Business Combinations* is replaced by *in a business combination*.

E15. FASB Statement No. 109, *Accounting for Income Taxes*, is amended as follows:

- a. In the heading to paragraph 11(h), *accounted for by the purchase method* is deleted.
- b. In the first sentence of paragraph 11(h), *accounted for as a purchase under APB Opinion No. 16, Business Combinations* is deleted.
- c. In the last sentence of paragraph 13, *accounted for by the purchase method* is deleted.
- d. In the first sentence of paragraph 30, *"negative goodwill"* is replaced by *excess over cost (also referred to as negative goodwill)*.
- e. In paragraph 36(d), the following footnote is added to *pooling of interests*:
 - *FASB Statement No. 141, *Business Combinations*, prohibits the use of the pooling-of-interests method for all business combinations initiated after June 30, 2001.
- f. In the first sentence of paragraph 259, *accounted for as a purchase under Opinion 16* is deleted.
- g. In paragraph 270, the following footnote is added to the end of the first sentence:
 - *Statement 141 prohibits the use of the pooling-of-interests method for all business combinations initiated after June 30, 2001.

E16. FASB Statement No. 123, *Accounting for Stock-Based Compensation*, is amended as follows:

- a. In the last sentence of paragraph 8, *purchase* is deleted.
- b. In the first sentence of paragraph 36, , *except for those made to reflect the terms of the exchange of shares in a business combination accounted for as a pooling of interests*, is deleted.

E17. Paragraph 59 of FASB Statement No. 128, *Earnings per Share*, is amended as follows:

- a. In the first sentence, *transaction accounted for as a purchase* is deleted.
- b. The second sentence is deleted.

E18. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

- a. In the second sentence of paragraph 11(c), *APB Opinion No. 16* is replaced by *FASB Statement No. 141*.
- b. In paragraph 29(f), *Opinion 16* is replaced by *Statement 141*.

E19. The following footnote is added to the end of the first sentence of paragraph 4 of FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*:

*Opinion 16 was superseded by FASB Statement No. 141, *Business Combinations*. However, Statement 141 (paragraph 42) does not change the requirement in paragraph 5 of this Interpretation that the amounts assigned to acquired tangible and intangible assets to be used in a particular research and development project that have no alternative future use be charged to expense at the date of acquisition.

E20. FASB Interpretation No. 9, *Applying APB Opinions No. 16 and When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*, is amended as follows:

- a. Paragraph 4 is amended as follows:

(1) The first sentence of paragraph 4 is replaced by the following:

Paragraph 35 of FASB Statement No. 141, *Business Combinations*, states 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. . . .”

(2) In the last sentence, *APB Opinion No. 16* is replaced by *Statement 141*.

b. Paragraph 5 is amended as follows:

(1) In the first sentence, *Paragraph 88 of APB Opinion No. 16* is replaced by *Paragraph 37 of Statement 141*.

(2) In the second sentence, *paragraph 88(b)* is replaced by *paragraph 37(b)*.

c. Paragraph 6 is replaced by the following:

As described in paragraph 37(e) of Statement 141, acquired intangible assets that meet the criteria in paragraph 39 of that Statement shall be assigned an amount based on their estimated fair values.

d. In the first sentence of paragraph 7, *paragraph 88(g)* is replaced by *paragraph 37(g) of Statement 141*.

e. Paragraph 8, as amended by FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, is amended as follows:

(1) The second sentence is replaced by the following:

If any of those factors meet the criteria in paragraph 39 of Statement 141, the fair value of that factor shall be recognized as an asset apart from goodwill.

(2) In the third sentence, *amount paid for that separately identified intangible* is replaced by *fair value for that separately recognized intangible asset*.

(3) The fourth sentence is replaced by the following:

An acquired intangible asset that does not meet the criteria in paragraph 39 of Statement 141 shall be included in the amount recorded as goodwill.

(4) In the fifth and sixth sentences, which were added by Statement 72, *identified intangible assets* is replaced by *separately recognized intangible assets*.

E21. FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*, is amended as follows:

a. In the first sentence of paragraph 13, *,whether accounted for by the purchase method or by the pooling of interests method,* is deleted.

- b. Paragraph 14 and the heading preceding it are deleted.
- c. Paragraph 15 is amended as follows:
 - (1) In the first sentence, *that is accounted for by the purchase method* is deleted.
 - (2) In the second sentence, *paragraph 88 of APB Opinion No. 16* is replaced by *paragraphs 36–39 of FASB Statement No. 141, Business Combinations*.
 - (3) In the third sentence, *Opinion No. 16* is replaced by *Statement 141*.
- d. Paragraph 16 is amended as follows:
 - (1) In the first sentence, *that is accounted for by the purchase method* is deleted.
 - (2) In the third sentence, *paragraph 88 of APB Opinion No. 16* is replaced by *paragraphs 37 and 38 of Statement 141*.
- e. In footnote 4 to paragraph 18, *paragraph 46(a) of APB Opinion No. 16* is replaced by *paragraph 59 of Statement 141*.
- f. In the heading above paragraph 19, *PURCHASE* is replaced by *BUSINESS*.
- g. In the first sentence of paragraph 19, *accounted for by the purchase method* is deleted.

E22. FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, is amended as follows:

- a. Paragraphs 81 and 82 are deleted.
- b. In the first sentence of paragraph 83, *purchase* is deleted and *APB Opinion No. 16* is replaced by *FASB Statement No. 141*.
- c. In the first sentence of paragraph 84, *purchase* is deleted and *Opinion 16* is replaced by *Statement 141*.

E23. In paragraph 6 of FASB Technical Bulletin No. 84-1, *Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement*, the phrase *paragraph 67 of Opinion 16* is replaced by *paragraphs 4–6 of FASB Statement No. 141, Business Combinations*.

E24. FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*, is amended as follows:

- a. In paragraph 1, *accounted for by the purchase method* is deleted.
- b. Paragraph 2 is amended as follows:
 - (1) In the first sentence, *accounted for by the purchase method* is deleted.
 - (2) In the second sentence, *purchase* is deleted.
- c. The first sentence of paragraph 3 is replaced by the following:

Paragraph 24 of FASB Statement No. 141, *Business Combinations*, states that:

The cost of an entity acquired in a business combination includes the direct costs of the business combination. . . . However, indirect and general expenses related to business combinations shall be expensed as incurred.
- d. Paragraph 4 is amended as follows:
 - (1) In the fifth sentence, *Paragraph 88 of Opinion 16 provides* is replaced by *Paragraphs 37 and 38 of Statement 141 provide*.
 - (2) In the sixth sentence, *Paragraph 88(i)* is replaced by *Paragraph 37(k)*.
 - (3) In the eighth sentence, *paragraph 88(i)* is replaced by *paragraph 37(k)*.
- e. In the second sentence of paragraph 6, *paragraph 43 of Opinion 16* is replaced by *paragraph 14 of Statement 141*.
- f. In the last sentence of paragraph 7, *Accounting Interpretation 39 of Opinion 16* is replaced by *Paragraph D12 of Statement 141*.
- g. Paragraphs 13–24 and the related headings are deleted.

Appendix F: GLOSSARY

F1. This appendix contains definitions of certain terms used in this Statement.

Allocation period

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 (FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, paragraph 4(b)).

Customer relationship

For purposes of this Statement, 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.

Fair value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Financial asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity (FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, paragraph 3(b)).

Goodwill

The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in paragraph 39 for recognition as assets apart from goodwill.

Intangible assets

Assets (not including financial assets) that lack physical substance.

Intangible asset class

A group of intangible assets that are similar, either by their nature or by their use in the operations of an entity.

Mutual enterprise

An 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. Mutual insurance companies, credit unions, and farm and rural electric

cooperatives are examples of mutual enterprises (FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 7).

Not-for-profit organization

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.

Pooling-of-interests method

A method of accounting for business combinations that was required to be used in certain circumstances by APB Opinion No. 16, *Business Combinations*. Under the pooling-of-interests method, the carrying amount of assets and liabilities recognized in the statements of financial position of each combining entity are carried forward to the statement of financial position of the combined entity. No other assets or liabilities are recognized as a result of the combination, and thus the excess of the purchase price over the book value of the net assets acquired (the purchase premium) is not recognized. The income statement of the combined entity for the year of the combination is presented as if the entities had been combined for the full year; all comparative financial statements are presented as if the entities had previously been combined.

Preacquisition contingency

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 (Statement 38, paragraph 4(a)).

Public business enterprise

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 (FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, paragraph 9).

Reporting unit

The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (as that term is defined in paragraph 10 of Statement 131) (FASB Statement No. 142, *Goodwill and Other*

Intangible Assets, paragraph F1).

Residual value

The estimated fair value of an intangible asset at the end of its useful life to the entity, less any disposal costs.

Servicing asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately (FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 364).

Footnotes

FAS141, Footnote 1—Terms defined in Appendix F, the glossary, are set forth in **boldface type** the first time they appear.

FAS141, Footnote 2—Cost is a term that is often used to refer to the amount at which an entity initially recognizes an asset at the date it is acquired, whatever the manner of acquisition.

FAS141, Footnote 3—This Statement applies to a business enterprise, a new entity formed to complete a business combination, or a **mutual enterprise**, each of which is referred to herein as an *entity*. That term can refer to any of the various forms in which the participants in a business combination may exist. However, a new entity formed to complete a business combination would not necessarily be the acquiring entity (refer to paragraph 19).

FAS141, Footnote 4—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.

FAS141, Footnote 5—Control 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.

FAS141, Footnote 6—The Board intends to address the accounting for other events or transactions that are similar to a business combination but do not meet this Statement’s definition of a business combination and the accounting for joint venture formations in another project.

FAS141, Footnote 7—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.

FAS141, Footnote 8—The October 2000 FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, proposes that a noncontrolling equity interest in a subsidiary be reported in consolidated financial statements as a separate component of equity and that distributions to holders of those noncontrolling equity interests be recognized as equity distributions. If those proposed provisions are affirmed, the Board will consider those provisions when it reconsiders the accounting for the acquisition of noncontrolling equity interests in a subsidiary, in particular whether the acquisition of those interests should be accounted for as an equity distribution rather than by the purchase method.

FAS141, Footnote 9—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).

FAS141, Footnote 10—Paragraph 46 provides guidance on accounting for contingent consideration in a business combination if the fair value of the net assets acquired exceeds the cost of the acquired entity.

FAS141, Footnote 11—Whether an increase in the cost of the acquired assets will be amortized depends on the nature of the asset. Guidance on the subsequent accounting for goodwill and other intangible assets acquired in a business combination is provided in FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

FAS141, Footnote 12—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.

FAS141, Footnote 13—Those potential income tax effects shall be accounted for in accordance with the provisions of Statement 109.

FAS141, Footnote 14—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.

FAS141, Footnote 15—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.

FAS141, Footnote 16—Refer to footnote 13.

FAS141, Footnote 17—The acquired assets include research and development assets acquired and charged to expense in accordance with paragraph 5 of Interpretation 4 (refer to paragraph 42).

FAS141, Footnote 18—Assets to be disposed of by sale include assets to be disposed of as that term is used in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and assets of a segment of a business being accounted for as a discontinued operation under 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*.

FAS141, Footnote 19—Prior to allocation of the excess, if any, the acquiring entity shall reassess whether all acquired assets and assumed liabilities have been identified and recognized and perform remeasurements to verify that the consideration paid, assets acquired, and liabilities assumed have been properly valued (refer to paragraph 35).

FAS141, Footnote 20—As stated in paragraph 8 of Statement 142, the accounting for some acquired intangible assets after initial recognition is prescribed by pronouncements other than Statement 142.

FAS141, Footnote 21—Statement 142 provides guidance for determining whether an intangible asset is subject to amortization.

FAS141, Footnote 22—Refer to footnote 21.

FAS141, Footnote 23—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.

FAS141, Footnote 24—The 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.

FAS141, Footnote 25—For example, when a business combination was initially recorded, a portion of the acquired entity was assigned to intangible assets that meet the recognition criteria in paragraph 39. Those intangible assets have been included in the amount reported on the statement of financial position as goodwill (or as goodwill and other intangible assets). However, separate general ledger or other accounting records have been maintained for those assets.

FAS141, Footnote 26—This transition provision does not, however, affect the requirement to change the amounts assigned to the assets acquired in a business combination due to (a) the resolution of a consideration contingency based on earnings (paragraph 28) or (b) changes to the purchase price allocation prior to the end of the allocation period (paragraph 40).

FAS141, Footnote 27—As described in paragraph A18, some of the intangible assets identified on that list as meeting the separability criterion should not be recognized apart from goodwill if terms of confidentiality or other agreements prohibit the acquiring entity from selling, leasing, or otherwise exchanging the asset.

FAS141, Footnote 28—In some cases, the terms of an operating lease might be unfavorable relative to market prices. Paragraph 37(k) of this Statement states that a portion of the purchase price be assigned to such as unfavorable leases.

FAS141, Footnote 29—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.

FAS141 Footnote 30—Melvin Simensky and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1998), page 293.

FAS141, Footnote 31—For example, AICPA Accounting Interpretation 2, “Goodwill in a Step Acquisition,” of Opinion 17, stated that when an entity acquires another entity or an investment accounted for by the equity method through a series of purchases (commonly referred to as a step acquisition), the entity should identify the cost of each investment, the fair value of the underlying assets acquired, and the goodwill for each step acquisition.

FAS141, Footnote 32—Under the fresh-start method, the assets and liabilities of the combining entities (regardless of whether they had been recognized in the statements of financial position of those entities) are recognized in the statement of financial position of the combined entity at fair value. The combined entity is treated as a new entity as of the date of the combination and its history commences on that date. The fresh-start method is currently used in practice to account for certain corporate reorganization transactions. As with the purchase method, the fresh-start method can be applied to business combinations that are effected by cash, other assets, debt, equity shares, or a combination thereof.

FAS141, Footnote 33—AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus* (New York: AICPA, 1994).

FAS141, Footnote 34—EVA was developed by the consulting firm of Stern Stewart & Company (and is a registered trademark of Stern Stewart) as a financial performance measure that improves management’s ability to make decisions that enhance shareholder value.

FAS141, Footnote 35—Refer to, for example, Eli Amir, Trevor S. Harris, and Elizabeth K. Venuti, “A Comparison of the Value-Relevance of U.S. versus Non-U.S. GAAP Accounting Measures Using Form 20-F Reconciliations,” *Journal of Accounting Research*, Supplement (1993): 230–264; Mary Barth and Greg Clinch, “International Accounting Differences and Their Relation to Share Prices: Evidence from U.K., Australian and Canadian Firms,” *Contemporary Accounting Research* (spring 1996): 135–170; Keith W. Chauvin and Mark Hirschey, “Goodwill, Profitability, and the Market Value of the Firm,” *Journal of Accounting and Public Policy* (summer 1994): 159–180; Ross Jennings, John Robinson, Robert B. Thompson, and Linda Duvall, “The Relation between Accounting Goodwill Numbers and Equity Values,” *Journal of Business Finance and Accounting* (June 1996): 513–533; and Mark G. McCarthy and Douglas K. Schneider, “Market Perception of Goodwill: Some Empirical Evidence,” *Accounting and Business Research* (winter 1995): 69–81.

FAS141, Footnote 36—Entities might not have adhered strictly to the purchase price allocation requirements in Opinion 16 because Opinion 17 required amortization of all acquired intangible assets and limited the maximum amortization for both goodwill and other intangible assets to 40 years.