KPMG

Business combinations

Handbook

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Contents

Preface 1

1. Scope 4

2. Identifying a Business Combination 14

3. The Acquisition Method 85

4. Identifying the Acquirer 86

5. Determining the Acquisition Date 115

6. Recognizing and Measuring the Consideration Transferred 120

7. Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree 168

8. Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase 237

9. Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations 244

10. Measurement Period 280

11. Determining What Is Part of the Business Combination Transaction 298

12. Subsequent Measurement and Accounting 361

13. Disclosures 382

14. Effective Date and Transition 400

15. Noncontrolling Interests in Consolidated Financial Statements 404

See KPMG Handbook, Consolidation, for details on the subsequent accounting for noncontrolling interests

SECTIONS 16 THROUGH 21
FAIR VALUE MEASUREMENTS

16. Overview of ASC Subtopic 820-10 405

17. Determining the Fair Value of Assets Acquired and Liabilities Assumed in a Business Combination 443

18. Determining the Fair Value of the Consideration Transferred in a Business Combination 498

19. Determining the Fair Value of a Noncontrolling Interest in a Business Combination 512

20. Determining the Fair Value of a Previously Held Equity Interest in a Business Combination 515

21. Not used

22. Goodwill and Other Intangible Assets 519

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SECTIONS 23 THROUGH 25
INCOME TAX CONSIDERATIONS

23. The Tax Effects of Business Combinations 541

See KPMG Handbook, Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations

24. The Tax Effects of Changes in Ownership Interests While Retaining Control 542

See KPMG Handbook, Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations

25. The Tax Effects of Asset Acquisitions 543

See KPMG Handbook, Accounting for Income Taxes, Section 10, Other Considerations

26. Private Company and Not-for-Profit Accounting Alternatives 544

27. Application of Pushdown Accounting 555

28. Combinations of Entities Under Common Control 579

29. Joint Venture Formations (Subtopic 805-60) 605

KPMG Financial Reporting View 620

Acknowledgments 622

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Preface

October 2025

The purpose of KPMG Handbooks is to assist you in understanding the application of US GAAP in practice, and to explain the conclusions that we have reached on many interpretive issues.

Business Combinations is designed to assist you in understanding the application of:

- FASB ASC Topic 805, *Business Combinations*; and
- Certain subsections of FASB ASC Topic 350, *Intangibles—Goodwill and Other.*

We expect to update this Handbook as needed based on developments in practice. You will always be able to find the most up-to-date version of this and other KPMG publications, including KPMG Handbook, Asset acquisitions, on KPMG Financial Reporting View.

CURRENTLY EFFECTIVE REQUIREMENTS

Each section of this Handbook includes excerpts from the FASB's Accounting Standards Codification® to supplement our interpretive guidance, and illustrative examples that address the specific implementation issues we have identified.

Section 26 discusses the accounting alternatives available only to private companies and not-for-profit entities.

PENDING CONTENT

This Handbook incorporates the following Accounting Standards Updates that are effective for some or all entities for fiscal periods beginning after December 15, 2023 and certain others that allow for early adoption. This includes:

- ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*
- ASU 2023-05, *Joint Venture Formations, Recognition and Initial Measurement*
- ASU 2024-02, *Amendments to Remove References to the Concepts Statements*
- ASU 2025-03, *Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

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NEW IN 2025

In 2025, we have updated or added the following significant guidance in this Handbook.

Topic	*Reference*
Additional guidance on determining the accounting acquirer in business combinations involving variable interest entities after ASU 2025-03	4.001a, 4.001c, 4.002, 4.002a, 4.024 – 4.026a, 4.028 Example 4.7 9.009, 9.025, 9.028 Example 9.10
Updated example of acquisition with a NewCo	Example 4.3a
Additional guidance on measurement of noncontrolling interest	Example 4.4
Additional guidance on in-process research and development (IPR&D) activities	7.134a – 7.134b
Example illustrating unit of account for IPR&D	Example 7.27a
Guidance on measurement of pre-existing contractual relationships	11.009
Example illustrating separate seller agreement requiring continued employment	Example 11.12b
Additional guidance on contributory asset charges	17.061a – 17.061b
Additional guidance on pushdown accounting in a contributed subsidiary's financial statements	27.006a
Additional guidance on common control considerations for portfolio companies	28.006a
Examples illustrating an assessment of whether an arrangement meets the definition of a joint venture	Example 29.1, Example 29.1a

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ABBREVIATIONS

The following abbreviations are used in this Handbook.

ASC	FASB's Accounting Standards Codification®
ASU	Accounting Standards Update
CAC	Contributory asset charges
EBITDA	Earnings before interest, taxes, depreciation and amortization
EITF	Emerging Issues Task Force
EPS	Earnings per share
GAAP	Generally accepted accounting principles
IPO	Initial public offering
IPR&D	In-process research and development
IRR	Implied rate of return
JV	Joint venture
LIFO	Last-in, first-out
LTCC	Long-term construction-type contracts
MPEEM	Multi-period excess earnings method
NCI	Noncontrolling interest(s)
NFP	Not-for-profit
OCI	Other comprehensive income
OPM	Option pricing method
PCS	Postcontract customer support
PFI	Projected financial information
R&D	Research and development
REIT	Real estate investment trust
SBM	Scenario based method
SEC	Securities and Exchange Commission
VIE	Variable interest entity
WACC	Weighted-average cost of capital
WARA	Weighted-average return on assets

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Section 1 - Scope

Detailed Contents

Business Combinations

Variable Interest Entities

When a Variable Interest Entity and its Primary Beneficiary Are under Common Control

Mutual Entities

Leveraged Buyout Transactions

Transactions outside the Scope of ASC Topic 805

Joint Venture Formations

The Acquisition of an Asset or a Group of Assets That Do not Constitute a Business

A Combination between Entities or Businesses under Common Control

A Combination between Not-for-Profit Organizations or the Acquisition of a For-Profit Business by a Not-for-Profit Organization

Financial Assets and Financial Liabilities of a Collateralized Financing Entity

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1.000 ASC Topic 805, *Business Combinations,* establishes the accounting and reporting for business combinations. ASC Topic 805 defines a business combination, and requires accounting for each business combination within the scope of ASC Topic 805 by the *acquisition method.* See discussion of *The Acquisition Method* in Section 3. In addition, ASC Subtopic 805-50, *Business Combinations - Related Issues,* provides guidance on transactions that may be similar to business combinations but that do not meet the requirements to be accounted for as a business combination, such as combinations of entities under common control. See Section 28 for additional discussion of combinations of entities under common control.

1.000a Other than for limited exceptions provided in ASC Topic 805, assets acquired, liabilities assumed or incurred, and equity interests issued in a business combination are recognized and measured at fair value at the acquisition date and, following the acquisition, are accounted for based on other applicable generally accepted accounting principles (GAAP).

ASC Paragraph 805-10-15-3

The guidance in the Business Combinations Topic applies to all transactions or other events that meet the definition of a business combination or an acquisition by a not-for-profit-entity.

ASC Paragraph 805-10-15-4

The guidance in the Business Combinations Topic does not apply to any of the following:

(a) The formation of a joint venture

(b) The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity

(c) A combination between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)

(d) An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a merger of not-for-profit entities (NFPs)

(e) A transaction or other event in which an NFP obtains control of a not-for-profit entity but does not consolidate that entity, as described in ASC paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

(f) Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in [ASC] Subtopic 810-10.

1.001 ASC Topic 805 represents the codification of FASB Statement 141(R), *Business Combinations,* which replaced FASB Statement No. 141, *Business Combinations*, and

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required prospective application to business combinations for which the acquisition date occurs in an annual reporting period beginning on or after December 15, 2008. Early application was prohibited.

BUSINESS COMBINATIONS

1.002 A business combination in ASC Topic 805 includes all transactions or events in which an acquirer obtains control of one or more businesses, regardless of how it obtains control or how the consideration is transferred. Thus, transactions in which an acquirer obtained control of a business through means other than an acquisition of net assets or equity interests are included in the scope of ASC Topic 805. For example, under ASC Topic 805, a business combination can occur on the lapse of minority veto rights that previously kept an acquirer who held a majority voting interest from controlling an acquiree. See discussion of *Control* in Section 2. Additionally, the acquisition of a business through a nonmonetary exchange is in the scope of ASC Topic 805. ASC paragraph 825-10-25-11

1.003 A business in ASC Topic 805 focuses on an integrated set of activities and assets capable of being conducted and managed for the purpose of providing a return. This requires that the integrated set include inputs and processes applied to those inputs which, together are or will be used to create outputs, but does not necessarily require that it currently include *outputs.* See discussion of *Identifying a Business Combination* in Section 2.

VARIABLE INTEREST ENTITIES

1.004 Under ASC Subtopic 810-10, *Consolidation - Overall,* the initial consolidation of a variable interest entity (VIE) *that is a business* by its primary beneficiary is a business combination and should be accounted for by the acquisition method.

1.005 Paragraph not used.

1.006 ASC Subtopic 810-10 requires an entity to determine whether it is the *primary beneficiary* of a VIE at the time it becomes involved with the VIE, and to continuously reassess whether changes in facts and circumstances result in a change in the determination of whether the entity is the primary beneficiary of the VIE. When an entity becomes the primary beneficiary of a VIE that is a business, even if the entity was previously involved with the VIE but was not the primary beneficiary, a business combination has occurred and must be accounted for by the acquisition method at that date. See discussion of *Variable Interest Entities* in Section 4.

WHEN A VARIABLE INTEREST ENTITY AND ITS PRIMARY BENEFICIARY ARE UNDER COMMON CONTROL

1.007 Combinations between entities or businesses under common control are outside the scope of ASC Subtopic 805-10. However, ASC Subtopic 810-10 provides guidance for situations in which an entity becomes the primary beneficiary of a VIE when the primary

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beneficiary and the VIE are under common control. In these situations, the primary beneficiary initially measures the assets, liabilities, and noncontrolling interests of the VIE at amounts at which they are carried in the accounts of the reporting entity (i.e., the ultimate parent) that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles). ASC paragraph 810-10-30-1

MUTUAL ENTITIES

1.008 Combinations of mutual entities are in the scope of ASC Topic 805.

LEVERAGED BUYOUT TRANSACTIONS

1.009 Under ASC Topic 805, the acquirer will account for leveraged buyout transactions resulting in a change in control by the acquisition method.

TRANSACTIONS OUTSIDE THE SCOPE OF ASC TOPIC 805

1.010 Business combination accounting under ASC Topic 805 does not apply to the formation of a joint venture, the acquisition of an asset or a group of assets that does not constitute a business, a combination between entities or businesses under common control, or a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

JOINT VENTURE FORMATIONS

1.011 A joint venture is a separate business or project owned and operated by a small group of businesses for their mutual benefit, where risks and rewards are shared, complementary knowledge is combined, and resources are pooled for the development of new markets, products, or technologies, with each joint venturer having a direct or indirect participation in the overall management. Because none of the participants in the formation of a joint venture obtains control over the entity, the formation of a joint venture does not meet the definition of a business combination under ASC Topic 805.

1.011a Although joint control is essential, joint control is not the only defining characteristic of a joint venture. The SEC staff has objected to a conclusion that joint control is the only defining characteristic of a joint venture. Rather, each of the characteristics in the definition should be met for an entity to be a joint venture, including that the purpose of the entity is consistent with that of a joint venture. In the stand-alone financial statements of a joint venture, ASC Topic 805 should be applied to transactions where businesses are contributed to a jointly controlled entity that does not meet the definition of joint venture. See Paragraph 29.002 for additional discussion about evaluating whether an entity meets the definition of a joint venture. ASC paragraph 805-10-S99-8 and SEC Speech: Christopher F. Rogers Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

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1.012 ASC Subtopic 805-60 provides guidance on the accounting for the formation of a joint venture after the adoption of ASU 2023-05, *Joint Venture Formations, Recognition and Initial Measurement* [1]. These requirements apply to the separate financial statements of an entity that meets the definition of a joint venture. See Section 29 for additional discussion of joint venture formations after the adoption of ASU 2023-05.

1.012aa Before the issuance of ASU 2023-05, there was minimal authoritative guidance for the accounting by the joint venture itself. Due to lack of authoritative guidance, historical practice has been that a joint venture generally measured contributions at the investor's basis (i.e., carryover basis), unless certain conditions were met (e.g., an investor's cash contribution that remains in the joint venture). However, based on the AICPA Issues Paper *Joint Venture Accounting* (7/17/79), nonpublic companies could adopt a policy using either fair value or carryover basis.

Contributions of Businesses (Before the adoption of ASU 2023-05)

1.012a At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member acknowledged that the amendments to investor accounting in ASU 2010-02, *Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification,* raised questions about the joint venture's accounting for contributions from the investors.[2] While the SEC staff did not provide specific views about how the changes to investor accounting under ASU 2010-02 might affect the accounting by the joint venture, the SEC staff did acknowledge that there may be more instances in which it would be appropriate for the joint venture to record the contributions at fair value.

1.012b Based on informal discussions with the SEC staff, we understand that the SEC staff *would not object* if a joint venture measured contributions at fair value when the investors' accounting is within the scope of ASC Subtopic 810-10 (see Chapter 7 of KPMG Handbook, Consolidation). We believe this view is supported because a change-in-control event has occurred and therefore the investors measure the contributed assets (businesses) at fair value before contributing to the joint venture. Accordingly, the investors' basis is fair value to be carried over by the joint venture.

Contributions that are not a Business (Before the adoption of ASU 2023-05)

1.012c We understand that, before the adoption of ASC Subtopic 610-20, Gains and Losses from the Derecognition of Nonfinancial Assets, the SEC staff *would have objected* to a joint venture recognizing at fair value contributions by investors of groups of assets or subsidiaries that do not constitute businesses. This is due to the fact that these transactions were outside the scope of the fair value provisions of ASC Subtopic 810-10 for an investor. Consequently, the rationale described above (Paragraph 1.012b) for fair value treatment at the joint venture level did not apply for such transactions.

1.012d After the adoption of ASC Subtopic 610-20, the investor in a joint venture accounts for its investment received from contributing assets or subsidiaries that are not a business at fair value similar to contributions of a business. Therefore, the rationale in

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Paragraph 1.012b for fair value treatment at the joint venture level now applies for such transactions. However, the SEC has not made public remarks similar to those described in Paragraph 1.012b after the adoption of ASC Subtopic 610-20.

1.012e As a result, many companies continue to follow the SEC staff's historical practice for joint ventures (investor's carryover basis), unless certain conditions are met (e.g., an investor's cash contribution that remains in the joint venture). However, there may be more situations where fair value is appropriate when the investor records its investment at fair value. If the contributions are not a business and the joint venture uses fair value, we believe that the joint venture should early adopt ASU 2023-05 in its entirety. It is also possible that a joint venture could have a mixed accounting model with some of the contributed assets measured at fair value (i.e., contributed assets constituting a business) and other contributed assets measured at the investor's carryover basis (i.e., the contributed assets do not constitute a business).

THE ACQUISITION OF AN ASSET OR A GROUP OF ASSETS THAT DO NOT CONSTITUTE A BUSINESS

1.013 If an acquired asset or an asset group (including liabilities assumed, if any) does not constitute a *business*, the transaction is not a business combination. These transactions would be accounted for as asset acquisitions. The Acquisition of Assets Rather than a Business Subsections of ASC Subtopic 805-50 provide continuing authoritative guidance with respect to the accounting for asset acquisitions. Asset acquisitions are accounted for using a cost accumulation and allocation model rather than the ASC Topic 805 model, which requires measurement of assets acquired and liabilities assumed at fair value with limited exceptions. There may be significant differences in the accounting for the acquisition of a group of assets versus a business. Examples of these differences are provided in Table 2.3.

A COMBINATION BETWEEN ENTITIES OR BUSINESSES UNDER COMMON CONTROL

1.014 Combinations between entities or businesses under common control involve exchanges or movements of net assets or equity interests among entities under common control, such that the same ultimate parent controls the entities both before and after the exchange or movement. These transactions do not result in an acquirer outside the control group obtaining control over the net assets or equity interests, but result in a shift of ownership of the net assets or equity investments within the entities or businesses under common control. Therefore, combinations between entities under common control do not meet the definition of a business combination.

1.015 Transfers or exchanges of net assets or equity interests between entities under common control should be recorded at the carrying amount of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the ultimate parent of the entities under common control, e.g., because push-down accounting was not applied, then the financial statements of the

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receiving entity should reflect the transferred assets and liabilities at the historical cost of the ultimate parent of the entities under common control. The Transactions between Entities Under Common Control Subsections of ASC Subtopic 805-50 provide continuing authoritative guidance for transactions between entities under common control. See Section 28, *Combinations of Entities under Common Control,* for additional discussion.

1.016 If a transaction results in the acquisition of all, or part, of a noncontrolling interest in a subsidiary (i.e., an increase in the ultimate parent's controlling interest in a subsidiary), the acquisition of the noncontrolling interest is accounted for as an equity transaction based on ASC Subtopic 810-10. If a common control transaction results in an increase in the noncontrolling interest of a subsidiary (i.e., a disposition of a portion of the ultimate parent's interest in a subsidiary where the parent retains control after the transaction), the transaction is also accounted for as an equity transaction based on ASC Subtopic 810-10. No gain or loss is recognized in consolidated net income or comprehensive income as a result of changes in the noncontrolling interest, unless a change results in the loss of control by the ultimate parent.

A COMBINATION BETWEEN NOT-FOR-PROFIT ORGANIZATIONS OR THE ACQUISITION OF A FOR-PROFIT BUSINESS BY A NOT-FOR-PROFIT ORGANIZATION

1.017 ASC Subtopic 958-805, *Not-for-Profit Entities – Business Combinations*, provides guidance on accounting by not-for-profit entities for a combination with one or more other not-for-profit entities, businesses, or not-for-profit activities. Under ASC Subtopic 958-805, which includes guidance on whether a combination is a merger or an acquisition, a not-for-profit entity applies the carryover method to account for a merger and the acquisition method to account for an acquisition.

1.018 The implementation guidance in ASC paragraphs 958-805-55-1 through 55-8 provides indicators that not-for-profit entities should consider when determining whether a combination is a merger or an acquisition. However, all of the facts and circumstances of the combination should be considered in making this determination.

1.018a ASC paragraph 958-805-55-1 states that ceding control by the prior not-for-profit entities to a new not-for-profit entity is the sole definitive criterion for identifying a merger, and one entity obtaining control over the other is the sole definitive criterion for an acquisition. If the participating entities in a combination retain shared control of the new not-for-profit entity, they have not ceded control. To qualify as a new not-for-profit entity, the newly established combined not-for-profit entity must have a newly formed governing body and is often, but not required to be, a new legal entity. ASC paragraphs 958-805-55-3 through 55-7 include additional considerations for purposes of evaluating whether a combination is a merger or an acquisition and focus on areas such as governance, related control powers, and financial capacity. These considerations include:

- Assessing whether the governing bodies of the entities participating in the combination ceded control and understanding the process leading up to the

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combination and the formation of the combined entity. (ASC paragraph 958-805-55-3)

- ASC paragraph 958-805-55-4 states that one entity dominating the negotiations is an indicator of an acquisition, whereas a situation where no one party dominates or is capable of dominating the negotiations and process leading to the formation of the combined entity is an indicator of a merger.
- We believe that decisions made on a mutual basis, such as the transaction timing, strategic plan, and operating plans associated with the transaction, indicate a merger.
- ASC paragraph 958-805-55-6 states that if one entity appoints significantly more of the governing board to the newly formed entity, retains more of its key senior officials, bylaws, operating policies, and/or practices, it may be more indicative of an acquisition than a merger.
- We believe other relevant characteristics to consider include board term limits, voting rights, and future board composition. For example, the board of the new entity usually includes board members from the previous entities' governing bodies. If those board members' initial terms are long and they can continue to be reappointed, this factor would indicate that the same prior leadership is still intact, and therefore control is being shared and has not been ceded.
- Alternatively, it may be reasonable to conclude that a combination is a merger even if the new board includes some individuals who were formerly members of the recently terminated legacy boards, if the new entity implements term limits, supermajority voting requirements, or other board member transition plans that meet the requirement of ceding control.
- We believe consideration should be given to existing affiliate and joint venture ownership governance. For example, if ultimate control of all existing affiliates and joint ventures resides with the new entity (i.e., all key operating and strategic decision will be controlled by the new entity's board of directors), that would indicate a merger.

- Analyzing the financial strength and size of each of the participating entities. (ASC paragraph 958-805-55-6)
  - ASC paragraph 958-805-55-6 indicates that if one entity is financially stronger and larger in size, that entity may be able to dominate the negotiations and transaction, which would be more indicative of an acquisition than a merger. To gauge the relative financial strength of the participating entities, we believe one can look at the credit ratings of the entities involved in the combination as part of the process. Financial strength and size, however, is just an indicator and should not be the only

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consideration in determining whether a combination is a merger or an acquisition.

- We believe that if one of the participating entities is experiencing financial difficulties and will depend on the other entity to provide back-office or information technology support for a below-cost fee, it could be an indicator of an acquisition.
- To gauge the relative size of the participating entities, we believe one can look at the participating entities' pre-combination total assets, total net assets, operating income, and total revenues, among other factors.

- Understanding the contributions made by the participating entities to the combination. (ASC paragraph 958-805-55-7)
  - ASC paragraph 958-805-55-7 indicates that a merger generally is accomplished by a newly formed entity assuming all of the assets and liabilities of the participating entities without transferring cash or other assets to those entities or any of their owners, members, sponsors, or other designated beneficiaries. For example, in a merger, there are no:
    - Financial inducements for the benefit of one party, such as built-in capital or funding commitments;
    - Guarantees, assumptions, or payoffs of the debt of either party by the other as part of the transaction; or
    - Commitments for guarantees or credit support on future debt for either participating entity.
  - ASC paragraph 958-805-55-7 also indicates that unlike the formation of a joint venture arrangement in which the participating entities continue to exist and usually hold a financial interest, the creators of the merged entity cease to exist as autonomous entities and no one holds a financial interest in the merged entity. The merged entity generally has a perpetual life rather than a life that is limited by the period of the venture or that allows for one or more of the participating entities to opt out of the venture or other arrangement.
  - We believe that one entity making significantly more contributions than another may be indicative of an acquisition over a merger.

1.018b ASC paragraphs 958-805-55-9 through 55-31 provide illustrative examples for assessing whether a combination is a merger, an acquisition, or is neither a merger nor an acquisition.

1.018c All of the indicators and illustrative examples should be carefully considered based on the actual facts and circumstances in determining whether the combination is a merger or an acquisition. In accordance with ASC paragraph 958-805-55-2, the participating not-for-profit entities must make a decision based on the preponderance of

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the evidence about whether each of the governing bodies has ceded control to create a new not-for-profit, whether one entity has acquired the other, or whether another form of combination, such as the formation of a joint venture, has occurred.

FINANCIAL ASSETS AND FINANCIAL LIABILITIES OF A COLLATERALIZED FINANCING ENTITY

1.019 A collateralized financing entity (CFE) is an entity that holds financial assets such as asset-backed securities and issues beneficial interests to investors. These beneficial interests are usually debt instruments that are considered financial liabilities under U.S. GAAP. Because a CFE generally has little or no equity, it is typically a variable interest entity (VIE) under U.S. GAAP and subject to the consolidation requirements that apply to an entity not controlled through voting equity interests. Consequently, an entity may be the primary beneficiary of, and therefore required to consolidate, a CFE if it has a controlling financial interest in the CFE. Unlike the initial consolidation of a VIE *that is a business,* which should be accounted for under the acquisition method, the consolidation of the financial assets and financial liabilities of a VIE that is a CFE is excluded from the scope of ASC Topic 805 and should not be accounted for under the acquisition method.

[1] ASU 2023-05 was issued in August of 2023 and introduced ASC Subtopic 805-60 Joint Venture Formations. See transition and effective date discussion at Paragraph 29.031.
[2] Joshua S. Forgione, Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments, December 7, 2009, available at www.sec.gov.

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Section 2 - Identifying a Business Combination

Detailed Contents

Definition of a Business Combination

Control

- Control Defined
- Control Does Not Exist if Minority Shareholders (or Other Interest Holders) Have Substantive Participating Rights
- Determination of Control Is a Point-In-Time Evaluation
  - Example 2.0: Acquisition of a Franchisee
  - Example 2.0a: Purchase of a Business That Was Subsequently Cancelled
- Control Achieved Without Transferring Consideration
- Transfer of Consideration Without Obtaining Control of a Business
- Combinations Involving Variable Interest Entities

Multiple Transactions Accounted for as a Single Transaction

- Example 2.0b: Accounting for Goodwill When Multiple Transactions That Cross Reporting Periods Are Accounted for as a Single Business Combination

Definition of a Business

- Table 2.2a: Other Areas Affected by the Definition of a Business
- Table 2.3: Significant Difference in the Accounting for the Acquisition of a Group of Assets Versus a Business
- Inputs, Processes, and Outputs
  - Example 2.6: Determining What Is a Part of the Set - Multiple Transactions with the Seller
  - Example 2.7: Determining What Is a Part of the Set - Contractual Arrangement with a Third Party
- Step 1 –Screening Test
  - Example 2.8a: Applying Step 1a
  - Example 2.8b: Applying Step 1b
  - Example 2.8bb: Applying Exception (a) in Step 1b
  - Table 2.4: Risk Factors and Examples to Consider When Identifying Similar Assets
  - Example 2.8c: Applying Step 1c
  - Example 2.8cc: Acquisition of Owned and Leased Assets
  - Example 2.8d: Applying Step 1d

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Example 2.8e: Applying Step 1e

Example 2.8f: Recognizing Certain Assets of a Medical Device Company as a Single Asset for Financial Reporting Purposes

Example 2.9: Applying Step 1 When Goodwill Results from the Effects of Deferred Tax Liabilities

Example 2.9a: Applying the Step 1 Threshold (Initial Screening) Test When a Bargain Purchase Exists

Example 2.10: Acquisition of Loan Portfolio – Scenario 1

Example 2.11: Acquisition of Oil and Gas Properties – Scenario 1

Example 2.11a: Acquisition of Petroleum Storage Facilities

Example 2.11b: Acquisition of a Property Subject to a Tax Abatement

Step 2 – Evaluate Whether an Input and a Substantive Process Exist

Example 2.12: Acquisition of a Drug Candidate – Scenario 1

Example 2.13: Acquisition of Biotech – Scenario 1

Example 2.13a: Acquisition of Professional Service Employees

Example 2.13b: Intent to Restructure Workforce Post-Acquisition

Example 2.14: Acquisition of Real Estate – Scenario 2

Example 2.15: Acquisition of Loan Portfolio – Scenario 1 (continued)

Example 2.16: Acquisition of Loan Portfolio – Scenario 2

Example 2.17: Acquisition of Brands – Scenario 1

Example 2.18: Acquisition of Oil and Gas Properties – Scenario 2

Example 2.19: Acquisition of Properties That Are Simultaneously Leased to Another Party

Applying the Definition of a Business to Financial Services Companies

Example 2.20: Acquisition of a Bank Branch

Example 2.21: Acquisition of an Asset Management Firm

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DEFINITION OF A BUSINESS COMBINATION

ASC Master Glossary: Business Combination

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

ASC Paragraph 805-10-25-1

An entity shall determine whether a transaction or other event is a *business combination* by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a *business*. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition...

2.000 Each transaction or event involving entities within the scope of ASC Topic 805, *Business Combinations* (see discussion in Section 1), that falls within the definition of a business combination is accounted for by applying the acquisition method.

2.001 The definition of a *business combination* includes all transactions or events in which an entity obtains control of a business, regardless of whether the entity obtains control through the transfer of consideration or without the transfer of consideration. Fundamental to the FASB's definition is its belief that all transactions or events in which an entity acquires control over a business are economically similar, and that the definition of a business combination should encompass all such transactions or events.

2.002 ASC paragraph 805-10-55-3 provides examples (not intended to be an exhaustive listing) of ways a business combination may be structured for legal, taxation, or other reasons:

(a) One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.

(b) One combining entity transfers its net assets or its owners transfer their equity interests to another combining entity or its owners.

(c) All of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity (sometimes referred to as a roll-up or put-together transaction).

(d) A group of former owners of one of the combining entities obtains control of the combined entity.

2.003 The structure of a transaction or event does not affect the determination of whether a business combination has occurred. Rather, the obtaining of control of one or more businesses by an acquirer is determinative. The concepts of *control* and what constitutes a *business* are discussed below. Identifying the accounting acquirer is discussed in Section 4.

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CONTROL

CONTROL DEFINED

> **ASC Master Glossary: Control**
>
> The same as the meaning of controlling financial interest in [ASC] paragraph 810-10-15-8.

2.004 ASC Subtopic 810-10 indicates that majority ownership is not always determinative and that majority ownership would not constitute a controlling financial interest if control does not rest with the majority owner. Conversely, an investor could obtain control over a business in situations where the investor owns less than a majority of the voting interest of an investee (e.g., in combinations achieved by contract alone). More specifically, ASC paragraphs 810-10-15-8 and 810-10-15-8A state:

> For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.
>
> Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

2.005 ASC paragraphs 805-10-55-10 through 55-15 provide guidance for identifying the entity that obtains control (i.e., the *acquirer)* in a business combination if the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer. See discussion in Section 4, *Identifying the Acquirer.*

2.006 ASC Subtopic 810-10, *Consolidation - Overall,* provides guidance on the consolidation of variable interest entities. See discussion of *Variable Interest Entities* beginning at Paragraph 2.014.

CONTROL DOES NOT EXIST IF MINORITY SHAREHOLDERS (OR OTHER INTEREST HOLDERS) HAVE SUBSTANTIVE PARTICIPATING RIGHTS

2.007 As noted in ASC paragraphs 810-10-15-8 and 810-10-15-8A, ownership of a majority voting interest does not constitute a controlling financial interest if control does not rest with the majority owner or, for limited partnerships, the limited partner with a

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majority of kick-out rights through voting interests. For example, as discussed in ASC paragraphs 810-10-25-1 through 25-14C and 55-1, a minority shareholder (or shareholders) or another limited partner (or limited partners) may have substantive participating rights such that the majority shareholder or the limited partner with a majority of kick-out rights through voting interests is unable to exercise control over an investee. See additional discussion about control in Chapter 5 of KPMG Handbook, Consolidation.

2.008 – 2.010 Paragraphs not used.

DETERMINATION OF CONTROL IS A POINT-IN-TIME EVALUATION

2.010a An entity can obtain control with the intention of relinquishing it in the future. Control is a point-in-time evaluation, and a business combination occurs when an acquirer obtains control of one or more businesses. Thus, when an entity obtains control of a business, even if it is expected to be temporary, a business combination has occurred and the transaction is within the scope of ASC Topic 805. There is no concept of *temporary control* that allows for an exception from the scope of ASC Topic 805.

2.010b Careful consideration should be given to contractual terms that accompany transactions with the intention of temporary control. Such terms may include substantive participating rights, which may prevent control, or reacquisition rights granted to the seller, which may be part of the consideration transferred in the business combination.

Example 2.0: Acquisition of a Franchisee

Franchisor operates a franchise with numerous stores owned by various franchisees. The franchise agreement stipulates certain conditions that the franchisee must maintain while owning and operating the franchise, including holding a business license to operate in its state or territory.

Franchisee does not maintain its business license. Franchisee applies for a new license, but regulatory approval and issuance is expected to take six months. Franchisee and Franchisor agree that Franchisor will acquire and operate the store until the business license is obtained. Control is intended to be temporary, and Franchisee holds a reacquisition right to repurchase the store at a formulaic price at any time in the next nine months, exercisable only after it obtains the business license. Franchisee will have no substantive participating rights while the store is owned by Franchisor. The store meets the definition of a business in ASC Topic 805.

Assessment

Franchisor concludes that the acquisition is a business combination because it has obtained control of a store that meets the definition of a business. After the transaction, Franchisee holds no rights to control the activities and decisions of the franchise during the period that it is owned by Franchisor. Additionally, Franchisor has sole rights and obligations to income or losses of the franchise during the period of ownership. The

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fact that control is intended to be temporary, and the fact that Franchisee holds a reacquisition right is not determinative in the analysis of control.

Franchisor should recognize the fair value of the reacquisition right (i.e., written call option) as part of the consideration transferred under ASC Topic 805 and evaluate the terms of the reacquisition right to determine whether it constitutes a derivative instrument requiring subsequent measurement at fair value under ASC Topic 815.

Example 2.0a: Purchase of a Business That Was Subsequently Cancelled

ABC Corp. enters into a purchase agreement to acquire a private label widget manufacturer (DEF Corp.) during April 20X0. Under the terms of the purchase agreement, ABC will pay the seller of DEF Corp. (Seller) a total of $40,000,000, consisting of $8,000,000 on the closing date (April 30, 20X0) and two installments of $16,000,000 on August 31, 20X0 and February 28, 20X1 (deferred balance).

The purpose of the transaction is to create an exclusive business arrangement between DEF and Seller, under which DEF will sell its widgets exclusively to Seller for a period of 10 years. There is a limited guarantee agreement which limits ABC's exposure in potential losses of DEF to $2,500,000 until the final installment payment occurs. There is also a share pledge agreement under which ABC does not have voting rights in DEF until it pays the final installment, and the DEF shares are returned to Seller if ABC does not pay the installments when due. Additionally, there is a shared services agreement under which Seller provides management, accounting, human resources, and information technology services to DEF.

Shortly after the closing date, ABC experiences turnover in several key executive management positions, and during August 20X0, ABC notifies Seller that it no longer intends to pay the $32,000,000 deferred balance. During December 20X0, ABC and Seller finalize negotiations and enter into a sales cancellation agreement.

Assessment

ABC concludes that no business combination took place because it never obtained control over DEF. ABC bases this conclusion on the fact that it did not obtain the voting rights associated with the shares, nor did it have control over management and human resource decisions, as these were outsourced to Seller under the shared services agreement. ABC accounts for the initial payment of $8,000,000 as a deposit and evaluates it for impairment.

CONTROL ACHIEVED WITHOUT TRANSFERRING CONSIDERATION

2.011 An entity can obtain control over another without transferring consideration. ASC paragraph 805-10-25-11 identifies the following circumstances under which an acquirer might obtain control over an acquiree without transferring consideration:

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(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority substantive participating rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.

(c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously.

2.012 A business combination occurs when an acquirer obtains control of one or more businesses. Thus, when an entity obtains control of a business, even without the transfer of consideration, a business combination has occurred and is within the scope of ASC Topic 805. Therefore, the acquisition method applies to these transactions, which requires, among other things, recognizing and measuring the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. ASC Topic 805 provides special guidance for these types of transactions. Applying the acquisition method to each of these types of transactions is discussed and illustrated beginning at Paragraph 9.003.

2.013 Business combinations achieved by contract alone often result from the formation of a variable interest entity that meets the definition of a business. See discussion below and the discussion of *Variable Interest Entities* beginning at Paragraph 4.025.

TRANSFER OF CONSIDERATION WITHOUT OBTAINING CONTROL OF A BUSINESS

2.013a In certain circumstances, an entity may transfer consideration before obtaining control of a business. In this case a business combination has not occurred as the entity has not obtained control of a business, and the entity should not apply the acquisition method. Instead, the entity should recognize the consideration transferred as an asset (e.g., a prepaid asset or deposit) given it meets the definition of an asset under Concepts Statement 8. The entity should derecognize the asset and apply the acquisition method when it obtains control of the business.

COMBINATIONS INVOLVING VARIABLE INTEREST ENTITIES

2.014 ASC Subtopic 810-10 clarifies the application of control to entities in which equity investors or limited partners lack power, through voting rights or similar rights, the obligation to absorb the expected losses or receive the expected residual returns of the entity, or lack sufficient equity at risk for the entity to operate without additional subordinated financial support from other parties. These entities are referred to as *variable interest entities,* or VIEs. See KPMG Handbook, Consolidation for addition guidance on VIEs. See discussion of *Variable Interest Entities* beginning at Paragraph 4.025.

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2.015 Paragraph not used.

MULTIPLE TRANSACTIONS ACCOUNTED FOR AS A SINGLE TRANSACTION

2.015a An entity may enter into multiple transactions to acquire a business. Examples include:

- An entity initially purchases 30 percent of a business and then shortly thereafter purchases an additional 25 percent to gain control.
- An entity negotiates the acquisition of a business in aggregate, but consummates the acquisition by entering into separate legal agreements with each business subsidiary.
- Assets and processes are acquired over time that do not meet the definition of a business on an individual basis, but would constitute a business if evaluated together.

2.015b We believe the following factors listed in ASC paragraph 810-10-40-6 (related to deconsolidation) may be considered to determine whether multiple transactions should be accounted for as a single transaction:

- They are entered into at the same time or in contemplation of one another.
- They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

2.015c If an entity determines that each transaction should be accounted for separately, assets acquired and liabilities assumed would be evaluated and accounted for *separately* in accordance with applicable GAAP. Alternatively, if an entity determines that multiple transactions should be accounted for as a single transaction, those transactions would be evaluated and accounted on a combined basis in accordance with applicable GAAP.

Example 2.0b: Accounting for Goodwill When Multiple Transactions That Cross Reporting Periods Are Accounted for as a Single Business Combination

On October 15, 20X1, ABC Corp. enters into a purchase agreement to acquire DEF Corp.'s fleet of merchant ships in two separate transactions, each representing the acquisition of a business. ABC will transfer consideration of $210,000,000 to obtain control of a portion of the fleet in transaction 1 on December 15, 20X1 and will transfer

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consideration of $210,000,000 to obtain control of the remainder of the fleet in transaction 2 on February 28, 20X2. ABC determines the two transactions should be accounted for as a single business combination, as they are in contemplation of one another and form a single transaction designed to achieve an overall commercial effect. ABC obtains a valuation of the net assets acquired for both transactions.

	Transaction 1	Transaction 2	Total
Consideration paid	$210,000,000	$210,000,000	**$420,000,000**
Fair value of net assets acquired	$220,000,000	$180,000,000	**$400,000,000**
(Bargain purchase) / goodwill	$(10,000,000)	$30,000,000	**$20,000,000**

Assessment

As these two transactions are accounted for as a single business combination, ABC determines that it should not recognize the bargain purchase amount from transaction 1. We believe ABC should make an accounting policy election to either (1) record a purchase price payable of $10,000,000 as of December 15, 20X1 and recognize goodwill of $20,000,000 once it completes transaction 2 (during 20X2), or (2) recognize a pro rata allocation of goodwill of $11,000,000[(1)] and a purchase price payable of $21,000,000 once it completes transaction 1 (during 20X1) and recognize the remaining goodwill of $9,000,000[(2)] once it completes transaction 2 (during 20X2).

[(1)] (220,000,000 / 400,000,000) × 20,000,000 = $11,000,000
[(2)] (180,000,000 / 400,000,000) × 20,000,000 = $9,000,000

2.016 – 2.024 Paragraphs not used

Table 2.1 – 2.2 Not used.

Examples 2.1 – 2.5 Not used.

DEFINITION OF A BUSINESS

2.025 Paragraph not used.

Table 2.2 Not used.

2.026 The evaluation of whether an acquired set of assets and activities (set) qualifies as a business may have significant accounting implications beyond accounting for acquisitions under ASC Topic 805. The definition of a business affects the accounting in other areas of US GAAP including, but not limited to, the following:

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Table 2.2a: Other Areas Affected by the Definition of a Business

Topic	Affected area	Paragraph
Goodwill Impairment Testing	A component of an operating segment is a reporting unit if the component is a business for which discrete financial information is available and segment management regularly reviews the operating results of that component.	ASC paragraph 350-20-35-34
Discontinued Operations	A business that meets the held for sale criteria at the acquisition date is a discontinued operation. If the one year criterion to be classified as held for sale is met at the acquisition date, a business is a discontinued operation at the acquisition date if the other held for sale criteria are probable of being met within a short period following the acquisition (usually within three months).	ASC paragraph 205-20-45-1D
Derecognition	The deconsolidation and derecognition guidance in ASC Topic 810 applies to businesses. Businesses are excluded from the derecognition guidance in ASC Subtopic 610-20. See Chapter 7 of KPMG Handbook, Consolidation for additional guidance on the derecognition of assets and businesses.	ASC paragraphs 810-10-40-3A, 610-20-15-4, 360-10-40-3B
Consolidations	If an entity meets the definition of a business, it is scoped out of the VIE guidance in ASC Topic 810 unless certain conditions exist.	ASC paragraph 810-10-15-17(d)
Consolidation of a VIE that is Not a Business	In the initial consolidation of a VIE that is not a business, the primary beneficiary measures and recognized the assets (except for goodwill) and liabilities of the VIE in accordance with the guidance on business combinations in ASC sections 805-20-25 and 805-20-30. A gain or loss is recognized.	ASC paragraphs 810-10-30-3 and 810-10-30-4

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Spinoffs and Nonreciprocal Transfers	A spinoff or nonreciprocal transfer of a business is recorded based on the carrying value of the subsidiary (after reduction, if appropriate, for an indicated impairment of value).	ASC paragraphs 505-60-25-2, 845-10-30-10
Gain or Loss on Disposal	When a business is disposed of, goodwill associated with that business shall be included in the carrying amount of the business to determine a gain or loss on disposal.	ASC paragraphs 350-20-40-2, 350-20-40-9, 360-10-35-39
Intangible Asset Impairment Testing	The unit of accounting to test indefinite-lived intangible assets for impairment cannot represent a group of indefinite-lived intangible assets that collectively are a business.	ASC paragraph 350-30-35-26
Eligibility for cash flow hedging	A business combination cannot be designated as the hedged item in a cash flow hedge. However, the guidance does not preclude a forecasted asset acquisition from being designated as the hedged item in a cash flow hedge, assuming all other criteria are met.	ASC paragraph 815-20-25-15(g)

2.026a For a transaction or event to be a business combination, the set that the acquirer has obtained control over must constitute a business. This is an important determination, given the different accounting models for the acquisition of a group of assets versus a business. Business combinations are accounted for using the ASC Topic 805 acquisition method that requires measurement of assets and liabilities at fair value with limited exceptions. Acquisitions of assets are accounted for using the cost accumulation and allocation model. Examples of these differences are provided in Table 2.3.

Table 2.3: Significant Difference in the Accounting for the Acquisition of a Group of Assets Versus a Business

	Asset Acquisition	Business Combination
Initial Measurement	The acquirer measures the assets acquired based on their cost, which is generally allocated to the assets on a relative fair value basis.	The acquirer measures identifiable assets and liabilities generally at fair value.
Direct Acquisition-Related Costs	The acquirer includes direct acquisition-related costs in the cost of the acquired assets.	The acquirer expenses direct acquisition-related costs as incurred.

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Contingent Consideration	If the arrangement is a derivative, the acquirer initially measures contingent consideration at fair value with changes in fair value reported currently in earnings. Otherwise, the acquirer generally recognizes contingent consideration when it is probable and estimable. Subsequent changes are generally recorded as adjustments to the carrying amount of the assets.	The acquirer recognizes contingent consideration at the acquisition date and measures it at fair value. Subsequent changes to the fair value of liability-classified contingent consideration are reported currently in earnings.
Settlement of Preexisting Relationships	There is no explicit guidance. We believe acquirers should apply ASC Topic 805 by analogy.	The acquirer recognizes a gain or loss for the effective settlement of a preexisting relationship. The acquirer measures the gain or loss either: (1) for a noncontractual relationship, at fair value, or (2) for a contractual relationship, at the lesser of: (a) the amount by which the contract is favorable or unfavorable to the acquirer, or (b) the amount of stated settlement provisions in the contract available to the party to whom the contract is unfavorable.

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Measurement Period	No concept of a measurement period exists in an asset acquisition. The acquirer must finalize all valuations of assets acquired and liabilities assumed before the next reporting date.	The acquirer may record provisional amounts for the assets acquired and liabilities assumed and adjust them during the measurement period, which ends the earlier of (1) one year from the acquisition date, and (2) when the acquirer has obtained all relevant information about facts that existed at the acquisition date or learns that more information is not obtainable.
Intangible Assets	Intangible assets may qualify for recognition even though they do not meet the criteria for intangible assets acquired in a business combination.	Intangible assets are recognized at fair value if they meet the contractual-legal criterion or the separability criterion. Private companies and not-for-profit entities may elect an accounting policy to subsume into goodwill non-compete agreements and customer-related intangibles that cannot be sold or licensed separately from other assets of the business.
In-process Research and Development (IPR&D)	The portion of the purchase price allocated to IPR&D at the acquisition date is expensed immediately unless it has an alternative future use.	IPR&D is recognized and accounted for as an indefinite-lived intangible asset until the acquirer completes or abandons the project.
Assembled Workforce	Assembled workforce is recognized as an intangible asset.	Assembled workforce is recognized as a part of goodwill.
Reacquired Rights	There is no explicit guidance. The acquirer may determine the measurement basis of reacquired	The acquirer measures reacquired rights based solely

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	rights either (1) using a measurement based solely on the remaining contractual terms (by analogy to ASC Topic 805) or (2) based on fair value.	on the remaining contractual terms.
Acquired Contingencies	Acquired contingencies are accounted for under ASC Topic 450, *Contingencies.* Acquired loss contingencies are recognized if they are both probable and reasonably estimable. Gain contingencies are not recognized until realized.	Acquired contingencies are recognized and measured at fair value if determinable at the acquisition date or during the measurement period. Otherwise, they are accounted for in a manner consistent with ASC Topic 450. The acquirer is required to develop a systematic and rational approach to subsequent measurement, depending on the nature of the contingency.
Indemnification Assets	There is no explicit guidance. Acquirers sometimes apply ASC Topic 805 by analogy.	The acquirer records an indemnification asset at the same time and on the same basis as the indemnified item, subject to any contractual limitations and collectibility.
Goodwill	Goodwill is not recognized. Generally, the acquirer allocates any excess cost over the fair value of the net assets acquired on a relative fair value basis only to certain nonfinancial assets acquired.	Any excess consideration transferred over the fair value of the net assets acquired is goodwill and is recognized as a separate asset.
Bargain Purchase Amount	Similar to goodwill, the acquirer should allocate a bargain purchase amount only to certain nonfinancial assets on a relative fair value basis.	The acquirer recognizes a bargain purchase gain immediately in earnings.
Deferred Taxes	Because neither goodwill nor a bargain purchase gain are recognized, if the cost differs from the tax bases of the assets acquired	Recognizing deferred tax assets and liabilities results in increases or decreases to goodwill or a bargain

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	and liabilities assumed, the simultaneous equations method is used to calculate the deferred tax assets and liabilities and the resulting adjustments to the related assets' and liabilities' carrying amounts. (See KPMG Handbook, *Accounting for Income Taxes* Section 10 - Other Considerations)	purchase gain. (See KPMG Handbook *Accounting for Income Taxes* Section 6 - The Tax Effects of Business Combinations)

2.026b For additional guidance on accounting for asset acquisitions, see KPMG Handbook, Asset acquisitions.

INPUTS, PROCESSES, AND OUTPUTS

ASC paragraph 805-10-55-3A

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. To be considered a business, an integrated set must meet the requirements in [ASC] paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.

ASC paragraph 805-10-55-4

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

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

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

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(c) *Output:* The result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.

ASC paragraph 805-10-55-5

To be capable of being conducted and managed for the purposes described in [ASC] paragraph 805-10-55-3A, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs. A business need not include all of the inputs or processes that the seller used in operating that business. However, to be considered a business, the set must include at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. [ASC] paragraphs 805-10-55-5A through 55-5C provide a practical screen to determine when a set would not be considered a business. If the screen is not met, further assessment is necessary to determine whether the set is a business. [ASC] paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9 provide a framework to assist an entity in evaluating whether the set includes both an input and a substantive process.

ASC paragraph 805-10-55-6

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

2.027 The three elements of a business are inputs, processes, and outputs. While a business typically has outputs, they are not required for a set to qualify as a business.

2.028 Inputs are resources that contribute to the creation of outputs when processes are applied to the inputs. Generally, inputs are the assets in the set and include long-lived tangible assets (e.g., real estate and equipment), intangible assets (e.g., intellectual property, customer lists, trade names, patents, and recipes), materials, contracts that provide the ability to obtain access to necessary materials or rights (e.g., distribution rights, mineral interests, broadcast rights, supply contracts, and some service contracts), and employees.

2.029 Processes are systems, standards, protocols, conventions, and rules that, when applied to inputs, create or have the ability to contribute to the creation of outputs. Processes typically include:

- Strategic management processes (e.g., the overall vision and direction of the set that contribute to the creation of outputs and obtaining customers),
- Operational processes (e.g., the fulfillment, production, development, or customer acquisition processes that contribute to creating outputs), and

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- Resource management processes (e.g., processes involved in deploying resources such as raw materials and employees to produce outputs).

Accounting, billing, payroll, and other administrative systems are typically not processes used to create outputs in most industries.

2.030 An entity could acquire a process even if it is not documented. While employees are an input, when they form an organized workforce, the capacity (e.g., knowledge, skills, or experience) of that workforce to perform a process is acquired even if the process is not documented. In other words, the workforce itself is an input but the knowledge of the activities the workforce performs can be a process. However, as noted in Paragraph 2.073, if the acquired set includes a workforce, other inputs must also be present to conclude that the set is a business.

2.031 Outputs are the result of processes applied to inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues. In general, outputs give rise to the revenue of the set. As discussed in paragraph BC59 of the Basis for Conclusions of ASU 2017-01, *Clarifying the Definition of a Business*, the FASB decided to align the definition of outputs with how that term is used in ASC Topic 606, *Revenue from Contracts with Customers*. However, a set does not need to have contracts in the scope of ASC Topic 606 to have outputs because the definition includes *investment income* and *other revenues.* For example, a set could generate outputs as a result of leasing property in the scope of ASC Topic 842, *Leases*.

2.032 An integrated set does not need to include all of the inputs and processes that the seller used in operating that set. For example, a set could qualify as a business if it is a division, product line, or subsidiary of another entity. However, a set is a business only if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The evaluation requires an entity to consider the substance of what was acquired regardless of whether the missing elements (e.g., missing inputs and processes) could be replaced by a market participant.

2.033 ASC Topic 805 includes two steps to determine if the minimum requirements to be a business are met. Step 1 is a screening test that, if met, results in the conclusion that the set is not a business. If Step 1 is not met, the entity evaluates whether the set includes an input and a substantive process (Step 2). However, before performing these steps an entity needs to identify the inputs, processes, and outputs included in the set.

Determining What Is a Part of the Set

2.034 In most cases, evaluating what is a part of the set will not be difficult, because the items included in the set will be explicitly identified in the contract between the acquirer and the seller. However, in other situations this analysis may not be straightforward and significant judgment will be required.

Employees

2.035 In some transactions, the acquirer will not acquire a legal entity of the seller (for tax or legal purposes this is often referred to as an *asset acquisition* instead of a *stock acquisition)*. For the acquirer to acquire employees of the seller, the employees are

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terminated by the seller and hired by the acquirer. We believe the employees would be a part of the acquired set and the form of the transaction would not be relevant in these circumstances. However, all facts and circumstances need to be considered in determining whether employees are part of the acquired set.

Multiple Transactions with the Acquirer and Seller

2.036 When an entity enters into multiple transactions at or near the same time with the same counterparty to acquire assets or activities, it evaluates whether the substance is a single transaction or multiple transactions. Entities should consider the factors in Paragraph 2.015b to determine whether multiple transactions should be accounted for as a single transaction.

2.037 In addition to the factors in Paragraph 2.015b, the guidance in ASC paragraphs 805-10-25-20 through 25-22 and 55-18 may be helpful in identifying whether a separate contract entered into between the acquirer and seller to provide future goods or services should be included in the set. That guidance indicates that some arrangements should be accounted for separately as a settlement of a pre-existing relationship, a transaction that compensates employees or former owners of the acquiree for future services, or a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

2.038 When re-deliberating ASU 2017-01, the FASB observed that many entities used the guidance in ASC paragraphs 805-10-25-20 to 25-22 and 55-18 to determine whether contractual arrangements were a part of the set; and in paragraph BC49 of the Basis for Conclusions of ASU 2017-01, the FASB noted that entities should continue to use judgment. As a result, that guidance remains relevant for determining whether contracts between the acquirer and seller for future goods or services are a part of the acquired set (see Section 11 for further details on this guidance).

2.038a Other indicators that a contract that compensates the seller for future goods or services is *not* a part of the acquired set include when the future goods or services provided by the seller are:

- Readily available in the marketplace; and
- An output of the seller's ordinary activities.

2.039 In addition, because the definition of a business is also relevant to the scope of derecognition guidance (i.e., ASC Topic 810 and ASC Subtopic 610-20), we believe it is also relevant to understand whether the seller disposed of an input or process. For example, if a contract between the acquirer and seller does not involve the seller transferring inputs or processes (e.g., it is a revenue contract from the perspective of the seller), then that transaction is not considered a disposal of an input or process by the seller, nor the acquisition of an input or process by the acquirer.

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Example 2.6: Determining What Is a Part of the Set - Multiple Transactions with the Seller

Entity A enters into a contract to sell a building to Entity B. At the same time, Entity A and Entity B enter into a contract whereby Entity A will provide property management services and Entity B will compensate Entity A for those services. The services are:

- Readily available in the marketplace; and
- A part of Entity A's ordinary activities.

Entity B evaluates whether the property management contract is a part of the set. Consistent with the guidance in ASC paragraph 805-10-55-21, because the transaction compensates the former owners for future services, the transaction would be considered separate from the set. That is because acquirer is compensating the seller for future property management services and the services are

- Readily available in the marketplace; and
- A part of the seller's ordinary activities.

Furthermore, in the property management contract, Entity A does not dispose of an input or process.

As a result, Entity B concludes that the property management contract is not a part of the acquired set.

Contractual Arrangements

2.040 A contract that is separately negotiated and entered into with an independent third party by the acquirer is typically not a part of the set even if it was entered into at or near the same time or relates directly to the acquirer's operation of the set. However, when the seller and third party previously had a contractual relationship that transfers to the acquirer the determination may not be as clear.

2.041 When evaluating whether a third party contract is a part of the set, the objective is to determine if the acquirer and third party entered into a separately negotiated contract or if the seller transferred the contract to the acquirer. In many cases, this will be a legal distinction because a contract is either acquired through a legal entity or assigned by the seller to the acquirer. However, entities should also evaluate the substance of the arrangement when the acquirer and third party enter into a contract directly.

2.041a To make this evaluation, entities should consider the following factors (not exhaustive):

- **Whether the acquirer and third party entered into substantive negotiations to continue the relationship.** If the contract between the acquirer and third party was the result of a bona fide negotiation, it may indicate the contract *is not* a part of the set. In contrast, if the contract was not

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the result of a bona fide negotiation, it may indicate the contract *is* a part of the set.

- **Whether it is feasible to change vendors.** If changing vendors is not feasible (even if available in the marketplace) because of a significant cost of changing or disruption caused by the change, it might indicate that the negotiations between the acquirer and third party are not substantive and the contract is a part of the set. In contrast, the fact that it is convenient to maintain the same vendor would not necessarily indicate the change was not feasible.
- **Whether the goods or services are readily available in the marketplace.** If the services are unique or scarce such that the acquirer would not be able to obtain the goods or services elsewhere, it might indicate that the seller transferred the contractual relationship to the acquirer. If the goods or services can be obtained in the marketplace, it might indicate that the contract is a separately negotiated contract and not a part of the set.
- **Whether the transaction can be closed without the contract transferring.** For example, if the contract between the acquirer and seller includes a contingency that requires the contract between the acquirer and a third party to be entered into, it would indicate the contract is a part of the set.

Example 2.7: Determining What Is a Part of the Set - Contractual Arrangement with a Third Party

Entity A owns a hotel property and has an at-market in-place contract with Manager X to manage that property. Entity B acquires the hotel from Entity A. Consider the following scenarios:

Scenario 1

The contract between Entity A and Manager X has a change-in-control provision that automatically terminates the contract on sale of the property. Entity B and Manager X must enter into a new contract and neither party is required to continue the relationship. Entity B and Manager X enter into a new contract with substantially similar terms.

The contract is not a part of the set because Entity B and Manager X had substantive negotiations to enter into the new contract, the services are readily available in the marketplace, the entity could reasonably replace the vendor with another party without a significant disruption in operations and the consummation of the transaction was not dependent upon entering into the new agreement.

Scenario 2

The contract between Entity A and Manager X does not terminate on sale of the property and Entity A can assign the contract to other parties. Entity A assigns the management contract to Entity B as a part of the transaction.

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The contract is a part of the set. The contract transferred from Entity A to Entity B. While the services are readily available in the marketplace, there were no substantive negotiations between Entity B and Manager X.

Scenario 3

The contract between Entity A and Manager X does not terminate on sale of the property and is assignable to other parties. At Entity B's request, Entity A terminates the contract with Manager X before the close of the transaction. Entity B and Manager X enter into a new contract with terms that are substantially the same as the contract between Entity A and Manager X; however, the transaction could not close until Entity B and Manager X had a new contract in place.

The contract is a part of the set. In substance, the contract transferred from Entity A to Entity B. While Entity B and Manager X entered into a new contract, it was not a result of a separate negotiation but rather the transaction was dependent on Entity B and Manager X entering into the same contract. Furthermore, Entity A and Manager X only terminated the contract to help facilitate the transaction closing.

STEP 1 –SCREENING TEST

ASC paragraph 805-10-55-5A

If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, the gross assets acquired should include any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of net identifiable assets acquired.

ASC paragraph 805-10-55-5B

A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:

(a) A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)

(b) In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

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ASC paragraph 805-10-55-5C

A group of similar assets includes multiple assets identified in accordance with [ASC] paragraph 805-10-55-5B. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics). However, the following should not be considered similar assets:

(a) A tangible asset and an intangible asset

(b) Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)

(c) A financial asset and a nonfinancial asset

(d) Different major classes of financial assets (for example, accounts receivable and marketable securities)

(e) Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

(f) Identifiable assets within the same major asset class that have significantly different risk characteristics.

2.042 Step 1 is an initial screen to determine when a set is not a business. Step 1 requires that when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. However, if Step 1 is not met, the entity will still need to evaluate Step 2 to determine if the set is a business. While Step 1 is required, an entity could choose to go directly to Step 2 if it concludes under Step 2 that the set is not a business. That is because Step 1 could not contradict that conclusion. However, an entity will need to appropriately evaluate Step 1 before concluding that a set is a business, because Step 1 is determinative that a set is not a business regardless of an entity's interpretation of Step 2.

2.043 There may be circumstances when Step 1 could be completed solely on a qualitative basis. Paragraph BC19 in the Basis for Conclusions of ASU 2017-01 states:

> The assessment could be qualitative if, for example, an entity concludes that all of the fair value will be assigned to one element of the acquisition. For example, if the acquisition includes a license for a drug candidate and an at-market contract and the entity concludes that the at-market contract has at the date of assessment little or no fair value assigned to it or the fair value of a single identifiable asset or group of similar identifiable assets is so significant that it is very clear that the threshold will be met, the entity may conclude that the threshold has been met. If there are multiple assets that the entity concludes will have more than an insignificant value assigned, the entity may be able to qualitatively conclude that there is clearly significant value in assets that are not similar and that the threshold is not met and go on to the rest of the framework. However, an entity must determine the fair value of each asset to allocate the consideration to assets

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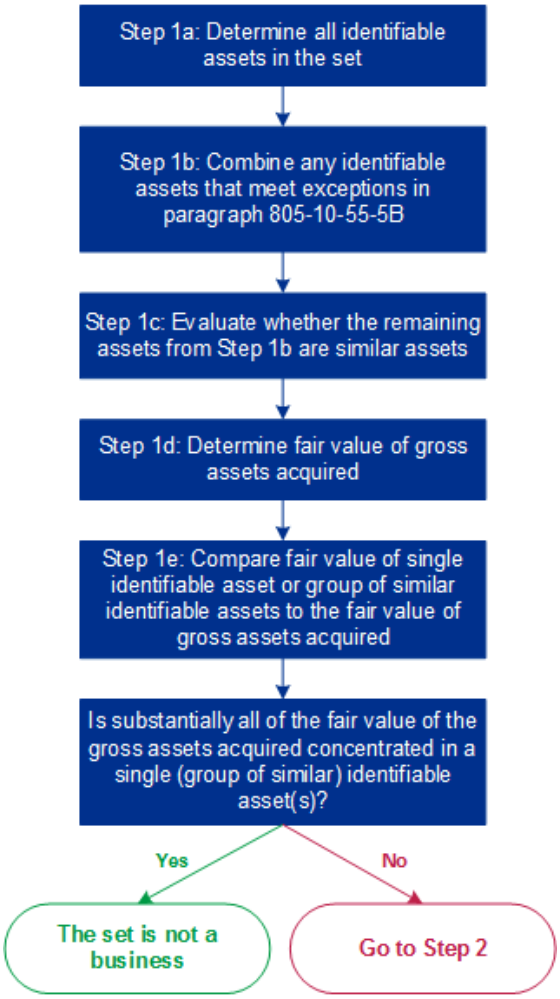
> recognized in both an asset acquisition and a business combination…if the set is not a business, an entity could choose to document its conclusion in the most cost-effective manner depending on its situation.

We would expect an entity to document its qualitative analysis and its considerations to conclude the screening test is met without a quantitative analysis.

The following flowchart illustrates the steps that may be useful when applying Step 1:



Step 1a: Determine all identifiable assets in the set

2.044 In Step 1a, an entity would determine all identifiable assets in the set. Paragraph BC24 in the Basis for Conclusions of ASU 2017-01 states, "For ease of application, the Board decided that an entity should use the same unit of account when assessing the threshold that it would use for identifying assets recognized in a business combination even if it results in some tangible assets and intangible assets being combined into a single asset."

2.044a As a result, the starting point is to determine what assets would be recognized under ASC Topic 805 if the set were considered a business rather than a group of assets.

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2.045 For example, in a business combination an entity would recognize and measure an in-process research and development (IPR&D) asset, but it typically would not recognize IPR&D as an asset in an asset acquisition (see Question 4.2.20 in KPMG Handbook, Asset acquisitions). Because the unit of account is the same as in a business combination, a single IPR&D asset would be considered a single identifiable asset for purposes of applying Step 1.

2.046 In contrast, an assembled workforce (or goodwill) is not an *identifiable asset* that could be recognized in a business combination, but an assembled workforce intangible asset could be recognized in an asset acquisition. Because the unit of account is the same as in a business combination, an assembled workforce intangible asset would not be considered a single identifiable asset for purposes of applying Step 1.

2.047 A single identifiable asset could also include certain complementary intangible assets that are recognized and measured as a single asset in a business combination. For example, ASC paragraph 805-20-55-18 states, "The terms brand and brand name, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Subtopic does not preclude an entity from recognizing, as a single asset separately 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."

2.047a Similarly, some tangible assets and intangible assets (e.g., a nuclear power plant and a license to operate it in ASC paragraph 805-20-55-2(b)) that are combined for financial reporting purposes in a business combination would also be considered a single identifiable asset for purposes of Step 1.

Example 2.8a: Applying Step 1a

Entity X acquires five separate apartment complexes. Each complex includes land, building, property improvements, and at-market in-place tenant leases. Entity X first determines the identifiable assets that could be recognized separately in a business combination.

The land, building, property improvements, and in-place leases would be recorded as separately identifiable tangible and intangible assets. Entity X also identifies an intangible asset for the trade name associated with the apartment complexes.

As a result, the identifiable assets in the set include five parcels of land, five buildings, various property improvements, the in-place lease intangible assets at each complex, and the trade name intangible asset.

Step 1b: Combine any identifiable assets that meet exceptions in ASC paragraph 805-10-55-5B

2.048 ASC paragraph 805-10-55-5B provides two exceptions to the general rule discussed in Step 1a. These exceptions require an entity to combine assets that would be

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considered separately identifiable in a business combination as a single asset **only** for purposes of applying Step 1.

2.048a Those exceptions are to consider as a single identifiable asset:

(1) A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (e.g., land and building); and

(2) In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

2.048b While identifiable assets that meet these exceptions are combined as a part of Step 1b, they generally would be recorded separately regardless of whether the set is a group of assets or a business. For example, a building and an in-place lease should be measured and recorded separately regardless of whether the acquired set meets the definition of a business.

2.049 The FASB included the exceptions in Step 1b to allow practical application of Step 1 in certain transactions. For example, in real estate transactions, land and buildings are often transferred together but are considered separate assets for accounting purposes. Without the first exception that requires the combination of tangible assets, these transactions would rarely meet Step 1. The second exception was included to promote consistency between real estate transactions in Step 1 so that an entity would not get a different outcome for similar transactions solely because the value of the leases was different or because the lease had above or below market rents.

2.050 We believe the exception for lease intangibles should be interpreted narrowly (i.e., it should be applied only when the contract meets the definition of a lease in ASC Topic 842, *Leases*); entities should not make analogies to combine other contracts and assets.

2.051 Additionally, we believe the reference to "an intangible asset representing the right to use a tangible asset" in ASC paragraph 805-10-55-5B(a) is limited only to intangible assets that represent a right to use a tangible asset that is physically attached to and cannot be physically removed and used separately from another tangible asset without incurring significant cost or significant diminution in utility or fair value of either asset. Paragraph BC25 of ASU 2017-01 cites two examples that would qualify: (1) a building and a related ground lease, and (2) a pipeline and the use rights for the land in which the pipeline is laid. By contrast, we believe that intangible assets associated with a product would not be combined with the related inventory, because they do not represent a right to use a tangible asset that is physically attached to the inventory. The analysis in Case G in ASC paragraphs 805-10-55-85 through 55-87 (see Example 2.17) appears to support this view. In that example, the entity acquires the intellectual property rights to a yogurt brand and the related equipment and inventory but does not combine those rights with the tangible assets for the screening test.

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Example 2.8b: Applying Step 1b

The following is a continuation of Example 2.8a.

Entity X evaluates whether any of the exceptions in ASC paragraph 805-10-55-5B (Step 1b) apply. Entity X concludes that the land, building, property improvements, and in-place leases at each property (apartment complex) are a single asset for the following reasons:

(1) The building and property improvements are attached to and cannot be physically removed from and used separately from the land without incurring significant costs or reducing their fair value; and

(2) The in-place lease intangibles for each apartment are required to be combined with the leased asset.

After applying the exceptions, the set has six single identifiable assets (i.e., the combined land, building, property improvements, and leases at each of the five properties are one asset and the trade name intangible asset). The exceptions in Step 1b do not apply to the trade name intangible asset.

Example 2.8bb: Applying Exception (a) in Step 1b

Entity A acquires Entity T. Based on its analysis of Step 1a, Entity A determines that the acquired set consists of:

(1) An oil and gas processing plant, including the land, building and processing equipment.

(2) A pipeline and related easement connecting the plant and terminal, which are located 5 miles from each other.

(3) An oil and gas terminal facility, including the land, building and storage tanks.

The pipeline is physically attached to components of both the processing plant and terminal facility and connects the two facilities.

Entity A evaluates whether any of the exceptions in ASC paragraph 805-10-55-5B (Step 1b) apply to each of the identifiable assets from Step 1a. First, Entity A concludes that the assets within each group of assets above should be combined for the following reasons:

(1) Processing plant – The processing plant building and processing equipment are attached to and cannot be physically removed from and used separately from each other and the land at the processing plant without incurring significant costs or reducing their fair value;

(2) Pipeline – The pipeline is attached to land and the easement is the intangible right to use the land attached to the pipeline;

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(3) Terminal facility – The terminal building and storage tanks are attached to and cannot be physically removed and used separately from each other and the land without incurring significant costs or reducing their fair value.

Next, Entity A evaluates whether the three combined assets above should be further combined into a single asset as follows:

— *Processing plant and pipeline*: Entity A concludes that the *processing plant* and pipeline should be combined and considered a single asset (processing plant/pipeline) because the pipeline is attached to and cannot be physically removed and used separately from the processing plant without incurring significant cost or significant diminution in utility or fair value to the pipeline.

— *Combined processing plant/pipeline and terminal facility*: Entity A concludes that the terminal facility and processing plant/pipeline should be combined and considered a single asset because the pipeline is attached to and cannot be physically removed and used separately from the storage tanks at the facility without incurring significant cost or significant diminution in utility or fair value to the pipeline.

Therefore, all of the identifiable assets in the set should be combined and considered a single asset for the screening test.

Step 1c: Evaluate whether the remaining assets from Step 1b are similar assets

2.052 In Step1c, an entity evaluates whether the assets identified in Step 1b are similar. However, an entity that acquires a combined single asset (e.g., the combined land, building, property improvements, and leases in Example 2.8b) does not need to evaluate components of that combined single asset for similarity. For example, it is not necessary to consider whether the commercial and retail space in a single real estate asset are different or similar. The analysis of significantly different risks is only about comparing an individual or combined asset identified in Step 1b with another individual or combined asset identified in Step 1b.

2.053 ASC paragraph 805-10-55-5C states, "When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics)."

2.053a In addition, that paragraph identifies types of assets that should not be considered similar, including:

(a) a tangible asset and an intangible asset,

(b) identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development),

(c) a financial asset and a nonfinancial asset,

(d) different major classes of financial assets (for example, accounts receivable and marketable securities),

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(e) different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles), and

(f) identifiable assets within the same major asset class that have significantly different risk characteristics.

2.054 ASC subparagraph 805-10-55-5-5C(a) states that a tangible asset and an intangible asset should not be considered similar. This factor is applied only after assets are combined in accordance with ASC paragraph 805-10-55-5B in Step 1b. Accordingly, an entity does not need to separate a tangible and an intangible asset (e.g., real estate asset and related lease intangible) in Step 1c when applying the above factors.

2.054a Furthermore, the individual combined assets (e.g., real estate asset and related lease intangible) could be considered similar to other assets that are identified in Step 1b. For example, a combined apartment complex and related leases would be compared to other assets to determine if they are similar assets and may be grouped with other similar combined assets (e.g., other combined apartment complexes and related leases) if the other criteria to be a similar asset are met. Also, an apartment complex that is combined with lease intangibles in Step 1b may be combined with a similar apartment complex without leases if there are similar risks associated with managing and creating outputs from the assets.

2.055 Significant judgment will be required to determine if single assets within a major asset class have significantly different risk characteristics (factor (f)). Paragraph BC31 in the Basis for Conclusions of ASU 2017-01 states, "The Board clarified that the risks to be evaluated should be linked to the risks associated with the management of the assets and creation of outputs because this assessment may be instructive on whether an integrated set of assets and activities has been acquired. That is, when the risks associated with managing and creating outputs from the assets are significantly different, the set would need more sophisticated processes to manage and create outputs." As a result, the relevant analysis is whether the risks associated with creating outputs are significantly different.

2.056 Consistent with ASC paragraph 805-10-55-8, we believe an entity should consider the risks associated with the management of the assets and the creation of outputs from the perspective of a market participant (see discussion of the market participant perspective in Paragraph 2.093). It is not necessarily relevant how the acquirer intends to operate the set, or how the seller operated the set, when determining the risks associated with the assets.

2.057 An entity should consider different risk factors depending on the nature of the asset. In paragraph BC32 of ASU 2017-01, the Board indicated its expectation that different types of risks would be important to the analysis of different types of transactions. For example, real estate and intellectual property have different risk characteristics to analyze. Entities may also need to consider different types of risks for assets within a particular industry.

2.057a A critical step in the analysis will often be identifying the most relevant risks related to the assets. For example, we believe that the most relevant risks for intellectual

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property under development (e.g., development risks) usually would be different from the relevant risks associated with intellectual property embedded in a mature product (e.g., customer or market risks).

2.058 Table 2.4 summarizes risk factors and examples associated with operating and managing the assets to create outputs that may be relevant based on the nature of the asset (not exhaustive). These risks will need to be *significant* to affect the conclusion of whether assets are similar, and while these factors may be present in a particular transaction, they may not be determinative and all facts and circumstances should be evaluated. We would expect more weight to be assigned to the most relevant risks associated with the assets.

Table 2.4: Risk Factors and Examples to Consider When Identifying Similar Assets

Type of Assets	Risk Factors	Examples of Assets That May Have Significantly Different Risks
Real Estate	Geographic location	Property in a developing or volatile economy versus a stable and low volatility economy
		Properties in jurisdictions or countries with significantly different regulations
		Single-family home in a large metropolitan area (population > 2 million) versus single-family home in a small town (population < 10,000)
	Class of customers	Four-star hotel versus a two-star hotel
		Commercial office building versus residential property
		Tenants with a high risk of default versus tenants with a low risk of default
	Size of the properties	Office building with two floors versus an office building with 30 floors
		Shopping center (e.g., with five tenants) and a shopping mall (with many tenants)
	Market risk	Property in a high growth area versus a property in a low growth area
		Significant cost to obtain tenants versus property with a waiting list to become a tenant

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	Types of assets	Residential versus commercial real estate
		Hotel versus commercial real estate
		Apartment building versus a single-family home
		Owned assets versus assets acquired under an operating lease
Life Sciences	Development risk	Drug compounds in different phases of clinical trials (e.g., early versus late phase of clinical development)
		Expertise required to develop the drug candidates
		Science or technology underlying the drug candidates
		Commercialized drug versus development stage compound
	Class of customers	Drug compounds that treat (or are intended to treat) different diseases (i.e., the patients have different demographics)
	Market risks	Generic brand versus premium brand
		Commercialized product with generic competition versus product with patent protection
Financial Assets	Credit risk	High quality bond versus junk bond
		Loan to a large multinational company with a high credit rating versus a loan to a start-up company with a low credit rating
	Term	Three-year loan versus a 20-year loan
	Type	Mortgage loan versus commercial loan
Oil and Gas Assets	Development risks	Property in shallow water versus property in ultra-deep water
		Property in location with known adverse weather conditions versus property with moderate weather conditions
		Offshore properties versus onshore properties

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	Jurisdiction (laws and regulations)	Property in a highly regulated country versus property in less regulated country Property in country with unstable government versus property in country with stable government Property in area with access to a workforce (e.g., local workforce available) and property in area with no workforce (e.g., workforce must be transported to site)
Transport-ation Assets	Type of asset	Assets that perform different functions (e.g., cargo aircraft versus a passenger aircraft) Oil tanker and cargo ship
	Market risks	Assets designed to operate in locations with known adverse weather conditions versus assets designed to operate in moderate weather conditions Assets (e.g., newer models, better technology, or unique functions) that demand higher rates from customers such as a boat with a day rate of $30,000 versus a boat with a day rate of $10,000

Example 2.8c: Applying Step 1c

The following is a continuation of Examples 2.8a and 2.8b.

The acquired apartment complexes are all in the same metropolitan area and have a similar class of customers. There are differences in prices charged for apartments on lower floors and apartments with a view. However, the ratio of price differences between apartments on lower floors and apartments with views is reasonably consistent at each apartment complex. The trade name intangible asset is not a similar asset to the apartment complexes (i.e., tangible assets) as a tangible asset and an intangible asset (except for lease intangibles and leased assets) are not similar per ASC paragraph 805-10-55-5C(a).

In applying ASC paragraph 805-10-55-5C, Entity X concludes that the five apartment complexes are similar assets because the risks of operating the assets and creating outputs from these assets are not significantly different.

As noted in the factors presented in Table 2.4, geographic location should be considered when determining whether real estate assets are similar assets. Apartment complexes in different parts of the United States or different parts of the same metropolitan area may not be similar assets if the risks associated with producing outputs (e.g., lease income) in different geographical locations are significantly different. Also, if there were another

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type of asset acquired in the transaction such as an office building or hotel, it would not be similar to apartment complexes.

Example 2.8cc: Acquisition of Owned and Leased Assets

As part of an acquisition, Entity A acquires two custom-made heavy machines from Entity T. Machine X was owned by Entity T and Machine Y was under a finance lease from an unrelated third party. Both machines are of the same make and model and used for similar purposes in construction. Machine Y is leased for its entire economic life. As part of steps 1a through 1b, the only two assets acquired in the set are Machine X and Y.

In applying ASC paragraph 805-10-55-5C, Entity A concluded that Machine X and Y were similar because they were in the same major asset class and the risks of operating the assets and creating outputs from these assets are not significantly different based on the following:

— *Same major class of tangible assets*: Entity A concluded that both assets were in the same major asset class because the nature or use in operations of each machine are similar. While Entity A is required to separately classify or disclose finance lease right of use (ROU) assets from the owned equipment, and the leased machine has different accounting requirements, the nature of the underlying asset is similar. Furthermore, because it is a finance lease it is economically similar to purchasing the asset with cash or a different form of financing, as discussed in paragraph BC57 of the Basis for Conclusions of ASU 2016-02.

— *Similar risk characteristics*: Entity A concluded that both machines had similar risk characteristics because they can be used interchangeably by Entity A to create outputs with similar customers over a similar time period. The way the machine was financed does not significantly affect the risk of *operating and managing the assets to create outputs* because the nature of a finance lease is similar to the purchase of an asset with a corresponding financing.

If Machine Y was subject to an operating lease it may not be considered similar because the time frame of operating and managing an asset under an operating lease may affect the risks of managing and creating outputs compared to an owned asset.

Step 1d: Determine fair value of gross assets acquired

2.059 In Step 1d, the entity determines the fair value of gross assets acquired (i.e., the denominator). The gross assets acquired generally include all assets that are recognized in a business combination including goodwill. The denominator also includes consideration transferred (plus the fair value of noncontrolling interests and previously held interests, if any) in excess of the fair value of net identifiable assets acquired. The consideration transferred would also include contingent consideration determined under ASC Topic 805 because contingent consideration may affect the value of goodwill, which is included in gross assets. However, transaction costs are excluded from both the numerator and denominator, because they are expensed in a business combination. Additionally, an

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assembled workforce, which is not a recognized intangible asset in a business combination, would be included in the denominator by virtue of its inclusion in goodwill.

2.060 The FASB specifically excluded items from the numerator and denominator such as cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. Cash and cash equivalents are excluded to prevent entities from increasing the purchase price with no economic substance (e.g., by choosing to include a greater amount of cash or cash equivalents in the acquired set) to avoid a conclusion that substantially all of the fair value is concentrated in a single asset (or group of similar assets).

2.060a The deferred tax items are excluded because those items are a reflection of the legal or tax form of the transaction rather than the substance of what was acquired.

2.060b Except for unfavorable lease intangible liabilities, which are combined with the related leased asset (see further discussion of leases in Paragraph 2.048), the numerator and denominator exclude all debt or other liabilities because the assumption of those liabilities may simply be a financing mechanism for the transaction. The Board indicated in paragraph BC20 of ASU 2017-01 that it decided to exclude liabilities from the screening test to avoid "a group of assets that would otherwise be subject to further evaluation under the model bypassing such evaluation solely because a transaction includes liabilities in addition to assets." Following this rationale, we believe that a gain from a bargain purchase also should be excluded from (i.e., it does not reduce) the denominator. ASC paragraph 805-10-55-5A states that gross assets should include any consideration transferred in excess of the fair value of net identifiable assets acquired. ASC paragraph 805-10-55-5A does not specifically state that gross amounts should include any deficit (i.e., bargain purchase amount). Including a bargain purchase amount in the numerator and denominator would distort the screening test in a manner similar to including liabilities. See Example 2.9a.

2.060c We believe that the exclusion of all liabilities (except for unfavorable lease intangible liabilities) from the numerator and denominator of the screening test also applies to asset retirement obligations related to assets included in the set. That is, an asset retirement obligation should not be netted against (should not reduce) the fair value of the assets included in the numerator and denominator. For example, assume an entity acquires a set that includes a manufacturing facility with an associated asset retirement obligation. The entity determines the fair value of the manufacturing facility to be $100 million (net of an asset retirement obligation of $20 million). In accounting for the acquisition, the entity would record the manufacturing facility at $120 million and a liability for the asset retirement obligation at $20 million. In applying the screening test, the entity would include the manufacturing facility with a value of $120 million in both the numerator and denominator. However, the presence of an asset retirement obligation may be a relevant qualitative factor to consider (see factors discussed in Paragraph 2.063).

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Example 2.8d: Applying Step 1d

The following is a continuation of Examples 2.8a, 2.8b, and 2.8c.

For this example, Entity X also assumes debt associated with building the apartment complexes of $2,500,000 and cash on hand of $50,000. Company X paid a purchase price of $25,600,000.

Entity X determines the fair value of the gross assets acquired to determine the denominator.

Items Acquired / Assumed	Estimated Fair Value	Included in Gross Assets
Apartment complex 1	$5,100,000	$5,100,000
Apartment complex 2	$4,850,000	$4,850,000
Apartment complex 3	$5,650,000	$5,650,000
Apartment complex 4	$5,400,000	$5,400,000
Apartment complex 5	$5,200,000	$5,200,000
Assumed debt	($2,500,000)	Not included
Cash on hand	$50,000	Not included
Trade names	$1,850,000	$1,850,000
Total	**$25,600,000**	**$28,050,000**

The fair value of gross assets acquired is $28,050,000 in this example. Cash, debt assumed, deferred taxes (if any), and goodwill resulting from the effects of deferred tax liabilities (if any) are not included in gross assets acquired.

Step 1e: Compare the single identifiable asset or group of similar identifiable assets to the fair value of gross assets acquired

2.061 In Step 1e, an entity compares the fair value of the single identifiable asset (or group of similar assets) to the fair value of the gross assets acquired. To do that, an entity would identify the individual identifiable asset with the greatest fair value or group of similar identifiable assets with the greatest fair value (whichever is greater). Next the entity compares that amount to the fair value of the gross assets acquired as determined in Step 1d. If the fair value of that single identifiable asset or group of similar identifiable assets represents substantially all of the fair value of the gross assets, then the screening test is met and the set is not a business.

2.062 The FASB decided to use the term *substantially all* because it is commonly used throughout U.S. GAAP. However, the FASB did not specify a quantitative threshold for what *substantially all* means in Step 1. In other U.S. GAAP, substantially all is generally interpreted to mean approximately 90 percent or greater; however, for purposes of the

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definition of a business, substantially all is not necessarily meant to be a bright-line quantitative threshold.

2.063 When there is uncertainty about whether the *substantially all* test is met (e.g., because the ratio is close to the quantitative threshold or the valuation of assets acquired is based on unobservable (Level 3) fair value measurement inputs subject to significant measurement uncertainty), we believe qualitative factors may also be considered. The purpose of a qualitative assessment is to evaluate whether the other assets in the set have substance, in which case Step 2 should be performed. We believe relevant qualitative factors include but are not limited to the following:

- **The composition of other assets.**
  - If the other assets are equipment or materials that can be easily replaced at a cost that is insignificant in relation to the fair value of the set, that may qualitatively indicate that the substantially all threshold is met because the other assets are not substantive.
  - If the other tangible or intangible assets complement the primary asset (e.g., a customer list accompanying a significant developed technology intangible asset), that may qualitatively indicate that the other assets are substantive and an entity should move to Step 2.
- **The set includes employees and goodwill.** The presence of goodwill is an indicator of a substantive process in the set. If the set includes employees and a more than insignificant amount of goodwill, that may indicate that an entity should move to Step 2 to evaluate whether the employees represent an organized workforce, in which case a substantive process would be present and the set likely would be a business.
- **The set is self-sustaining.** If the set is self-sustaining (i.e., the set was a stand-alone entity or a largely independent division, subsidiary or product line of a larger entity), that may qualitatively indicate that in substance an entity is acquiring more than just a single asset and the other elements are substantive; therefore the entity should move on to Step 2.
- **An asset retirement obligation is included in the set.** Asset retirement obligations, although excluded from the substantially all quantitative test, generally are associated with the normal operation of long-lived assets. If exclusion of an asset retirement obligation associated with an asset in the set is the reason a quantitative threshold has been met, that may qualitatively indicate that in substance an entity acquired more than just a single asset and the other elements are substantive depending on the nature and composition of the other assets.

2.064 We would expect entities to apply the quantitative and qualitative factors consistently to similar transactions. In general, we would place greater emphasis on the quantitative assessment when there is a higher concentration of fair value in a single asset (or group of similar assets) or the fair value measurements of the assets are not subject to

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significant measurement uncertainty. As a result, qualitative factors ordinarily would not overcome the quantitative assessment when the fair value of a single asset (or group of assets) is well above 90 percent of the fair value of the gross assets even if employees are included in the set. In contrast, we believe it would be rare for an entity to conclude that Step 1 is met when the concentration of fair value is more than just a few percentage points less than 90 percent of the fair value of the gross assets.

Example 2.8e: Applying Step 1e

The following is a continuation of Examples 2.8a, 2.8b, 2.8c, and 2.8d.

Entity X evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $28,050,000. The apartment complexes were found to be similar and are grouped together for Step 1. In Step 1e, their combined value of $26,200,000 is compared to the gross assets acquired of $28,050,000.

This results in 93 percent of the value of the gross assets acquired being associated with a group of similar assets. Entity X also considers qualitatively whether in substance it acquired a group of similar assets and whether the other elements are substantive. Entity X determines the other elements (e.g., trade names) acquired are not substantive because the other elements are not a result of goodwill and an organized workforce, and the set was not a stand-alone self-sustaining operation.

The quantitative and qualitative factors indicate that, in substance, the entity acquired a group of similar assets and the set is not a business.

Example 2.8f: Recognizing Certain Assets of a Medical Device Company as a Single Asset for Financial Reporting Purposes

Entity B acquires Medical Device Corp. on December 15, 20X7. Medical Device has a monopoly on a certain medical device product. The product has been on the market and generating revenue for 20 years.

Entity B acquires all of the existing product technology, manufacturing equipment, employees and supply contracts of the product line. The identifiable intangible assets include technology, trade name, FDA approval and customer (doctor) relationships. The trade name and customer relationship were determined to have nominal value. As Entity B has a monopoly on the product, if it is medically necessary, doctors are compelled to prescribe it as there are no alternatives. The technology and FDA approval are recognized as a single asset (the "technology asset") by analogy to ASC subparagraph 805-20-55-2(b), which indicates that a power plant and a license to operate that plant may be recognized as a single asset if their useful lives are similar. The fair value of the

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technology asset, goodwill, and other tangible assets represent 94%, 2%, and 4%, respectively, of the fair value of the gross assets acquired.

Because the fair value of the technology asset is 94% of the fair value of the gross assets acquired, Medical Device Corp concludes that substantially all of the fair value of the gross assets is concentrated in a single identifiable asset. Step 1 is met and Step 2 is unnecessary. The set is not a business.

Example 2.9: Applying Step 1 When Goodwill Results from the Effects of Deferred Tax Liabilities

Entity A acquires 100% of Biotech Corp. on January 1, 20X9 for $10,000,000. Biotech's operations include IPR&D activities on a single development stage drug compound. No employees are included in the set. The enacted tax rate is 25% for 20X9 and all future years.

The identifiable assets acquired and liabilities assumed have the following fair values and tax bases.

	Estimated Fair Value	Tax Basis	Temporary Difference
Cash	$50,000	$50,000	$0
IPR&D	$9,450,000	$0	$9,450,000
Research lab	$400,000	$200,000	$200,000
Current liabilities, excluding deferred taxes	($200,000)	($200,000)	$0
Identifiable net assets acquired	**$9,700,000**	**$50,000**	**$9,650,000**

The assets acquired and liabilities assumed would be recognized (under ASC Topic 805) as follows:

Cash	$50,000
IPR&D	$9,450,000
Research lab	$400,000
Current liabilities	($200,000)
Deferred tax liabilities	($2,412,500)
Goodwill	$2,712,500
Consideration paid	$10,000,000

Step 1a

Entity A determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, IPR&D, and the research lab.

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Step 1b

Entity A evaluates whether any of the exceptions in ASC paragraph 805-10-55-5B (Step 1b) apply. Entity A concludes that none of the assets meet the exceptions and none of the acquired assets are combined.

Step 1c

In applying ASC paragraph 805-10-55-5C, Entity A concludes that none of the acquired identifiable assets (e.g., cash, IPR&D, and the research lab) are similar assets.

Step 1d

In applying Step 1d, the gross assets acquired would not include the goodwill associated with the deferred tax liabilities acquired in this transaction. The deferred tax liabilities acquired in this example generated $2,412,500 of goodwill, which is excluded for purposes of applying Step 1, leaving $300,000 of goodwill.

The gross assets acquired in this example for purposes of Step 1 are as follows:

Items Acquired / Assumed	Value under ASC Topic 805	Included in Gross Assets
Cash	$50,000	Not included
IPR&D	$9,450,000	$9,450,000
Research lab	$400,000	$400,000
Current liabilities	($200,000)	Not included
Deferred tax liabilities	($2,412,500)	Not included
Goodwill	$2,712,500	$300,000
Total	**$10,000,000**	**$10,150,000**

The fair value of gross assets acquired is $10,150,000.

Step 1e

Entity A evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $10,150,000. As previously discussed, none of the acquired assets were found to be similar and none are grouped together for Step 1c. In Step 1e, the largest acquired asset had a value of $9,450,000 and is compared to the gross assets acquired of $10,150,000.

This results in 93 percent of the value of the gross assets acquired being associated with a single identifiable asset (e.g., IPR&D). Entity A also considers qualitatively whether in substance the other elements (e.g., research lab, goodwill) of the transaction are substantive. While the set includes goodwill, the value associated with the goodwill is de minimis (below 3 percent) and is not attributable to an organized workforce because there are no employees acquired. As a result, the quantitative and qualitative factors

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indicate that substantially all the fair value is concentrated in a single asset and the set is not a business.

Example 2.9a: Applying the Step 1 Threshold (Initial Screening) Test When a Bargain Purchase Exists

ABC Corp. enters into a purchase agreement to acquire a small software company (Target) for $9,000,000. Target has five employees that are all software developers, earns some revenue, but is not profitable. Target's owners believe its software alone is worth more than the purchase price. However, Target is running out of money, and its owners are willing to sell to ABC at a significant discount.

Target's software has a fair value of $10,000,000 and it has a customer-related intangible with a fair value of $500,000.

ABC's senior management and IT department believe Target's five software developer employees can be replaced after consummation of the transaction without significant time, effort or delay in the ability to continue producing outputs, as they are not considered essential (e.g., the software is already developed).

ABC determines that it should exclude the bargain purchase amount from the numerator and denominator in Step 1 (see Paragraph 2.060b). Because an assembled workforce is not a recognized identifiable asset in a business combination (and because there is no goodwill in this example), ABC will exclude the assembled workforce from Step 1.

ABC performs Step 1 to evaluate whether the fair value is concentrated in a single asset or group of similar assets.

Items Acquired	Value Under ASC Topic 805	Included in Gross Assets
Software	$10,000,000	$10,000,000
Customer-related intangible	$500,000	$500,000
Bargain purchase	$(1,500,000)	Not included
Total	**$9,000,000**	**$10,500,000**

ABC compares the largest acquired asset (software) valued at $10,000,000 to the fair value of gross assets acquired of $10,500,000.

This results in 95% of the value of the gross assets acquired being associated with a single identifiable asset. ABC also evaluates whether qualitatively, the other elements (customer-related intangible and employees) are substantive. There is no goodwill associated with the set (i.e., there is no value in the assembled workforce because the employees can easily be replaced) and the value of a single asset is well above 90%. ABC concludes that substantially all the fair value is concentrated in a single asset and the set is not a business.

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2.065 Paragraph not used.

Example 2.10: Acquisition of Loan Portfolio – Scenario 1[1]

Facts

- Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- Bank A does not acquire the employees that managed the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions, or systems.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (Screening Test):

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

See Example 2.15 for the analysis of Step 2.

Conclusion

The acquired set does not meet the screening test (Step 1); therefore, Step 2 is required.

Alternatively, because no employees, protocols, conventions or systems were acquired, it is clear that the set does not include an organized workforce or an acquired process. Bank A could have elected to bypass the screening test (and the necessary assessment of similarity of risk characteristics) and gone directly to Step 2 to conclude the set is not a business. This alternative analysis applies only when it is clear that the set would *not* be a business under Step 2. An entity may not skip Step 1 if it's clear that there is an input and a substantive process, because the screening test could still lead to a conclusion that the set is not a business.

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Example 2.11: Acquisition of Oil and Gas Properties – Scenario 1

Facts

- XYZ Co. acquires the mineral rights (i.e., lease agreements to develop and produce the underlying mineral reserves) in certain properties in the southwest shale.
- The acquisition provides XYZ Co. with an average 50% working interest in the properties.
- The properties are proved and unproved properties. The proved properties are currently producing oil and gas. The properties classified as unproved have known reserves (they have been *proved up)* but are classified as unproved because of the requirement to classify properties as unproved if an entity does not expect to produce from those properties within the next five years.
- XYZ Co. also assumes customer contracts in the acquisition, which are at market rates. No employees are in the set.

Analysis

Step 1 (Screening test)

The oil and gas properties are found to be two single identifiable assets that would be recognized in a business combination under Topic 805. The two assets are proved and unproved properties. Even though they have different disclosure requirements, we believe that proved and unproved oil and gas properties can be considered to be within the same major asset class and therefore could be considered similar assets if they do not have significantly different risks. When evaluating whether those assets are similar, an entity should consider the nature of proved and unproved properties and the risks associated with managing and creating outputs from the proved and unproved properties (i.e., the risk characteristics).

In this example, the two identified assets do not have significantly different risks associated with creating outputs and therefore are similar assets. They are similar assets because they are in the same geographic area (e.g., southwest shale) and are expected to have similar outputs (e.g., mix of hydrocarbons) from both assets. The unproved properties, while not meeting the proved definition because XYZ Co. does not expect to produce from those properties over the next five years, are considered to have the same risk profile as the proved properties because they have known reserves.

If the unproved properties had not already been proved up, XYZ Co. may have concluded that the proved and unproved properties have significantly different risks.

Additionally, oil and gas properties in different regions of the United States, in different jurisdictions, and those that have different characteristics such as offshore and onshore could result in different conclusions about whether they are similar and would require analysis of the specific facts and circumstances.

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There is no fair value associated with the customer contracts because the contracts are at market rates and are readily available in the market place, and there were no other assets acquired. Accordingly, XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (the proved and unproved oil and gas properties). Step 1 is met and the set is not a business.

Example 2.11a: Acquisition of Petroleum Storage Facilities

Facts

- ABC Co. (ABC) enters into an asset purchase agreement with DEF Co. (DEF) for total consideration of $500 million.
- DEF will transfer to ABC the following:
  - Two petroleum storage and distribution terminal facilities located along the Oregon coastline; and
  - Customer relationships and fixed assets comprised of automobiles, equipment, tools and IP equipment.
- The set has revenues from both facilities that will continue after the acquisition.
- The type and class of customers are similar for the facilities.

Analysis

Step 1 (threshold test)

The land, buildings, storage tanks, and interconnecting pipes at each facility are attached to each other and cannot be physically removed from and used separately from one another without incurring significant cost or reducing their fair value. As such, they are considered to be a single asset for the screening test.

The next step is to determine if the two petroleum storage and distribution terminal facilities are similar assets. The two identified facilities do not have significantly different risks associated with creating outputs. They are in the same geographic area (e.g., Oregon coastline), both on-shore properties, both expected to have similar outputs (e.g., crude oil and refined petroleum products) from both assets and the type and class of customers are similar for the assets. As such, they are similar assets and grouped together for the screening test.

ABC next compares the largest acquired group of similar assets (petroleum storage and distribution facilities) valued at $483,000,000 to the fair value of gross assets acquired of $500,000,000.

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Items Acquired	Estimated Fair Value	Included in Gross Assets
Petroleum storage and distribution facilities	$483,000,000	$483,000,000
Customer-related intangibles and fixed assets	$17,000,000	$17,000,000
Total	**$500,000,000**	**$500,000,000**

Items Acquired	Percentage
Petroleum storage and distribution facilities	96.6%
Customer-related intangibles and fixed assets	3.4%
Total	100%

Because 96.6% of the fair value of the gross assets acquired is concentrated in the group of similar assets, ABC concludes that the *substantially all* test (step 1) is met and the set is not a business.

Step 2 (input and substantive process)

Step 2 is not necessary in this scenario.

Conclusion

ABC concludes the transaction is an asset acquisition rather than a business combination because substantially all the fair value is concentrated in a group of similar assets.

Example 2.11b: Acquisition of a Property Subject to a Tax Abatement

Facts

- ABC Co. (ABC) constructed a new facility and entered into a property tax abatement agreement with the local government.
- The term of the property tax abatement is 30 years.
- ABC enters into an asset purchase agreement with DEF Co. (DEF) where DEF acquires the facility (land and building) and the related property tax abatement.
- There is no goodwill or other assets in the set.
- The FV of the facility is $10,000,000 and the FV of the property tax abatement is $2,500,000.

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Analysis

To apply Step 1, DEF evaluates whether the set includes a single identifiable asset or a group of similar assets.

Step 1a

DEF concludes that the identifiable assets in the set include the land, building and property tax abatement. The abatement is an identifiable intangible asset under ASC Topic 805 because it meets the contractual-legal criterion.

Step 1b

The land and building are combined under ASC paragraph 805-10-55-5B for the screening test because they are attached to and cannot be physically removed and used separately from each other without incurring significant costs or reducing their fair value. However, the property tax abatement does not meet one of the exceptions in ASC paragraph 805-10-55-5B and is not combined with the land and building into a single identifiable asset. Although the property tax abatement was derived from the construction of the facility and is an intangible asset related to the property, it does not represent the right to use the land or building and is not a lease.

Step 1c

The facility (combined land and building) is a tangible asset and the property tax abatement is an intangible asset. Therefore, the two assets cannot be considered similar.

Step 1d

The fair value of the gross assets acquired is $12,500,000.

Step 1e

DEF compares each of the single identified assets to the gross assets acquired. The fair value of the facility compared to the gross assets acquired is 80% ($10,000,000/$12,500,000) and the fair value of the property tax abatement is 20% of the gross assets acquired. DEF concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single asset or group of similar assets.

Conclusion

The acquired set does not meet the screening test (Step 1); therefore, Step 2 is required.

STEP 2 – EVALUATE WHETHER AN INPUT AND A SUBSTANTIVE PROCESS EXIST

Framework – Inputs, Substantive Processes, and Other Considerations

ASC paragraph 805-10-55-5D

When a set does not have outputs (for example, an early stage company that has not generated revenues), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it

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includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs. An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

(a) A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

(b) Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

  (1) Intellectual property that could be used to develop a good or service

  (2) Resources that could be developed to create outputs

  (3) Access to necessary materials or rights that enable the creation of future outputs.

  Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

ASC paragraph 805-10-55-5E

When the set has outputs (that is, there is a continuation of revenue before and after the transaction), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

(a) Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

(b) An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).

(c) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

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(d) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

ASC paragraph 805-10-55-5F

If a set has outputs, continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis in [ASC] paragraph 805-10- 55-5E of whether a process has been acquired.

ASC paragraph 805-10-55-6

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

ASC paragraph 805-10-55-8

Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

ASC paragraph 805-10-55-9

When evaluating whether a set meets the criteria in [ASC] paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill.

2.066 In Step 2, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The guidance provides a framework to assist entities in evaluating whether both an input and a substantive process are present and gives examples about applying the implementation guidance.

2.067 The first decision point is to determine if the set has outputs. The guidance has a different set of criteria depending on whether the set has outputs. Outputs are the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (e.g., dividends, interest), or other revenues. Although outputs are not required for a set to be a business, outputs are one of the three elements of a business. The FASB created a more stringent set of criteria when outputs are not present.

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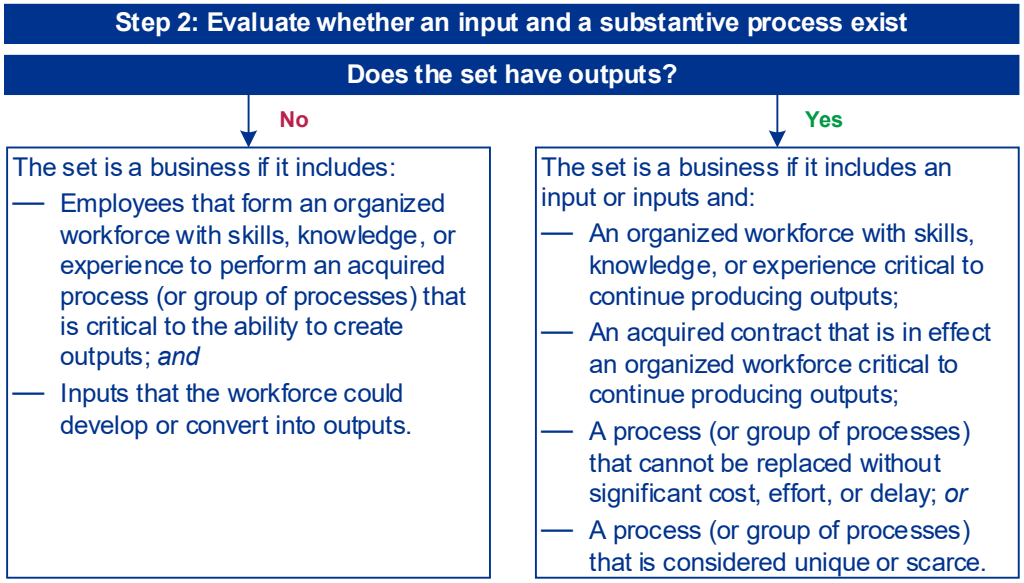

2.067a Based on informal discussions, we understand that the FASB staff believes it is acceptable for an acquirer to evaluate a set of assets and activities with only inconsequential outputs as a set without outputs. Judgment is required and an acquirer may also need to consider qualitative aspects. For example, we believe it generally would be appropriate to evaluate a start-up with only minimal outputs that is ramping up central activities as a set with outputs. Conversely, we believe it generally would be appropriate to evaluate a set with only minimal outputs that is winding down activities as a set without outputs.

2.067b Determining whether one or more inputs exist is usually straightforward. Accordingly, the discussion below focuses primarily on determining whether a substantive process exists.

Acquired Set with No Outputs (ASC paragraph 805-10-55-5D)

2.068 For a set with no outputs (e.g., an entity in the development stage that has not generated revenues) to have both an input and substantive process, it must include:

(a) Employees that form an organized workforce; and

(b) An input that the workforce could develop or convert into outputs.

2.069 The employees that form the organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

Organized Workforce

2.070 The organized workforce must consist of employees. An acquired contract that performs a process would not on its own be considered an organized workforce when a set does not have outputs. However, if the set includes both employees and service contracts, the processes performed by the vendor may be considered a critical process.

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For example, paragraph BC48 of the Basis for Conclusions of ASU 2017-01 states, "The Board also noted that a critical process performed by employees could include the management of service providers. The Board stated that, as an example, an entity should come to consistent conclusions when evaluating a set that has 100 employees and a set that has 20 employees with the equivalent of 80 employees replaced by outsourced service providers because the 20 employees would be responsible for the management and performance of the outsourced employees."

2.071 ASC paragraph 805-10-55-5D(a) states that a process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs. However, the FASB did not provide additional guidance and as a result, determining whether the acquired workforce is performing a critical process will require significant judgment.

2.072 We believe the analysis of whether the process is critical should focus on the nature of the process being performed by the workforce. To evaluate whether the process is critical or minor, entities may compare the process being performed by the workforce to the *missing processes* from the set. If the acquired process (or group of processes) is considered qualitatively and quantitatively minor compared to all of the processes required to produce outputs, the process would not be critical. The following factors may indicate that the employees are performing a process that is critical to developing or converting inputs into outputs (none of which individually would be determinative):

- **Size of the workforce.** The greater the number of employees, the more likely the process is substantive. However, the number of employees is not determinative as a few employees might have significant knowledge, experience, or skills that are critical to developing the acquired inputs into outputs.
- **Stage of activities.** If the organized workforce has not yet commenced activities to develop or convert inputs into outputs, it could call into question whether the processes acquired are in fact substantive or could be used to develop or convert the inputs into outputs. In contrast, if the organized workforce has commenced key activities to develop or convert inputs into outputs, the processes being performed would likely be critical.
- **Research and development activities.** The process may be substantive if the organized workforce has employees with necessary skills, knowledge, or experience in performing research and development processes that are significant to converting inputs into outputs. In an entity without outputs, research and development activities are likely to be one of an entity's most significant processes in the development stage. Example 2.13 below illustrates an example where research and development processes performed by acquired scientists are critical to the development of intellectual property.
- **How close the set is to generating revenues.** If the entity is close to generating revenues, the processes the employees are performing are more likely to be critical to developing or converting the inputs into outputs. The

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workforce may not be critical if there is significant uncertainty about its knowledge, skills, experience, or ability to complete the required steps to turn the inputs into outputs. For example, the need to hire a significant number of employees after the acquisition with the necessary knowledge, skills, or experience to continue the activities required to develop or convert the acquired inputs into outputs could indicate that the processes performed by the acquired workforce are not critical.

- **Whether the set is self-sustaining and operated on a stand-alone basis.** If the set includes an organized workforce that was operating the set on a stand-alone basis (i.e., it was not a division, subsidiary, product line, or portion of a larger entity), the organized workforce may be performing critical processes to manage and operate the set. This factor does not refer to the entity's financing needs or ability to access capital.
- **Presence of goodwill.** The presence of goodwill in a set with no outputs may indicate that the organized workforce is performing a critical process.
- **Process of integrating multiple assets.** If the employees are performing resource allocation, strategic management, or operational processes that manage different risks to integrate multiple different assets to develop inputs into outputs, the process is likely critical.

Inputs That the Entity Could Convert into Outputs

2.073 Acquiring employees is not enough to conclude that a set with no outputs is a business. That acquired workforce must be able to develop or convert another acquired input or inputs into outputs. As a result, the set also must include an input or inputs that could be developed or converted (or are being developed or converted) into outputs. These inputs include but are not limited to items such as technology, drug compounds, real estate, oil and gas properties, and distribution or production rights.

2.074 These types of assets form the foundation of what would ultimately be the goods or platform for the services to be provided to customers. Assets such as equipment that could be used to convert other inputs (e.g., a piece of machinery used to manufacture a good) may not be sufficient on their own because those inputs generally are not developed or converted into outputs and are used only to convert another input into outputs.

Example 2.12: Acquisition of a Drug Candidate – Scenario 1[2]

Facts

- Pharma Co. acquired two development stage drug compounds from Biotech that treat different illnesses.
- The two drug compounds each have significant value and significantly different risks (e.g., they treat different illnesses, have different patient subsets, and have different expected lives).

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- Pharma Co. also assumes from Biotech their (1) clinical research organization (CRO) contract and (2) clinical manufacturing organization (CMO) contract.
- Pharma Co. does not acquire the scientists and long-lived tangible assets.
- Biotech is not currently generating revenues.

Analysis

Step 1 (Screening Test):

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

Pharma Co. also concludes that there is no fair value associated with the CRO and CMO contracts because the services are provided at market rates and could be provided by multiple vendors. Therefore, all of the consideration in the transaction will be allocated to the IPR&D activities.

The fair value of the gross assets is spread across the two identifiable IPR&D assets because these assets are not similar for the purposes of applying the screening test. Step 1 is not met.

Step 2 (Input and Substantive Process):

When there are no outputs, there must be inputs and employees (an acquired contract that represents an organized workforce is not sufficient). Accordingly, the acquired CRO and CMO contracts are not relevant to the Step 2 analysis because there are no outputs in the set. Pharma Co. concludes that the criteria in ASC paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process are not met because the set does not have employees.

Conclusion

The acquired set is not a business because the set does not include employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

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Example 2.13: Acquisition of Biotech – Scenario 1[3]

Facts

- Pharma Co. acquires the outstanding shares of Biotech, whose operations include IPR&D activities on several development stage drug compounds. The compounds target different illnesses and patient subsets.
- Pharma Co. also acquires long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment.
- Pharma Co. concludes there is significant fair value in the acquired workforce, the different IPR&D projects, and tangible assets.
- The set includes the scientists with the necessary skills, knowledge, or experience to continue to perform R&D activities.
- There is also a more-than-insignificant amount of goodwill.
- Biotech has not generated revenues.

Analysis

Step 1 (Screening Test):

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

In addition, there is significant fair value in different asset classes: intangible (IPR&D assets) and tangible (the headquarters, the research lab, and testing equipment). Step 1 is not met.

Step 2 (Input and Substantive Process):

When there are no outputs, there must be inputs and employees. Pharma Co. concludes that the scientists make up an organized workforce with the necessary skills, knowledge, or experience to perform R&D processes. Those processes, when applied to the IPR&D inputs, are critical to the ability to develop the inputs into outputs.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process.

Conclusion

The acquired set is a business because the set includes employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process that when applied to acquired inputs (IPR&D) is critical to the ability to develop those inputs into outputs.

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Example 2.13a: Acquisition of Professional Service Employees

Facts

ABC Co. acquires 100% of the outstanding shares of Sub Co. from DEF Co. for consideration of $2 million in cash. Sub has 35 employees from a service line that DEF is discontinuing and holds no assets. ABC will retain the employees to integrate into its operations.

Analysis

Step 1 (Screening Test):

ABC concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single asset or a group of similar assets. The employees represent an assembled workforce, but an assembled workforce would not be recognized as a separate asset in a business combination. Rather, it would be subsumed into goodwill, and goodwill is excluded from the numerator of the screening test.

Step 2 (Input and Substantive Process):

ABC evaluates Sub as a set that does not have outputs, because there is no continuation of revenues. The set includes an assembled workforce; however, there are no inputs in the set for the employees to turn into outputs.

Conclusion

The acquired set is not a business because the set does not include inputs. ABC recognizes an intangible asset for the assembled workforce it acquires.

Example 2.13b: Intent to Restructure Workforce Post-Acquisition

Facts

- Widget Co. acquires the outstanding shares of Acme Co., an early stage competitor of Widget that also plans to manufacture and sell widgets.
- Acme has not started manufacturing widgets or generated any revenues.
- Widget also acquires long-lived tangible assets such as a corporate headquarters, manufacturing facilities, equipment and raw materials.
- Widget's intent of the acquisition is to acquire the manufacturing facilities, equipment and raw materials to expand its production capacity.
- The set includes employees with the necessary skills, knowledge, or experience to manufacture and sell widgets, however Widget already has an established workforce to manufacture and sell widgets.

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- Widget intends to implement a significant restructuring plan after the acquisition to eliminate the redundancies between the two companies that includes terminating substantially all of the Acme workforce.
- Widget concludes there is significant fair value in the acquired workforce (although it has plans to terminate substantially all of the workforce) and tangible assets.
- There is also a more-than-insignificant amount of goodwill.

Analysis

Step 1 (Screening Test):

Widget concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single asset or a group of similar identifiable assets, because it acquires a variety of assets in different classes, all with substantial fair value. Step 1 is not met.

Step 2 (Input and Substantive Process):

When an acquired set has no outputs, there must be inputs and employees that constitute an organized workforce to conclude the set is a business. Although Widget decided before the acquisition to terminate all of Acme's employees, the restructuring is for the benefit of Widget and not executed until after the acquisition. Therefore, Widget considers terminating the employees to be a separate transaction rather than part of the acquisition and the employees are considered part of the set.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is capable of performing a critical process.

Conclusion

The acquired set is a business because the set includes employees that represent an organized workforce with the necessary skills, knowledge, or experience to perform widget manufacturing and selling processes that, when applied to the acquired inputs (manufacturing facilities, equipment and raw materials), are critical to the ability to develop those inputs into outputs.

Acquired Set with Outputs (ASC paragraph 805-10-55-5E)

2.075 When the set has outputs, only one of the factors in ASC paragraph 805-10-55-5E needs to be present for a set to have a substantive process. The set will have both an input and a substantive process when any of the following are present:

(a) Employees that form an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

(b) An acquired contract that provides access to an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process (or

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group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

(c) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs; or

(d) The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

2.076 ASC paragraph 805-10-55-5E does not specifically state types of inputs that must be acquired because by definition a set that has outputs would have an input (or inputs) that could be converted into outputs. However, the process acquired must relate to an acquired input because all of the factors require that the process acquired be applied to an input in the acquired set.

Organized Workforce Consisting of Employees

2.077 Similar to sets with no outputs, a set that has outputs is a business when it includes an organized workforce that consists of employees that have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. While employees are an input, they can also provide a process (see Paragraph 2.030) if they constitute an organized workforce. However, to be a business, we believe the workforce must perform a process on another acquired input. That is, the employees cannot be the only input in the set.

2.078 An entity would perform a similar evaluation of whether the acquired process (employees that make up an organized workforce) is critical as it would if the set did not have outputs (see Paragraph 2.072). However, the focus of the analysis is on whether that process is critical to the continuation of outputs. The following factors may indicate that the acquired process is considered critical:

- **Involvement in fulfillment activities.** If the workforce is directly involved in fulfillment of providing goods or services or obtaining customers, that would indicate that the acquired process is critical to continuing to produce outputs. For example, an entity acquires a set with a workforce that is directly involved in generating new customers, producing goods sold (manufacturing employees), or fulfilling a service to the customers (customer-facing employees providing the service).
- **Skillset of the workforce.** If the workforce has specialized skills or knowledge required to perform operational processes needed to continue producing outputs, that would be an indicator that the workforce is critical. The specific skills of the workforce must be considered in light of the set's activities. For example, a group of cleaning employees might be very skilled at cleaning; however, if the business activities of the set are not cleaning

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services, they usually would not be performing a process that is critical to continuing to produce outputs.

- **Size of the workforce.** The greater the number of employees the more likely the process is to be substantive. However, the number of employees is not determinative because a few employees might have significant knowledge, experience, or skills that are critical to continuing to produce outputs.
- **Ability to operate on a stand-alone basis.** If the set includes an organized workforce that was operating the set on a stand-alone basis (i.e., it was not a division, subsidiary, product line, or portion of a larger entity), the organized workforce may be performing processes critical to continuing to produce outputs. This factor does not refer to the entity's financing needs or ability to access capital.
- **Presence of goodwill.** The presence of goodwill may indicate that the organized workforce is performing a critical process.
- **Strategic management process.** If the processes performed are strategic management processes that involve determining the strategy for creating outputs, setting the price with customers, or determining the types of goods or services to sell to customers, that may indicate that the acquired processes are critical.
- **Resource allocation process.** If the organized workforce is performing resource allocation processes to facilitate the delivery of goods or services to customers, these processes may be critical to continue producing outputs.
- **The number of processes acquired.** While only a single substantive process is required for a set to be a business, the more processes the organized workforce is performing, the more likely the group of processes together would be considered critical.
- **Process of integrating multiple assets.** If the process acquired includes resource allocation, strategic management, or operational processes that manage different risks to integrate multiple different assets to continue producing outputs, those processes would likely be considered critical.

Acquired Contracts

2.079 In contrast to sets that do not have outputs, entities must evaluate acquired contracts (when the set is receiving goods or services) to determine if the entity in effect acquired an input or an organized workforce performing a substantive process. Paragraph BC46 in the Basis for Conclusions of ASU 2017-01 states:

> The Board concluded that the assessment of a contractual arrangement, such as a supply agreement, should be relatively straightforward, meaning those contracts would likely be inputs because the supplier is not applying a process to another input in the set. However, the Board rejected the view that a service provided through a contractual arrangement should never indicate that a substantive process

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> was acquired. The Board observed that there are many industries in which operating activities are outsourced, and the activities performed by a service provider may not be significantly different than the activities that would be performed by employees. The Board acknowledges that in some circumstances, whether an organized workforce accessed through a contractual arrangement performs or provides a process could be subjective and the critical factor to determining whether a set is a business.

2.080 Based on the Basis for Conclusions and as illustrated in Case F of ASU 2017-01 (ASC paragraphs 805-10-55-82 through 55-84), a typical supply agreement is an input. However, when the vendor provides a service, the vendor could be applying a process to an input for the set. For example, the service provider in an asset management contract typically applies processes to the investment portfolio and customer contracts to raise and deploy capital to create outputs. As a result, similar to employees, an acquired service contract could be both an input and a process.

2.081 When the set includes a service contract, entities will need to make an evaluation similar to evaluating an employee workforce to identify the processes that are performed in the contract and whether that process (or group of processes) is critical to continue producing outputs. However, we believe there should be more scrutiny applied to conclude that an acquired service contract represents a substantive process when a set does not include employees.

2.082 The inherent limitations of what may be performed by an acquired contract requires an entity to analyze the substance of the acquired contract to determine if in effect it has acquired an organized workforce. As a result, the guidance requires that entities should also consider the duration and renewal terms of the acquired contract when making this determination. The FASB did not provide additional guidance on how to evaluate the duration or renewal options; however, we believe the objective is to determine whether the entity acquired a substantive process (through the contract) or whether the contract is in substance an input.

2.083 The nature of an acquired organized workforce is such that an entity obtains the employees' knowledge and skills and therefore acquires a process that can be passed along to other employees. As a result, the entity controls the process and can sustain it even after termination of an individual employee. In contrast, if a service contract is not renewed or was cancelled, the process may be terminated or need to be replaced. As a result, if a contract has a long duration, the substance of the acquisition may be more akin to acquiring an organized workforce and process that the entity effectively controls.

2.084 We believe that if the services contract is for a short duration (e.g., less than one year with no explicit or implicit renewal options), generally the contract would not provide an organized workforce performing a critical process. In contrast, a service contract with a term greater than one year should be evaluated to determine whether the process being performed is critical, similar to the evaluation for an employee workforce (see Paragraphs 2.077 and 2.078). However, one year should not be viewed as a bright line.

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2.085 When considering short-term contracts with a renewal option (or long-term contracts with termination provisions akin to a renewal), further consideration is needed. The following factors may indicate that a service contract with renewal periods that extend beyond one year is akin to acquiring an organized workforce:

- The services are proprietary or not easily accessible in the marketplace. If the services are not readily available in the marketplace, it may indicate that the acquired contract is a substantive process that is critical to continue producing outputs; or
- Replacing the service provider would result in a significant cost, effort, or delay in the ability to continue producing outputs.

2.086 However, if the services are provided only on a temporary basis, or if the services are merely meant to help the acquirer transition on a temporary basis, that would indicate that in substance the entity did not acquire an organized workforce that is critical to continuing to produce outputs. This is different from acquiring an organized workforce that has a going concern element (even if the entity planned to terminate the employees).

2.086a Because the assessment of whether the set is a business is made from the perspective of a market participant, it is not relevant whether the acquirer plans on terminating the contract.

Acquired Process Cannot Be Replaced without Significant Cost, Effort, or Delay or Is Considered Unique or Scarce

2.087 An organized workforce is not required when outputs are present. The FASB decided that an organized workforce might not be required if the set includes automated processes (e.g., through acquired technology, infrastructure, or specialized equipment) or other significant processes that significantly contribute to the ability to continue producing outputs. As such, criteria (c) and (d) of ASC paragraph 805-10-55-5E address the scenarios when a set would have a substantive process but no workforce. A substantive process could also be present when the process would significantly contribute to the ability to create outputs and either:

- The acquired process (or group of processes) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs; or
- Is considered unique or scarce.

Examples include:

- A manufacturing process included in an assembly line that is highly automated;
- A process embedded in the setup of the infrastructure that requires minimal involvement from employees to complete;
- Proprietary production techniques; and
- Technology that performs processes to fulfill contracts with customers.

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Revenue or Lease Contracts

2.088 While service contracts might provide access to an organized workforce performing a substantive process, a revenue contract, lease arrangement (the acquiree is the lessor), or other similar contracts should be excluded from the evaluation. ASC paragraph 805-10-55-5F specifically requires an entity to exclude those contracts from the evaluation of whether a substantive process is present. As a result, an entity would not be able to conclude that it acquired a process solely because a revenue or lease contract was present.

Presence of Goodwill

2.089 The presence of more than an insignificant amount of goodwill indicates that an acquired process is substantive. However, the presence of goodwill does not always mean a process is present. The entity should not assume that a process was acquired because the set includes goodwill. Rather, the entity would first need to identify the acquired process (and the organized workforce performing that process if the set does not have outputs) and then it could use the presence of goodwill to help evaluate whether the process is substantive.

2.090 One of the components of goodwill is usually the value of the assembled workforce. As a result, fair value associated with a workforce may indicate that an organized workforce is performing a critical process. Similarly, the excess of fair value over the net assets acquired could also indicate that there is value in an acquired process that would typically not be an identifiable asset.

2.091 Whether an entity records goodwill depends on the transaction being a business combination. As a result, for purposes of this analysis (i.e., to determine if a transaction is a business combination), the evaluation would focus on whether the consideration transferred was in excess of the fair value of the identifiable net assets acquired.

Market Participant Concept

2.092 The evaluation of whether the acquired assets and activities constitute a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. It does not matter how the seller used, or acquirer plans to use, the set when evaluating whether the set is a business.

2.092a For example, an entity may acquire a division from a seller of a vertically integrated business. Because that set was operated by the seller, the division did not have external customers; it only transferred goods to other divisions of the seller – e.g., intercompany transfers. After the transaction, the former division would transfer the same goods to its former parent although those sales would be recorded as revenue. When viewing this set from the standpoint of a market participant, that set would have outputs and the acquirer would need to evaluate whether both an input and substantive process was acquired in accordance with ASC paragraph 805-10-55-5E.

2.093 Similarly, an entity might acquire a supplier even though the entity was that supplier's only customer to more effectively manage its supply chain. It would not be relevant how the acquirer intended to use the set when viewing the set from the

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standpoint of a market participant. From the standpoint of a market participant, that set would have outputs (even if post-transaction the goods or services are provided only to internal divisions of the acquirer) and the acquirer would need to evaluate whether both an input and substantive process was acquired in accordance with ASC paragraph 805-10-55-5E.

2.094 The evaluation of whether ASC paragraphs 805-10-55-5D and 805-10-55-5E are met should occur from a market participant's perspective. This may affect the conclusion on whether a process is critical to the creation of outputs. A process that is not critical to a specific acquiree that already has the same process in place may nevertheless be critical to a market participant as that term is defined in ASC Topic 805.

2.094a For example, Company A acquires a set that includes processes to produce a unique type of computer monitor that Company A already produces. Company A acquired the set to take its competitor out of the market, because Company A and the competitor are the only ones that currently produce the item. While the process to create the unique computer monitor is not critical (or unique) to Company A, the process to produce this item may be critical (or unique) to a market participant and must be evaluated from that perspective when evaluating whether a business was acquired.

Example 2.14: Acquisition of Real Estate – Scenario 2[4]

Facts

- REIT acquires 10 single-family homes, which have significant value in the aggregate, in the Washington, D.C. metro area. The acquisition includes the land, building, property improvements, and in-place leases.
- Each single-family home has a different layout (e.g., floor plan, square footage, and design). The lessees are a similar class of customers.
- REIT also acquires an office park with six 10-story office buildings leased to maximum occupancy, which have significant value in the aggregate.
- REIT acquires the vendor contracts for outsourced cleaning, security, and maintenance.
- Seller’s employees that perform leasing (sales, underwriting, etc.), tenant management, financing, and other strategic management processes are not included in the set.
- No other assets are acquired in the transaction.

Analysis

Step 1 (Screening Test):

REIT chooses to perform the screening test qualitatively because it is clear that substantially all of the fair value of the gross assets is not concentrated in a single asset or

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group of similar assets. There is significant value in the 10 single-family homes and six 10-story office buildings.

The single-family homes and office buildings are in a different class of tangible assets, and managing those assets (and producing outputs) has significantly different risks. Step 1 is not met.

Step 2 (Input and Substantive Process):

The set has outputs as a result of the continuing lease income from in-place leases on the properties acquired. Accordingly, REIT considers the criteria in ASC paragraph 805-10-55-5E.

The set does not include employees but does include acquired service contracts (e.g., contracts for outsourced cleaning, security, and maintenance). The acquired service contracts are not substantive as the processes performed are not critical to continue producing outputs (lease income). The functions of cleaning, security, and maintenance do not generate substantive income in the real estate industry. These functions may be substantive in other industries, but are not in the real estate industry.

In accordance with ASC paragraph 805-10-55-5F, the leases are excluded from the analysis of whether a process was acquired. There is no substantive process acquired in the set and Step 2 is not met.

Conclusion

The set does not include a substantive process and is therefore not a business.

Example 2.15: Acquisition of Loan Portfolio – Scenario 1 (continued)[5]

Facts

- Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- Bank A does not acquire the employees that managed the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions, or systems.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (Screening Test):

As described in Example 2.10, the fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

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Step 2 (Input and Substantive Process):

The set has outputs as a result of the continuing interest income from the loans acquired. Bank A evaluates the criteria in ASC paragraph 80-10-55-5E.

In accordance with ASC paragraph 805-10-55-5F, the loans are excluded from the analysis of whether a process was acquired. The set does not include an organized workforce or an acquired process. Step 2 is not met.

Conclusion

The set does not include a substantive process and is therefore not a business.

Example 2.16: Acquisition of Loan Portfolio – Scenario 2[6]

Facts

- Bank A acquires from Bank Z a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g., term, size, and risk ratings).
- The set includes the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers).
- There is a more-than-insignificant amount of goodwill.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (Screening Test):

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios) because these assets are not similar for the purposes of applying the screening test. Bank A also concludes that there is a more-than-insignificant amount of goodwill associated with the acquired workforce, which affects the gross assets acquired (e.g., the denominator). Step 1 is not met.

Step 2 (Input and Substantive Process):

The set has outputs as a result of the continuing interest income from the loans acquired. Accordingly, Bank A evaluates the criteria in ASC paragraph 805-10-55-5E.

The set includes an organized workforce that performs processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs. The fact that there is a more-than-insignificant amount of goodwill acquired

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indicates the acquired workforce is performing a substantive process critical to continue producing outputs. Step 2 is met.

Conclusion

The acquired set is a business because the set includes both an input and a substantive process that together significantly contribute to the ability to continue producing outputs.

Example 2.17: Acquisition of Brands – Scenario 1[7]

Facts

MSZ Corp. acquires

- The rights to Yogurt Brand F, including all related intellectual property;
- All customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, and raw material supply contracts; and
- The specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F.

MSZ Corp. does not acquire employees, manufacturing facilities, non-specialized manufacturing equipment, and processes required to produce the product, and distribution facilities (and related distribution processes).

There is a more-than-insignificant amount of goodwill.

The set currently produces outputs (Yogurt Brand F).

Analysis

Step 1 (Screening Test):

The gross assets include intellectual property (trademark, related trade name, and recipes) associated with Yogurt Brand F, customer contracts and related relationships, equipment, finished goods inventory, and the excess of the consideration transferred over the fair value of the net assets acquired.

There is significant fair value in both tangible and intangible assets. MSZ Corp. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. Step 1 is not met.

Step 2 (Input and Substantive Process):

As a part of Step 2, MSZ Corp. notes that the set has outputs through the continuation of revenues. MSZ Corp. considers the criteria in ASC paragraph 805-10-55-5E. The set does not include an organized workforce or an acquired contract that is in effect an organized workforce. However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property,

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raw material supply contracts, and the equipment, they significantly contribute to the ability to continue producing outputs. The set includes both inputs and substantive processes. Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to continue producing outputs.

Example 2.18: Acquisition of Oil and Gas Properties – Scenario 2

Facts

- XYZ Co. buys all the outstanding shares of Entity A, which owns and operates a number of diverse oil and gas properties (both proved and unproved properties).
- XYZ Co. acquires the employees and all of the assets including the long-lived tangible assets of Entity A.
- There is significant fair value in the acquired workforce, production processes, the oil and gas properties and other tangible assets.
- Entity A is currently generating revenues.

Analysis

Step 1 (Screening Test):

XYZ Co. first needs to determine whether Step 1 is met. XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets.

This is because there is significant fair value in many different asset classes, including intangible assets such as the acquired workforce and production processes (both of which are included in goodwill for the screening test), and tangible assets including the oil and gas properties (both proved and unproved properties), and other tangible assets. Step 1 is not met.

Step 2 (Input and Substantive Process):

XYZ Co. notes that the acquired set has outputs and concludes that the employees make up an organized workforce that has the necessary skills, knowledge or experience to perform oil and gas processes. The oil and gas production processes cannot be replaced without significant cost, effort or delay. Those processes are applied to the oil and gas properties inputs and are critical to the ability to continue converting the inputs into outputs.

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There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process. XYZ Co. concludes the set includes inputs and substantive processes and is therefore a business. Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to create outputs.

Example 2.19: Acquisition of Properties That Are Simultaneously Leased to Another Party

Facts

- Company A acquires 15 movie theater properties from Company B, an independent third party.
- Company A simultaneously leases these theaters to Company C, also an independent third party, under a triple-net master lease with a 20-year term.
- Company A will not operate the theaters. Company C acquires the operations (theater management and other employees, ticketing systems, vendor contracts, etc.) from Company B at the same time that it enters into the lease with Company A and will operate the theaters.
- The 15 movie theaters vary in location, with different economic conditions, market risks and local regulations. In addition, Company C will continue the seller's practice of allowing the local management of each theater to select the types of films to show based on the class of customer at each location. Films range from new releases, classics, independent, documentary, etc.
- The fair values of the individual theaters vary; however, they are all within a reasonable range with no significant outliers.

Analysis

Step 1 (Screening Test):

Company A concludes that substantially all of the fair value of the gross assets acquired are not concentrated in a single or a group of similar identifiable assets. Company A notes that the nature of the theaters' activities is similar. However, Company A concludes that each theater property has significantly different risks associated with creating outputs because of the different locations and classes of customers, and therefore they are not a group of similar assets. The fair value of the gross assets acquired is spread across the individual theaters.

Step 2 (Input and Substantive Process):

Company A concludes the set does not include a substantive process and is therefore not a business. Company A notes that the acquired set has outputs and evaluates whether there is

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an input and a substantive process using the criteria in paragraph 805-10-55-5E. Company A acquired inputs (the 15 theater properties); however Company A did not acquire processes. Rather, Company C acquired the theaters' processes directly from Company B and will operate the theaters. Company A is not a party to that contract, and therefore the processes transferred to Company C are not part of Company A's acquired set.

Step 2 is not met.

Conclusion

The acquired set is not a business because the set does not include both an input and a substantive process that together significantly contribute to the ability to create outputs.

APPLYING THE DEFINITION OF A BUSINESS TO FINANCIAL SERVICES COMPANIES

2.095 Although the new framework applies equally across all industries, there are unique aspects to applying the definition of a business to transactions involving financial services companies due to the nature of their operations, which are often heavily cash dependent and contain significant financial assets and liabilities. Transactions occurring between financial services companies might also include few, if any, tangible assets. Because cash and liabilities (such as customer deposits) are excluded from the screening test, whether that test is met often will depend on the significance of loan or other financial asset portfolios included in the set.

2.096 For instance, bank branch acquisitions may be accounted for as asset acquisitions because the acquired set does not meet the definition of a business. The definition also affects whether disposal transactions are in the scope of Topic 860 or Topic 810, which could have meaningful implications for financial services companies.

Example 2.20: Acquisition of a Bank Branch

Facts

Bank A acquires a bank branch from Bank B. The branch consists primarily of savings accounts, checking accounts, certificates of deposit, cash, and a small portfolio of homogeneous consumer loans, as well as the physical premises (land, building, furniture, and equipment). In the transaction, Bank A receives net cash from Bank B of $27,030,000, consisting of $29,300,000 at the branch, less $2,270,000 consideration paid.

The bank branch serves as a location for customers to make deposits and loan payments in-person and initiate new banking services.

Bank A identifies a core deposit intangible asset as part of the acquisition.

There is no goodwill associated with the set.

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There are no marketing, strategic operations, loan or different product origination or other back office operations within the bank branch as these functions were being performed centrally at Bank B.

The branch managers and tellers become employees of Bank A on acquisition. The employees could be replaced easily within the labor market.

The assets acquired and liabilities assumed would be recognized (under Topic 805) as follows:

Cash	$29,300,000
Loans	$1,550,000
Furniture	$30,000
Equipment	$80,000
Building	$200,000
Land	$600,000
Core deposit intangible	$350,000
Other liabilities	$(40,000)
Deposit liabilities	$(29,800,000)
Consideration paid	$2,270,000

Analysis

Step 1 (Screening Test):

Bank A concludes that substantially all of the fair value is not concentrated in a single or group of similar identifiable assets. The cash and liabilities are excluded from the analysis in Step 1d under Topic 805. The analysis is as follows.

Step 1a

Bank A determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, loans, furniture, equipment, building, land and the core deposit intangible.

Step 1b

Bank A evaluates whether any of the exceptions in paragraph 805-10-55-5B apply. Bank A concludes that the building and land are a single asset because they are attached to and cannot be physically removed from and used separately from each other without incurring significant costs or reducing the fair value.

Step 1c

In applying paragraph 805-10-55-5C, Bank A notes that assets in different asset classes are not similar assets. However, Bank A concludes that the loan portfolio consists of loans that are similar assets. Additionally, Bank A concludes that all of the furniture are similar assets, and all of the equipment are similar assets.

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Step 1d

The gross assets acquired are as follows:

Items Acquired / Assumed	Value under Topic 805	Included in Gross Assets
Cash	$29,300,000	Not included
Loans	$1,550,000	$1,550,000
Furniture	$30,000	$30,000
Equipment	$80,000	$80,000
Building and land	$800,000	$800,000
Core deposit intangible	$350,000	$350,000
Other liabilities	$(40,000)	Not included
Deposit liabilities	$(29,800,000)	Not included
Total	**$2,270,000**	**$2,810,000**

The fair value of gross assets acquired is $2,810,000 as the cash and liabilities are excluded.

Step 1e

Bank A evaluates whether substantially all of the fair value is concentrated in a single asset or group of similar assets.

The acquired asset with the greatest fair value is the loan portfolio. Its fair value of $1,550,000 is compared to the gross assets acquired of $2,810,000, yielding 55%.

Step 1 is not met.

Step 2 (Input and Substantive Process):

The bank branch produces deposit fee revenue and interest income on loans, which are considered outputs. Accordingly, Bank A considers the criteria in paragraph 805-10-55-5E.

The set does not include an organized workforce that is critical to developing or converting inputs into outputs, because:

- While the branch is dependent on its employees to conduct daily business, the bank tellers and managers do not have specialized skills or knowledge required to perform operational processes needed to continue producing outputs based on the commonality in operating procedures across bank branches and the fact that they can be easily replaced within the labor market.
- The branch employees help customers who want to take out a loan complete a loan application, but they are not otherwise involved in the underwriting or origination decision process.
- The employees do not perform strategic management or resource allocation processes.

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There are no acquired contracts that provide access to an organized workforce. The set also does not include a process that cannot be replaced without significant cost, effort or delay, or that is considered unique and scarce. Bank A could easily move the branch servicing of the loan and deposit accounts acquired to other branches. The in-person collection of customer deposits and loan payments is not proprietary or highly automated.

Conclusion

The acquired set is not a business because the set does not contain a substantive process.

Additional considerations

If substantially all of the fair value of the gross assets acquired had been concentrated in a single or group of identifiable assets, e.g., the loan portfolio, Step 1 would have been met and the set would not be a business. Step 2 would not have been required.

While the above example concludes that the acquired bank branch is not a business, there may be circumstances in which acquired bank branches would be considered businesses. These may include:

- If the set includes autonomous banking operations with employees who possess specialized skills or knowledge and who perform the strategic functions necessary to generate outputs, which might be the case when multiple bank branches are acquired, rather than one (e.g., a set that includes all bank branches within a particular region that function independently from other bank branches).
- If the bank branch includes loan or other product origination operations and relationship managers tasked with generating new business.
- If there are strategic or marketing decisions made at the branch level.
- If the acquired branch includes proprietary customer service operations (e.g., virtual teller technology) that are unique.

If there is a more than insignificant amount of goodwill in the set, that may indicate that one or more substantive processes, such as the ones listed above, are present.

The assessment of these factors would require additional analysis and judgment assessing the individual facts and circumstances to determine whether the acquired branch(es) meet the definition of a business.

Example 2.21: Acquisition of an Asset Management Firm

Facts

ABC Corp., a diversified financial company, acquires an asset management entity that provides investment advisory services to individuals in a stock deal valued at $11,830,000.

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The acquired set includes several asset managers and cash, land, building, furniture, and equipment.

The acquired set also includes a contract with a third party for investment research services priced at a market rate.

ABC identifies a large customer relationship intangible asset.

There is a more-than-insignificant amount of goodwill.

The acquisition is structured as a nontaxable stock acquisition and therefore the tax bases of the asset management entity's assets and liabilities carry over to ABC.

The set currently produces outputs (i.e., it provides asset management services and earns fees).

The assets acquired and liabilities assumed would be recognized (under Topic 805) as follows:

Cash	$60,000
Furniture	$20,000
Equipment	$50,000
Acquired contract	$0
Building	$750,000
Land	$250,000
Customer relationship intangible	$5,700,000
Goodwill	$6,400,000
Deferred income tax liabilities	$(1,400,000)
Consideration paid	$11,830,000

Analysis

Step 1 (Screening Test):

ABC concludes that substantially all of the fair value is not concentrated in a single or group of similar identifiable assets. The analysis is as follows.

Step 1a

ABC determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, furniture, equipment, an acquired contract, a building, land, a customer relationship intangible, and goodwill. The acquired contract is priced at the current market rate and therefore has an immaterial fair value (assumed to be $0 for this example).

Step 1b

ABC evaluates whether any of the exceptions in paragraph 805-10-55-5B apply. ABC concludes that the building and land are a single asset because they are attached to and cannot be physically removed from and used separately from each other without incurring significant costs or reducing the fair value.

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Step 1c

In applying paragraph 805-10-55-5C, ABC notes that assets in different asset classes are not similar assets. ABC concludes that all of the furniture are similar assets, and all of the equipment are similar assets.

Step 1d

In applying Step 1d, the gross assets acquired would not include the goodwill associated with the deferred tax liabilities acquired in this transaction. The deferred tax liabilities generate $1,400,000 of goodwill, which is excluded for purposes of applying Step 1, leaving $5,000,000 of goodwill.

The gross assets acquired are as follows:

Items Acquired / Assumed	Value under Topic 805	Included in Gross Assets
Cash	$60,000	Not included
Furniture	$20,000	$20,000
Equipment	$50,000	$50,000
Acquired contract	$0	$0
Building and land	$1,000,000	$1,000,000
Customer relationship intangible	$5,700,000	$5,700,000
Goodwill	$6,400,000	$5,000,000
Deferred income tax liabilities	$(1,400,000)	Not included
Total	**$11,830,000**	**$11,770,000**

The fair value of gross assets acquired is $11,770,000.

Step 1e

ABC evaluates whether substantially all of the fair value is concentrated in a single asset or group of similar assets. The asset with the greatest fair value is the customer relationship intangible asset. Its fair value of $5,700,000 is compared to the gross assets acquired of $11,770,000, yielding 48%.

Step 1 is not met.

Step 2 (Input and Substantive Process):

The set has outputs as a result of the continued management fee income. Accordingly, ABC evaluates the factors when a set has outputs.

The acquired set includes furniture, equipment, an acquired contract, land and building, and a customer relationship intangible as inputs.

The set also includes an organized workforce that performs processes (investment management) critical to the ability to continue producing outputs. ABC determined that the asset managers included in the set have specialized skills and knowledge in providing investment advice to clients. The asset managers are also directly involved in generating

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new customers and producing revenue from existing clients. Therefore, ABC concludes that the employees represent an organized workforce and Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to continue producing outputs.

Note that this fact pattern may be similar to other common financial services transactions, such as the acquisition of an insurance agency or other service organizations.

Endnotes

[1] Based, in part, on Case H, Scenario 2, in ASU 2017-01.
[2] Based, in part, on Case B, Scenario 2, in ASU 2017-01.
[3] Based, in part, on Case C in ASU 2017-01.
[4] Based, in part, on Case A, Scenario 2, in ASU 2017-01.
[5] Based, in part, on Case H, Scenario 2, in ASU 2017-01.
[6] Based, in part, on Case H, Scenario 3, in ASU 2017-01.
[7] Based, in part, on Case G in ASU 2017-01.

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Section 3 - The Acquisition Method

OVERVIEW OF THE ACQUISITION METHOD

ASC paragraph 805-10-25-1

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

3.000 The definition of a business combination in the ASC Master Glossary includes events and transactions in which an acquirer obtains control of one or more businesses, regardless of how it obtains control. See the discussion of *Business Combinations Achieved without the Transfer of Consideration* in Section 4.

3.001 Each transaction or other event that falls within the scope of ASC paragraphs 805-10-15-3 and 15-4, as discussed in Section 1, is accounted for using the acquisition method. If a transaction or event is outside the scope of ASC Topic 805, it is accounted for based on other applicable GAAP.

ASC paragraph 805-10-05-4

…The acquisition method requires all of the following steps:

a. Identifying the acquirer

b. Determining the acquisition date

c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree

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

3.002 See the guidance in the following Sections for applying the acquisition method:

a.	Identifying the Acquirer	Section 4
b.	Determining the Acquisition Date	Section 5
c.	Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree	Section 7
d.	Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase	Section 8

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Section 4 - Identifying the Acquirer

Detailed Contents

Acquirer (and Acquiree) Defined

Application of ASC Subtopic 810-10 Guidance to Identify the Acquirer

Consideration of Other Factors to Determine the Acquirer When Application of ASC Subtopic 810-10 Guidance Does Not Clearly Identify the Acquirer

- Combinations Effected Primarily by the Transfer of Cash or Other Assets, or Incurring Liabilities
  - Capital Transactions versus Business Combinations
- Combinations Effected Primarily by Exchanging Equity Interests
  - Example 4.0: Composition of Senior Management of the Combined Entity
  - Example 4.1: Voting Rights, Board of Directors, and Senior Management
  - Example 4.2: Voting Rights, Large Minority Interest, Board of Directors, and Senior Management
  - Example 4.3: Voting Rights, Board of Directors, Senior Management, and Payment of a Premium
- Relative Size of the Combining Entities
- Combinations Involving More Than Two Entities
  - Example 4.3aa: Transaction With Three or More Entities Where More Than One (But Not All) Are Under Common Control
- Additional Factors
- Transactions Involving a Newly Formed Entity
  - Transactions Involving a Non-Substantive Newco
  - Example 4.3a: Acquisition with NewCo
  - Newly Formed Entity in an Exchange that Lacks Substance
  - Example 4.3b: Use of a NewCo in an Up-C Structure
  - Roll-Up Or Put-Together Transactions
  - Example 4.4: Roll-Up or Put-Together Transaction Involving Two Entities
  - Example 4.5: Roll-Up or Put-Together Transaction Involving More Than Two Entities
  - Transactions Involving a Substantive Newco
  - Example 4.6: Newly Formed Entity Controlled by a Venture Capital Company
  - Example 4.6a: Newly Formed Entity Controlled by a Venture Capital Company
  - Special Purpose Acquisition Company (SPAC)
  - Reverse Morris Trust (RMT)

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Business Combinations Achieved Without the Transfer of Consideration

Variable Interest Entities

Example 4.7: Initial Consolidation of a VIE

Business Combinations Achieved by Contract Alone Often Result in the Formation of Variable Interest Entities

Reverse Acquisitions

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ACQUIRER (AND ACQUIREE) DEFINED

ASC Master Glossary: Acquirer

The entity that obtains control of the acquiree. See paragraphs 805-10-25-4 through 25-5 for guidance on determining the acquirer.

ASC Master Glossary: Acquiree

The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

ASC paragraph 805-10-25-4

For each business combination, one of the combining entities shall be identified as the acquirer.

ASC paragraph 805-10-25-5 (Before adoption of ASU 2025-03)[1]

The guidance in the General Subsections of [ASC] Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer—the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of [ASC] Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in [ASC] paragraphs 805-10-55-11 through 55-15.

ASC paragraph 805-10-25-5 (After adoption of ASU 2025-03)

The guidance in the General Subsections of [ASC] Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer—the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance does not clearly indicate which of the combining entities is the acquirer, the factors in [ASC] paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity is the acquirer unless the business combination is effected primarily by exchanging equity interests. The determination of which party, if any, is the primary beneficiary of a VIE shall be

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made in accordance with the guidance in the Variable Interest Entities Subsections of [ASC] Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or the guidance in [ASC] paragraphs 805-10-55-11 through 55-15. For a business combination that is effected primarily by exchanging equity interests in which a VIE is acquired, the factors in [ASC] paragraphs 805-10-55-12 through 55-15 shall be considered in determining which entity is the accounting acquirer.

4.001 The acquirer is the entity that obtains control of a business (or businesses) (see discussions of *Control* and *Business* in Section 2). There is only one acquirer in every business combination, including combinations of three or more entities. For business combinations involving more than two entities, see discussion of *Combinations Involving More Than Two Entities* beginning at Paragraph 4.018.

4.001a We believe the following decision tree and related discussion provide a useful framework of how to determine the accounting acquirer in a business combination between two substantive entities (see discussion beginning at Paragraph 4.020a for details on evaluating newly formed entities). The decision tree includes the term “forward merger” to describe a business combination where the legal acquirer is also the accounting acquirer. A reverse acquisition is a business combination where the accounting acquirer is the legal acquiree (see Paragraph 4.029 for a discussion of reverse acquisitions).

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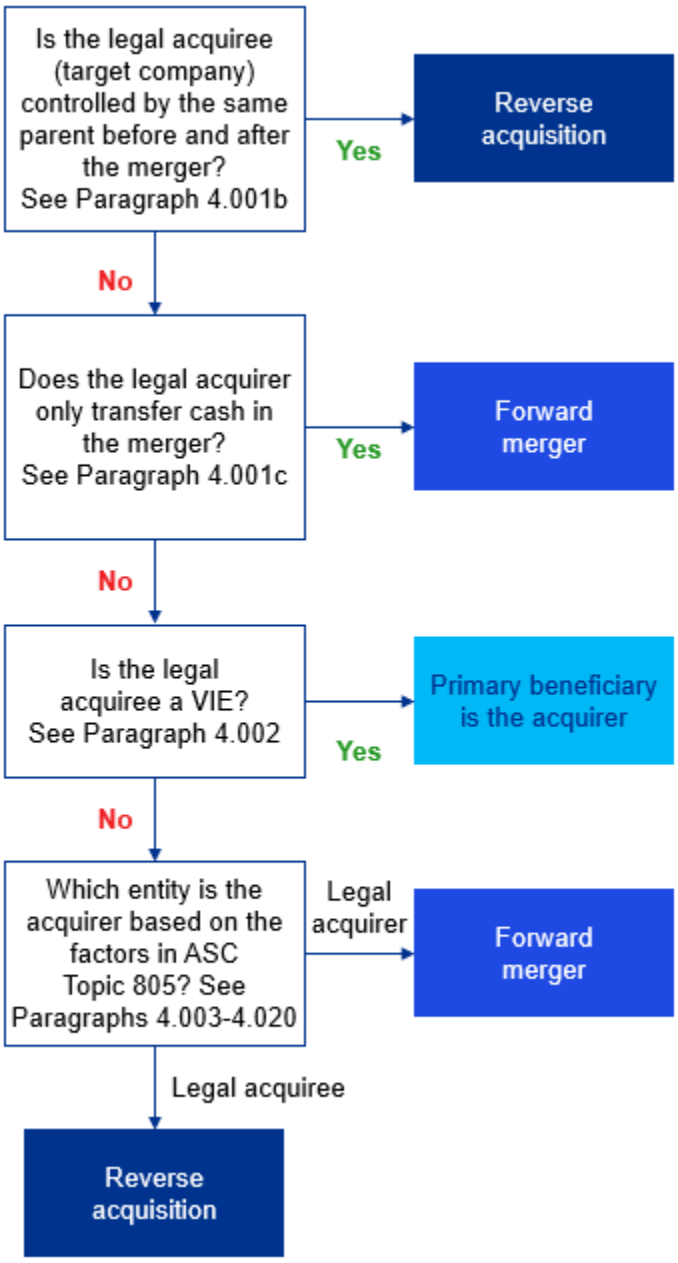
Before adoption of ASU 2025-03



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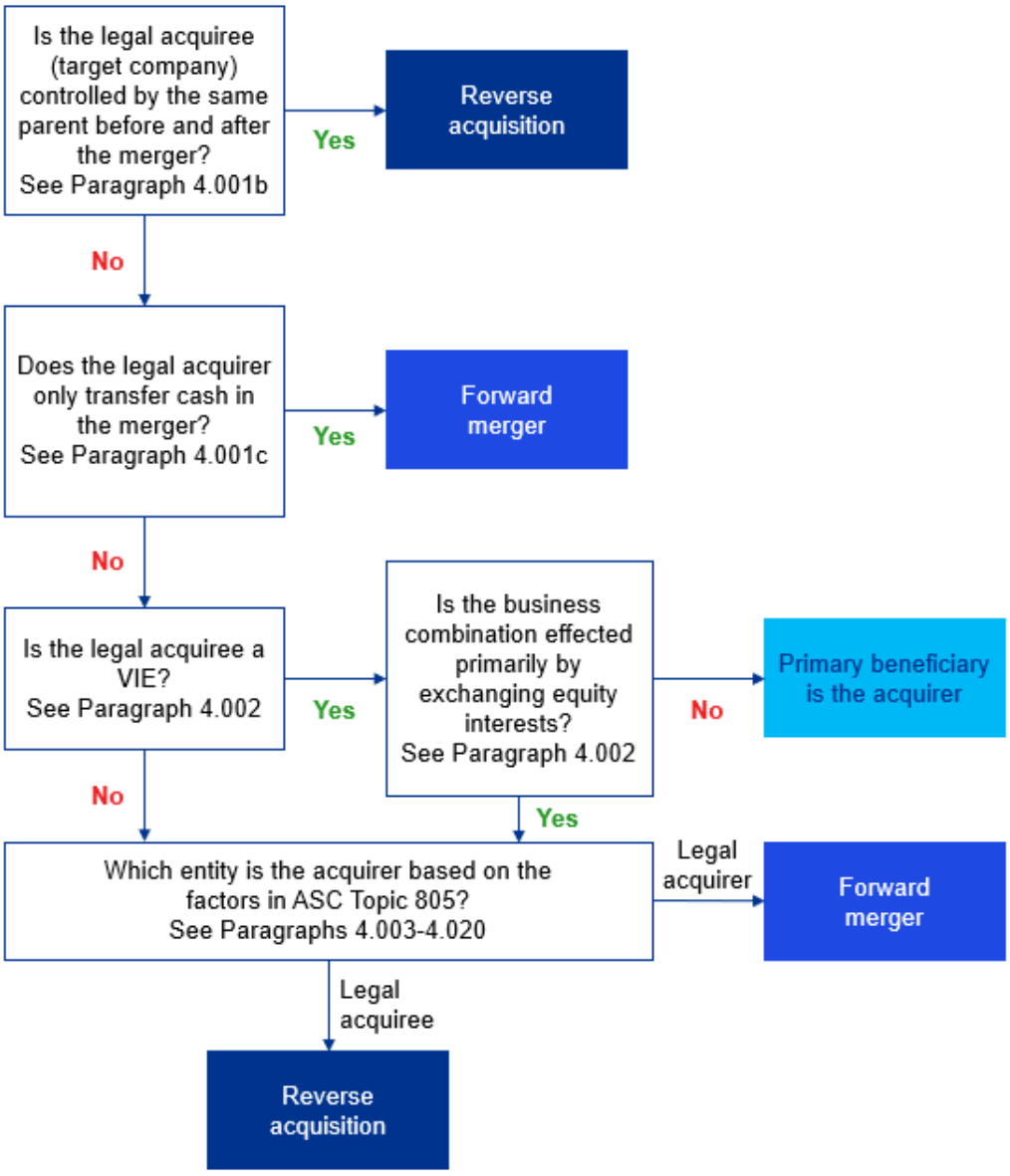
After adoption of ASU 2025-03



4.001b For the legal acquirer to be the accounting acquirer, the target company must undergo a change of control. If the parent entity (or individual) that controlled the target company before the transaction controls the legal acquirer (and, indirectly, the target company) post-transaction (under either the voting or variable interest model), the transaction is accounted for as a reverse acquisition in the legal acquirer's financial statements because the target company has not undergone a change in control. See Paragraph 6.015 and Example 6.3, Part 2.

4.001c Under ASC Topic 805, in a transaction effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities. When the only consideration given is in the

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form of cash for a controlling financial interest in the equity or net assets of the target company, the selling shareholder(s) would not obtain an ownership interest in the combined entity nor rights to govern the combined entity and the application of Subtopic 810 would clearly indicate the legal acquirer is the accounting acquirer.

4.002 Special consideration is needed when determining the acquirer of a VIE. Before the adoption of ASU 2025-03, the accounting acquirer in a business combination in which a VIE is acquired is always the primary beneficiary of the VIE. However, ASU 2025-03 amends the framework for identifying the accounting acquirer when the legal acquiree is a VIE. After adoption of ASU 2025-03, an entity first considers whether the acquisition was primarily effected by the exchange of equity interests. In a business combination in which a VIE is acquired, the primary beneficiary of the VIE is the accounting acquirer unless the business combination is effected primarily by exchanging equity interests.

4.002a In all other business combinations, including when the legal acquiree is a VIE and the business combination is effected primarily by exchanging equity interests (after adoption of ASU 2025-03), if applying the guidance in ASC Subtopic 810-10, *Consolidation - Overall,* does not clearly indicate which of the combining entities is the acquirer, the general factors in ASC Subtopic 805-10 are considered in making the determination. See *Combinations Effected Primarily by Exchanging Equity Interests at* Paragraph 4.008 and the discussion of *Variable Interest Entities* beginning at Paragraph 4.025.

APPLICATION OF ASC SUBTOPIC 810-10 GUIDANCE TO IDENTIFY THE ACQUIRER

4.003 ASC paragraph 810-10-15-8 specifies that the usual condition for obtaining control is the ownership of more than 50% of the outstanding voting interest of another entity. However, such ownership does not constitute control if it does not give the holder control of the majority-owned entity. For example, as discussed in ASC paragraphs 810-10-25-1 through 25-14C, a minority shareholder or limited partner may have substantive participating rights that prevent the majority holder from exercising control over the investee. Conversely, an investor could obtain control over a business in situations where the investor owns less than a majority (and perhaps none) of the voting interests in the investee (e.g., in a situation where control is achieved by contract alone). See discussion of Control beginning at Paragraph 2.004.

CONSIDERATION OF OTHER FACTORS TO DETERMINE THE ACQUIRER WHEN APPLICATION OF ASC SUBTOPIC 810-10 GUIDANCE DOES NOT CLEARLY IDENTIFY THE ACQUIRER

4.004 If applying the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer, ASC Topic 805 requires that other facts and circumstances be considered in making the determination, including the factors described in ASC paragraphs 805-10-55-11 through 55-15, discussed below. No individual factor is necessarily determinative. Rather, all pertinent facts and circumstances should be considered in determining which of the combining entities is the acquirer.

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Combinations Effected Primarily by the Transfer of Cash or Other Assets, or Incurring Liabilities

> **ASC paragraph 805-10-55-11**
>
> In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities.

4.005 In business combinations effected primarily by the transfer of cash, other assets, or by incurring liabilities, the entity that transfers the cash or other assets, or incurs the liabilities, is usually the acquirer. Regardless of the form of the transaction, if the acquirer retains control of the transferred assets or liabilities (including an equity interest in a subsidiary) after the business combination, it measures the transferred assets and liabilities at their carrying amounts immediately before the acquisition date and does not recognize a gain or loss on the transfer. See discussion and examples of *Assets or Liabilities Transferred by the Acquirer* in Section 6.

Capital Transactions versus Business Combinations

4.006 The guidance in ASC paragraph 805-10-55-11 does not apply to a transaction that in substance is a capital transaction rather than a business combination. In these instances, the entity that distributes cash or assets is the acquiree and not the acquirer for accounting purposes. The SEC staff, in the Division of Corporation Finance, *Financial Reporting Manual,* par. 12100, states that the acquisition of a private operating company by a nonoperating public *shell company typically* results in the owners and management of the private company having actual or effective voting and operating control of the combined company. This transaction is equivalent to the issuance of shares by the private company for the net monetary assets of the shell company, accompanied by a recapitalization (i.e., a reverse recapitalization). The accounting is similar to that for a reverse acquisition; that is, the private company is the accounting acquirer (see *Reverse Acquisitions* beginning at Paragraph 9.012), except that it recognizes no goodwill or other intangible asset because the transaction does not constitute the acquisition of a business. Similar to a reverse acquisition, the historical financial statements of the private operating company (the accounting acquirer) are presented as the historical financial statements of the combined entity in a reverse recapitalization. The equity of the private operating company acquirer is presented as the equity of the combined entity; however, the share capital account of the accounting acquirer is adjusted to reflect the par value of the outstanding shares of the legal acquirer after considering shares issued in the transaction. Earnings per share of the acquirer is restated for prior periods to reflect the changes in the capital share account (see discussion of Preparation and presentation of consolidated financial statements beginning at Paragraph 9.016). See the discussion beginning at Paragraph 9.020 for a discussion about SPAC mergers that may be accounted for as a reverse recapitalization if the legal acquiree is the accounting acquirer.

4.007 Special considerations apply to transactions involving a newly formed entity. See discussion at Paragraph 4.020a.

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Combinations Effected Primarily by Exchanging Equity Interests

4.008 In most business combinations effected primarily through the exchange of equity interests, the acquirer is the entity that issues the new equity interests. However, ASC paragraphs 805-10-55-10 through 55-15 consider other pertinent facts and circumstances in identifying the acquirer in such business combinations, including the factors described in ASC paragraph 805-10-55-12. See discussion of *Reverse Acquisitions* beginning at Paragraph 9.012, in which the issuing entity is the acquiree. See the discussion beginning at Paragraph 9.020 for a discussion about the accounting acquirer analysis in a SPAC transaction.

> **ASC paragraph 805-10-55-12**
>
> In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests. However, in some business combinations, commonly called reverse acquisitions, the issuing entity is the acquiree. Subtopic 805-40 provides guidance on accounting for reverse acquisitions. Other pertinent facts and circumstances also shall be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including the following:
>
> a. *The relative voting rights in the combined entity after the business combination.* The acquirer usually is the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities...

4.009 The existence of equity interests, other than common shares, with voting rights (e.g., voting preferred shares) may lead to identifying an acquirer other than the entity that would have been identified in the absence of such equity interests. Options, warrants, and convertible securities that are in-the-money and that are vested and exercisable or convertible into shares with voting rights at the date of acquisition, including exercisability or convertibility triggered by the terms of the acquisition, should also be considered when determining relative voting rights.

4.010 In some transactions, voting rights of one or more classes of shares automatically change at a future date or on the occurrence of specified events. For example, a class of shares may be designated as nonvoting for the first year following the business combination. All of the facts and circumstances of the transaction should be evaluated to determine how this affects the identification of the acquirer. The factors described in Paragraph 4.012 may be helpful in evaluating whether the period of time the shares are nonvoting is substantive.

> **ASC subparagraph 805-10-55-12(b)**
>
> *The existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest.* The

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acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.

4.011 This may be a significant factor in determining the acquirer for a put-together or roll-up transaction. The application of this guidance is demonstrated in Examples 4.4, 4.5, and 4.6.

ASC subparagraph 805-10-55-12(c)

The composition of the governing body of the combined entity. The acquirer usually is the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

4.012 ASC Topic 805 is silent as to whether the owner election rights need to exist only at the acquisition date, or for a period of time thereafter. However, if control of the board by a shareholder group is temporary, the control may not be substantive. In evaluating this factor, consideration should be given not only to the board's current composition, but also to the period of time each board member is entitled to hold his or her board position, taking into account scheduled board member retirements and scheduled elections after the acquisition date. While there is no minimum duration required for a shareholder group to be in control of the board for it to be deemed substantive, we believe that control generally should extend for a sufficient duration to allow the board to consider and act on significant substantive matters arising from the acquisition, such as those related to corporate governance; the appointment and compensation of senior management; the issuance of debt or equity securities; and substantive business integration, exit, and disposal activities. Judgment is required in determining whether control of a shareholder group following an acquisition is substantive.

ASC subparagraph 805-10-55-12(d)

The composition of the senior management of the combined entity. The acquirer usually is the combining entity whose former management dominates the management of the combined entity.

4.013 Senior management generally consists of the executive chairman of the board, chief executive officer, chief operating officer, chief financial officer, divisional heads, and members of the executive committee, if one exists. This description of senior management is meant to identify functions, not necessarily managers with a specific title. These functions should comprise the highest level of operating decision makers within the combined entity. If the senior management of the combined entity is not dominated by individuals from one of the combining entities, we believe that more weight should be given to those executive positions that are most closely aligned with the core business activities of the combined entity. In addition, the terms of employment contracts, such as length of time, with senior management should be considered.

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Example 4.0: Composition of Senior Management of the Combined Entity

ABC Corp. and DEF Corp. agree to merge their similarly sized pharmaceutical businesses. ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. The shareholders of DEF will receive 50.01% of the voting interests of the combined company.

The board of directors of the combined company will have four former ABC and four former DEF directors. Staggered board elections will begin two years after consummation of the business combination, and there are no scheduled board member retirements before that time. Removal of board members requires a vote of at least two-thirds of the shareholders. Management will consist of:

ABC	**DEF**
CEO	President of Human Resources
COO	General Counsel
Chief Medical Officer	CFO

No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, etc.

Assessment

ABC will have the most influence in the combined company and is the acquirer. Although the owners of DEF will receive a marginally larger portion of the voting rights of the combined company, the senior management of ABC will assume the role of CEO and other executive positions that are most closely aligned with the core business activities of the combined entity (that is, development and marketing of pharmaceutical products).

Considering the neutral status of the board of directors, the absence of board elections for two years, the absence of significant blocks of voting rights, and the similar size of the combining entities, the small voting majority of the owners of DEF does not represent a decisive element of continuing control for DEF.

ASC subparagraph 805-10-55-12(e)

The terms of the exchange of equity interests. The acquirer usually is the combining entity that pays a premium over the precombination fair value of the equity interests of the other combining entity or entities.

4.014 The FASB did not provide any hierarchy for these factors. Some factors may be more relevant to identifying the acquirer in one combination and less relevant in others. Judgment is required in instances where the various factors individually point to different entities as the acquirer.

4.015 Factors (a) through (d) relate to persons involved in controlling the operations of an entity. These functions are sometimes collectively referred to as the *governance system* of an entity. The premium mentioned in factor (e), referred to as a *control premium*[2], can be

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presumed to be paid because the members of the governance system of the paying entity can extend their control to the acquirer.

4.016 The following examples assume that neither the guidance in ASC Subtopic 810-10, nor any other factors clearly indicate which entity is the acquirer and, thus, the determination of the acquirer is appropriately being made based on an analysis of the factors in ASC paragraph 805-10-55-12.

Example 4.1: Voting Rights, Board of Directors, and Senior Management

ABC Corp. and DEF Corp. agree to merge their similar-sized businesses. ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. The shareholders of DEF will receive 50.01% of the voting interests of the combined company.

The board of directors of the combined company will have five former ABC and four former DEF directors. Staggered board elections will begin two years after consummation of the business combination, and there are no scheduled board member retirements before that time. Removal of board members requires a vote of at least two-thirds of the shareholders. Management will consist of:

ABC	**DEF**
Chairman/CEO	President
Co-COO*	Co-COO*
CFO	

*ABC and DEF each have the right to appoint an individual that shares the COO position with the Co-COO appointed by the other company.

No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, management, etc.

Assessment

ABC is the acquirer. Although the owners of DEF will receive the larger portion of the voting rights of the combined company, the members of the board of directors and senior management of ABC will dominate the respective bodies of the combined company. Considering the absence of significant blocks of voting rights, the absence of board elections for two years, and the similar size of the combining entities, the small voting majority of the owners of DEF does not represent a decisive element of continuing control for DEF. Thus, ABC will have the most influence in the combined company for at least two years after the business combination.

Example 4.2: Voting Rights, Large Minority Interest, Board of Directors, and Senior Management

Bank A and Bank B agree to enter into a business combination. On consummation, Bank A's former shareholders will own 55% and Bank B's former shareholders will

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own 45% (30% of which will be owned by shareholder X) of the outstanding voting shares of the combined entity. The largest former shareholder of Bank A will own 7% of the combined entity.

As a condition of closing, shareholder X will be granted the right to appoint a majority of the combined entity's first board of directors (board members serve a three-year term). The acquisition agreement also provides for the carryover of the CEO, CFO, and COO of Bank B into comparable positions in the combined entity. The board of directors will have the authority to appoint and remove the senior officers of the combined entity. No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, or management.

Assessment

Bank B is the acquirer. Despite the voting majority of the former shareholders of Bank A, the significant minority interest of shareholder X and his or her right to appoint a majority of the combined entity's first board of directors (which will serve for three years), together with the carryover of the senior management of Bank B indicate that Bank B has the most influence in the combined entity.

Example 4.3: Voting Rights, Board of Directors, Senior Management, and Payment of a Premium

ABC Corp. acquires 15% of the outstanding shares of a public company, DEF Corp., for cash, paying a premium of 10% above the market price, and acquires the remaining outstanding shares of DEF in exchange for shares of ABC. After the acquisition, the former shareholders of DEF own 58% of the outstanding shares of the combined entity. If exercised, warrants and convertible debentures held by former shareholders of DEF would increase the interest of former shareholders of DEF to 71%; however, the warrants and convertible debentures cannot be exercised for three years from the closing date.

The board of directors of the combined entity consists of five nominees of ABC and four nominees of DEF for a two-year term. Removal of board members requires a vote of at least two-thirds of the shareholders. The chairman and the CEO of ABC retain their positions in the combined entity. No other relevant circumstances exist with respect to voting, ownership of significant blocks of shares, or management.

Assessment

ABC has the most influence in the combined entity and is the acquirer. ABC paid partly in cash, including a premium above market price, and dominates the board of directors and senior management of the combined entity. DEF's former shareholders will own the majority of shares in the combined entity, but they will not own two-thirds of the shares for at least three years following the business combination.

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Relative Size of the Combining Entities

> **ASC paragraph 805-10-55-13**
>
> The acquirer usually is the combining entity whose relative size (measured in, for example, assets, revenues, or earnings) is significantly larger than that of the other combining entity or entities.

4.017 Judgment is required when comparing the combining entities based on their relative size. When each combining entity is involved in similar activities and lines of business, a comparison of relative size may be straightforward. For example, reported revenues and total assets might be an appropriate comparison in these circumstances.

4.017a However, in circumstances where the combining entities are involved in disparate activities and businesses, a comparison of relative size based on reported amounts might not be appropriate, and information other than the reported amounts of assets, earnings, and revenues may require consideration. Comparing the amount of reported revenues without considering the nature and source of those revenues may not be meaningful. For example, comparing revenues generated by an entity with high volume, high turnover, and low gross margins (e.g., a grocery store chain) with revenues generated by an entity with low volume, high value-added, and high gross margins (e.g., a custom designer and manufacturer of specialized equipment) might not be meaningful.

4.017b Likewise, comparing the reported amount of total assets or net assets of an entity whose principal revenue-generating assets are internally developed intangible assets (and thus not reflected in the entity's reported amounts) to the reported amount of total assets or net assets of an entity whose principal revenue-generating assets are similar long-lived intangible assets that were acquired in a series of business combinations (and thus are reflected in the entity's reported amounts) may not be particularly meaningful.

4.017c A comparison of operating cash flows might, in certain instances, be helpful in identifying whether one of the combining entities is significantly larger than the other combining entities. In certain instances, we believe that market capitalization may also be an appropriate factor to consider in assessing the relative size of the combining entities.

Combinations Involving More Than Two Entities

> **ASC paragraph 805-10-55-14**
>
> In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities, as discussed in [ASC] paragraph 805-10-55-13.

4.018 The definition of *control* could be viewed to exclude certain transactions in which no former shareholder group obtains control of the combined entity, such as combinations involving more than two entities, including roll-up and put-together transactions. However, those transactions are business combinations under ASC Topic 805.

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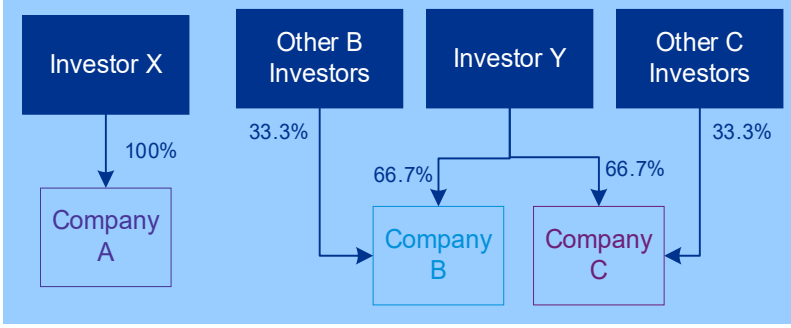
4.019 All of the factors in ASC paragraphs 805-10-55-11 through 55-15 require consideration in identifying the acquirer if application of the guidance in ASC Subtopic 810-10 does not clearly identify the acquirer. The guidance in ASC paragraph 805-10-55-12(b), which indicates that in combinations involving the exchange of equity interests, the acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity, may be particularly helpful in identifying the acquirer in some combinations involving more than two entities. Example 4.5 illustrates an example of a business combination of more than two entities.

4.020 For business combinations involving three or more entities where more than one (but not all) of the entities are under common control, we believe the entities under common control should be considered as a group for the accounting acquirer analysis.

Example 4.3aa: Transaction With Three or More Entities Where More Than One (But Not All) Are Under Common Control

Companies A, B and C agree to merge in a single integrated transaction. NewCo, which has no pre-combination activities, is formed to effect the transaction by issuing shares to the former owners of Companies A, B and C in exchange for their existing ownership interests. Companies A, B and C are all businesses. NewCo is considered to not be substantive (see Paragraph 4.020a).

Company A is 100% owned by Investor X. Company B and Company C are under common control of Investor Y. Investor Y owns 66.7% of Company B and Company C. The noncontrolling shareholders of Company B and Company C are a disparate group of unrelated investors. Ownership of the entities prior to the transaction is as follows.



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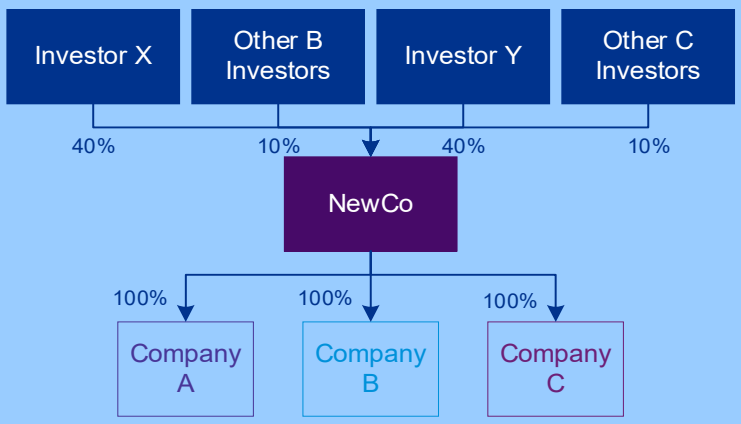
After the transaction, the ownership interest in NewCo is as follows.



No individual investor has a controlling financial interest in NewCo. Other factors include:

- The initial board of NewCo consists of 7 members: 3 members appointed by Company A, and 2 members appointed by each of Company B and C.
- Executive management of Company A will be executive management of the combined entity.
- Company A is larger than Company B and Company C on an individual basis. However, Company B and Company C combined are larger than Company A.

Assessment

Company B and Company C should be considered a single entity for purposes of the accounting acquirer analysis because they are entities under common control. For example, when evaluating the relative voting rights factor, Company B and Company C would have 60% of the voting rights. Similarly, when evaluating the composition of the governing body factor, the combined Company B and Company C would appoint 4 out of 7 board members. Based on the facts and circumstances, Company B and Company C together are the acquirer. Therefore, NewCo's financial statements would reflect Company B and Company C at carryover basis and would apply acquisition accounting to the assets and liabilities of Company A in accordance with ASC Topic 805.

Additional Factors

4.020aa If the factors listed in ASC paragraphs 805-10-55-11 through 55-15 do not clearly indicate the accounting acquirer, other relevant factors may be considered including details of initial negotiations, which entity initiated the business combination, and the combined entity's name, location of its headquarters, and ticker symbol.

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Transactions Involving a Newly Formed Entity

4.020a Special considerations apply when a new entity (NewCo) is formed to effect a transaction. A newly formed entity with pre-combination activities deemed to be significant (i.e., NewCo is substantive), but which do not constitute a business, can be the acquirer in a business combination. That is, the accounting acquiree must be a business for the transaction to be a business combination, but it is not necessary that the accounting acquirer be a business. A nonsubstantive NewCo could indicate the transaction is not a business combination or that another entity (e.g., one of the combining entities) is the acquirer.

> **ASC paragraph 805-10-55-15**
>
> A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in [ASC] paragraphs 805-10-55-10 through 55-14. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

4.020b Factors to consider in determining whether the newly formed entity is substantive include, but are not limited to:

- Whether the newly formed entity has assets other than cash related to the initial equity investment made by its founder;
- Whether the newly formed entity survives the transaction;
- The pre-combination activities of the newly formed entity (e.g., raising capital, issuing debt, identifying a target, negotiating, and promoting the business combination);
- The governance of the newly formed entity and whether a new investor effectively obtained control of the acquiree;
- The reason why the newly formed entity was used;
- How long the newly formed entity has been in existence; and
- Whether the elements of the transaction are integrated or preconditioned on each other.

Transactions Involving a Non-Substantive Newco

4.020c A transaction involving a newly formed entity with no significant pre-combination activities may or may not be a business combination, depending on the facts and circumstances.

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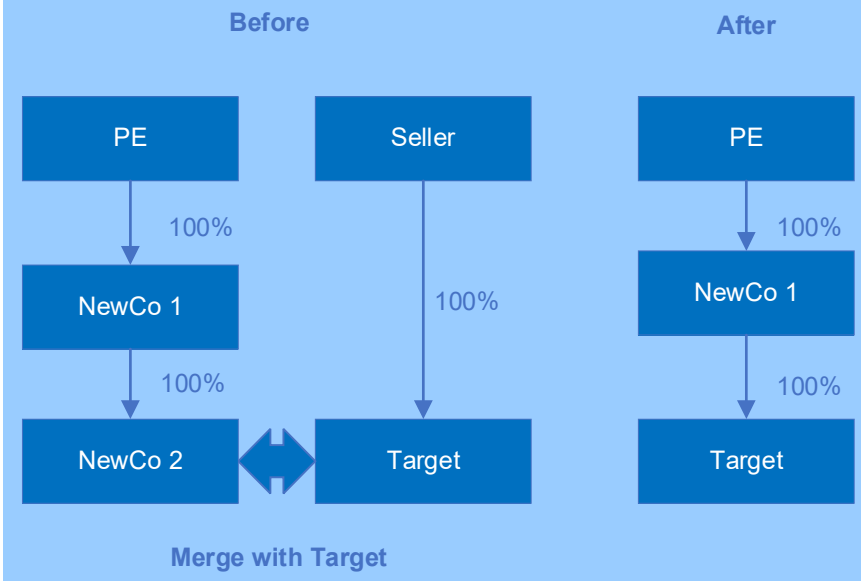
Example 4.3a: Acquisition with a NewCo

PE forms NewCo 1 to effect the acquisition of Target, which is a business. PE contributes cash into NewCo 1 and owns a 100% controlling interest. NewCo 1 then forms NewCo 2 and contributes the cash to NewCo 2.

NewCo 2 immediately transfers that cash for 100% of Target's shares and merges with Target. Target is the surviving entity in the merger with NewCo 2. The following diagram illustrates the legal entity structure before and after the transaction.



NewCo 1 is substantive because:

- NewCo 1 transferred cash to acquire Target;
- NewCo 1 survives the merger and is the reporting entity;
- The governance of NewCo 1 is different from Target; and
- Newco 1 is used by PE to obtain control of Target.

While NewCo 2 transferred cash, NewCo 2 is not substantive, and therefore cannot be the accounting acquirer, because:

- NewCo 2 was formed as a transitory entity only to effect the transaction;
- NewCo 2 has no pre-combination activities; and
- NewCo 2 does not survive.

NewCo 1 is the accounting acquirer and accounts for the acquisition of Target as a business combination. If Target prepares separate financial statements, it can elect to apply pushdown accounting (see Section 27, *Application of Pushdown Accounting)*. If pushdown accounting is not applied in Target's standalone financial statements, Target's assets and liabilities would remain at its historical cost basis.

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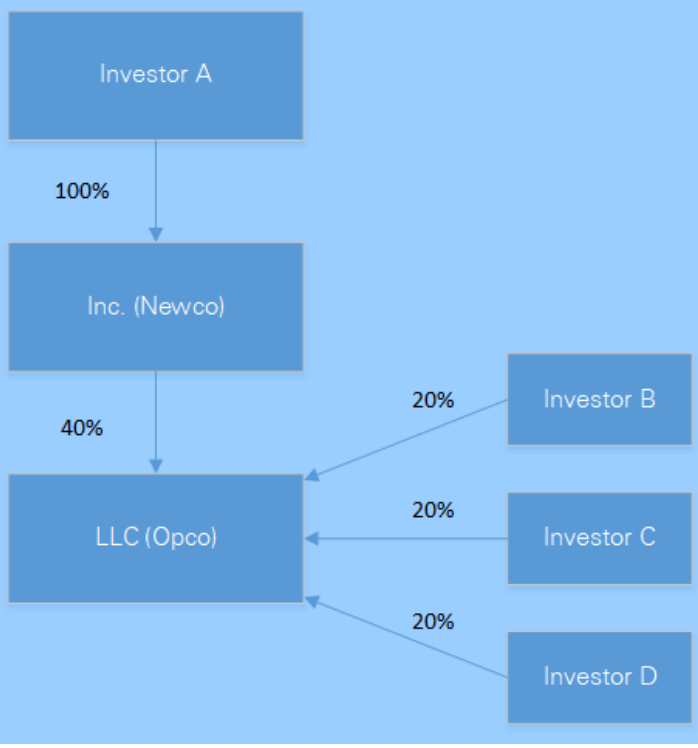
Newly Formed Entity in an Exchange that Lacks Substance

4.020d If a newly formed entity with no significant pre-combination activities obtains a controlling financial interest in an operating entity in a legal entity reorganization or an exchange that lacks substance, the transaction would not be a business combination. Paragraph 6 of FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations,* stated, "if the exchange lacks substance, it is not a purchase event and should be accounted for based on existing carrying amounts." Although FASB Technical Bulletin No. 85-5 was superseded by Statement 141(R), we believe this guidance remains relevant for transactions that lack economic substance (see also *Combinations Between Entities or Business with a High Degree of Common Ownership* beginning at Paragraph 28.009).

Example 4.3b: Use of a NewCo in an Up-C Structure

OpCo is an operating entity in the legal form of an LLC (a limited liability corporation) with four Investors, one of whom holds a 40% interest (Investor A), and the remainder of whom each holds a 20% interest (Investors B, C, and D). None of the Investors individually controls OpCo. To effect an initial public offering of OpCo, Investor A forms a corporation (NewCo) that will acquire OpCo and file a registration statement. This is an example of a transaction commonly referred to as an "Up-C" structure.

Two steps are required to arrive at the desired structure. In Step 1, Investor A creates NewCo and transfers all of its 40% interest in OpCo to NewCo. NewCo has no other substantive assets or activities. After this step, the entities are organized as follows.



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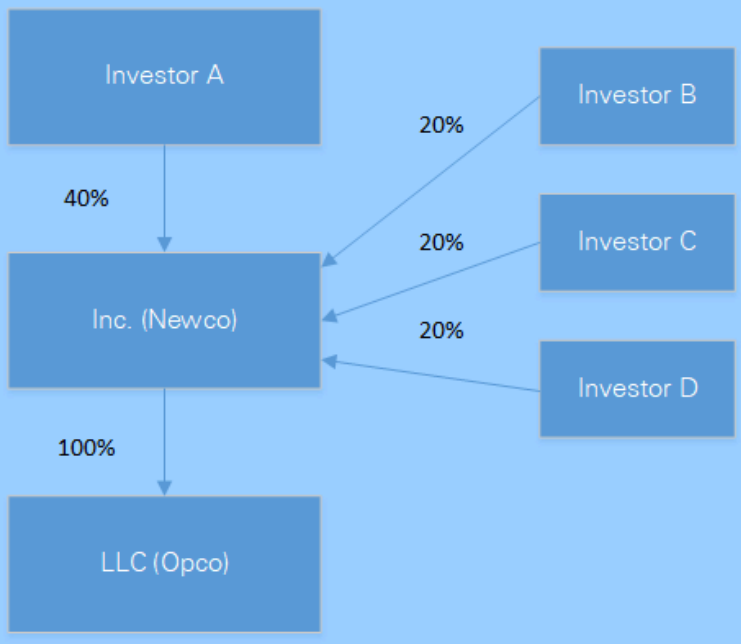
In Step 2, Investors B, C, and D each exchange their 20% interest in OpCo for a 20% interest in NewCo. After the reorganization, the entities are structured as follows:



Assessment

NewCo's acquisition of OpCo is not a business combination. NewCo did not engage in any significant pre-combination activities and did not raise any capital, identify acquisition targets or negotiate transactions. Each Investor holds the same percentage interest in NewCo as they held in OldCo before Step 1. Both Step 1 and Step 2 lack economic substance and merely represent a change in the legal form to effect the IPO. NewCo consolidates OpCo at the carryover basis of OpCo's assets and liabilities.

Roll-Up Or Put-Together Transactions

4.021 A transaction in which two or more entities transfer net assets that constitute a business, or the owners of those entities transfer their equity interests to a newly formed entity, is sometimes referred to as a *roll-up* or *put-together* transaction. These transactions are business combinations and should be accounted for using the acquisition method. If a new entity with no significant pre-combination activities is formed to issue equity interests to effect a business combination, the newly formed entity should be looked through, with one of the existing combining entities determined to be the acquirer.

Example 4.4: Roll-Up or Put-Together Transaction Involving Two Entities

ABC Corp. contributes its wholly owned subsidiary, Sub A, and DEF Corp. contributes its wholly owned subsidiary, Sub D, to the newly formed XYZ Corp. In exchange, ABC receives a 52% equity interest in XYZ and as a result has the ability to appoint a

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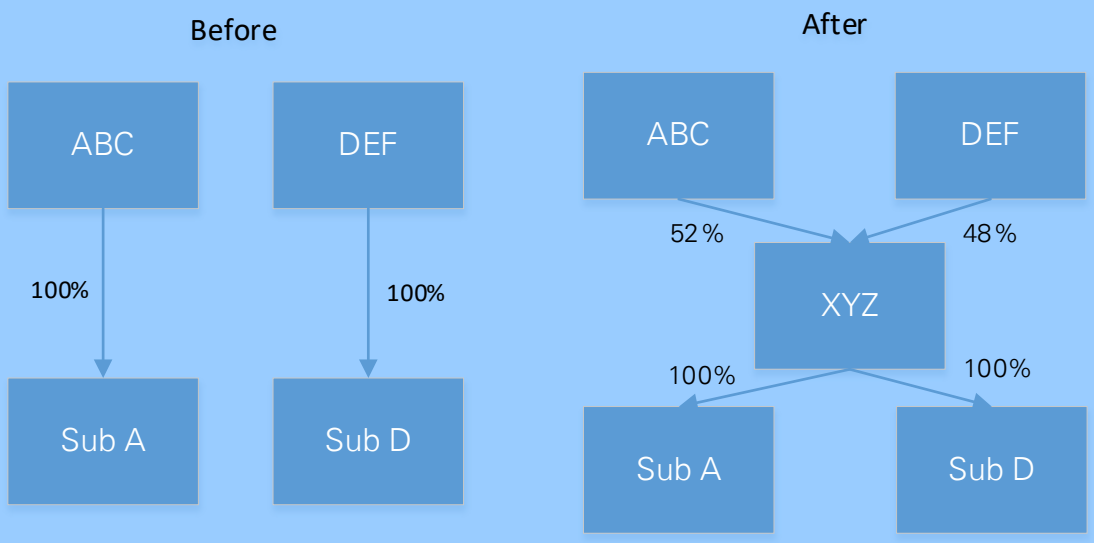
voting majority of the board of directors of XYZ. DEF receives the remaining 48% equity interest in XYZ. XYZ had no significant pre-combination activities. There are no other factors that indicate which of the combining entities is the acquirer.



Assessment

At the XYZ level, Sub A is the acquirer. XYZ had no significant pre-combination activities and, thus, one of the combining entities must be identified as the acquirer. Sub A's parent (ABC) received a 52% equity interest in XYZ, and there are no other factors that indicate which of the combining entities is the acquirer. XYZ should account for this transaction using the acquisition method. Because Sub A is the acquirer, its assets and liabilities should be recognized at their carryover basis, and the assets and liabilities of Sub D should be recognized and measured under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles of ASC Topic 805).

At the ABC consolidated level, it has effectively acquired a controlling financial interest in Sub D (by acquiring a 52% equity interest in XYZ) in exchange for a noncontrolling interest in Sub A (through the 48% noncontrolling interest in XYZ acquired by DEF). Thus, in its consolidated financial statements, ABC should continue to recognize the assets and liabilities of Sub A at their carryover basis, and account for the acquisition of Sub D using the acquisition method. Therefore, ABC should recognize and measure:

- the assets and liabilities of Sub D under ASC Topic 805 (i.e., same bases as recognized and measured in the consolidated financial statements of XYZ), and
- the noncontrolling interest in XYZ as (1) DEF's proportionate share of Sub A's net assets at their historical carrying amounts, and (2) the acquisition-date fair value of the noncontrolling interest in Sub D.

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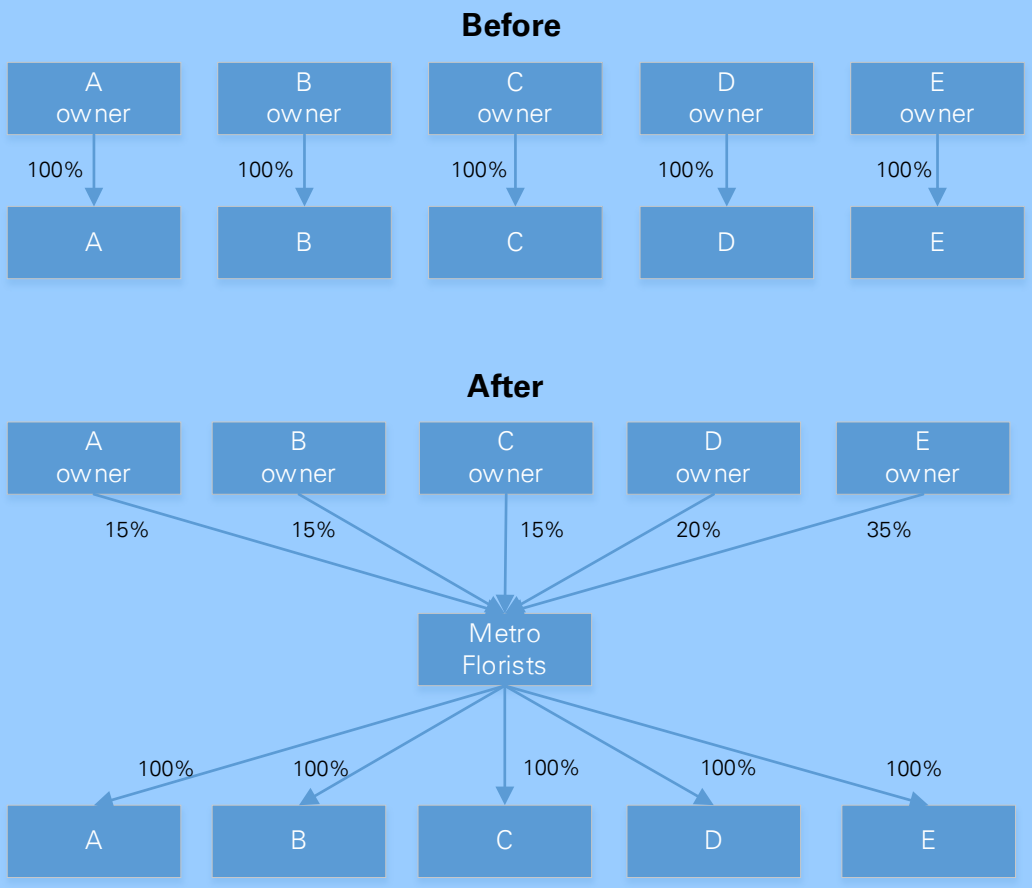
ABC recognizes no gain or loss on this transaction (unless there is a bargain purchase gain).

Example 4.5: Roll-Up or Put-Together Transaction Involving More Than Two Entities

Companies A, B, C, and D each operate independent florist shops in suburbs of Metro City. Company E operates four florist shops in Metro City. To capitalize on economies of scale and other synergies, the owners agree to form a single entity (Metro Florists, a voting interest entity) and contribute their shops to Metro Florists through a roll-up transaction. The ownership of Metro Florists will be as follows:

- Companies A, B, and C shareholders – 15% each
- Company D shareholders – 20%
- Company E shareholders – 35%

Metro Florists had no significant pre-combination activities. There are no other factors that indicate which entity is the acquirer.



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Assessment

Metro Florists had no significant pre-combination activities and, thus, one of the combining entities must be identified as the acquirer. At the Metro Florists level, Company E is the acquirer. Company E's owner receives a greater interest in Metro Florists (35%) than the owners of any of the other combining companies, and no other factors indicate to the contrary. Metro Florists' consolidated financial statements will include the assets and liabilities of Company E at their carryover basis, and will include the assets and liabilities of Companies A, B, C, and D, which are recognized and measured under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles prescribed by ASC Topic 805).

Transactions Involving a Substantive Newco

4.022 Although a new entity formed to effect a business combination is not necessarily the acquirer, a newly formed entity that transfers cash or other assets or incurs liabilities as consideration *may* be the acquirer. See Paragraph 4.020b for factors to consider in determining whether the newly formed entity is substantive. If a newly formed entity is substantive, further analysis of ASC Subtopic 810-10 and ASC paragraphs 805-10-55-11 through 55-15 (as discussed in 4.001 through 4.020a) will need to be performed to determine if the newly formed entity is the acquirer. This situation could arise, for example, in a roll-up transaction in which the number of shares in the combined entity issued to new management and a sponsoring venture capital company exceeds the number of shares issued to the former owners of the numerous combining companies (refer to Example 4.6 for further discussion).

Example 4.6: Newly Formed Entity Controlled by a Venture Capital Company

Assume the same facts as in Example 4.4, except that XYZ was formed by Venture Capital, which transferred cash to XYZ in exchange for a 52% equity interest in XYZ. ABC transferred Sub A to XYZ in exchange for a 25% interest in XYZ, and DEF transferred Sub D to XYZ in exchange for a 23% interest in XYZ. Through its 52% equity interest, Venture Capital has the ability to appoint a voting majority of the board of directors of XYZ and has a controlling financial interest in XYZ under ASC Topic 810. All other facts remain the same (i.e., there are no other factors that indicate which of the combining entities is the acquirer).

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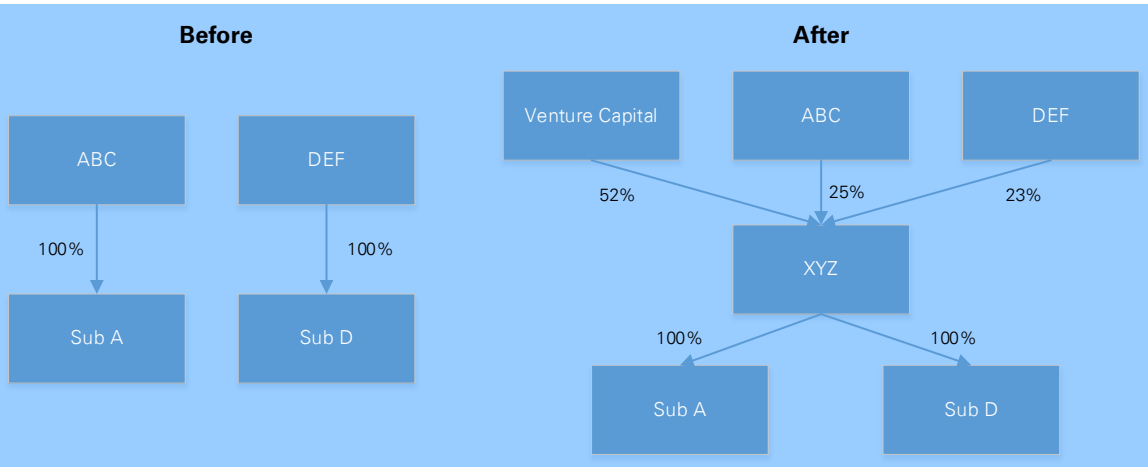

Assessment

At the Venture Capital level, if Venture Capital prepared consolidated financial statements, it would have acquired both Sub A and Sub D in a business combination. Although XYZ is newly formed, it was not formed only to issue equity interests to effect a business combination between two combining entities, but rather was used for Venture Capital to obtain control of combined Sub A and Sub D. That is, XYZ is substantive because it survived the transaction and the reason for its formation was substantive (i.e., Venture capital could not acquire the combined Sub A and Sub D without forming XYZ). Therefore, XYZ is the acquirer of Sub A and Sub D.

XYZ should account for this transaction using the acquisition method, resulting in the recognition and measurement of the assets and liabilities of both Sub A and Sub D under ASC Topic 805 (i.e., 100% step-up to their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles prescribed by ASC Topic 805).

ABC, in its consolidated financial statements, will recognize a gain or loss on the disposition of its controlling interest in Sub A equal to the difference between the carrying value of that interest before the transaction and the fair value of the 25% interest in XYZ received in the exchange. In the absence of evidence to the contrary, ABC and DEF would be presumed to have the ability to exercise significant influence over XYZ and would account for their respective investments in XYZ using the equity method of accounting in accordance with ASC Topic 323*, Investments—Equity Method and Joint Ventures.*

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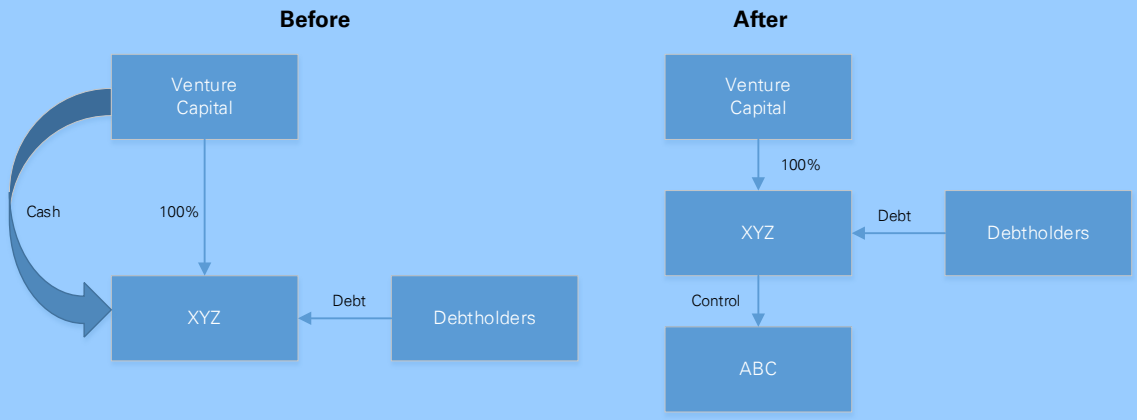
Example 4.6a: Newly Formed Entity Controlled by a Venture Capital Company

Venture Capital forms a new company (XYZ) and transfers cash to XYZ in exchange for a 100% equity interest in XYZ. Additionally, XYZ raises funds through a debt offering and uses the proceeds and the cash received from Venture Capital to acquire a controlling financial interest in ABC. XYZ survives the transaction as the parent of ABC.



Assessment

XYZ is the acquirer. Although XYZ is newly formed, it raised funds independently through the debt offering in addition to the cash contributions from the parent to consummate the acquisition. As such, XYZ is considered to be substantive.

Special Purpose Acquisition Company (SPAC)

4.022a A SPAC is generally structured as a legal entity and often is funded through the issuance of equity securities based on an agreement with its investors that the proceeds will be used to acquire companies and/or assets within a predetermined period of time or the unused proceeds will be returned to the investors. Management of the target company is often retained to operate the business post-acquisition. SPACs' pre-combination activities are to raise capital through an IPO, identify potential targets, perform due diligence, and acquire one or more operating companies, usually within a 24-month period.

4.022b A SPAC generally has significant pre-combination activities associated with executing its investment strategy and is therefore typically considered a substantive entity that could be the accounting acquirer. As such, entities will need to determine whether the SPAC or target company is the acquirer in the merger. See the discussion beginning at Paragraph 9.020 for a discussion about SPAC mergers.

Reverse Morris Trust (RMT)

4.022c A RMT is a structure in which a company spins off a business to its shareholders. The divested business is then merged with another company, with the shareholders of the

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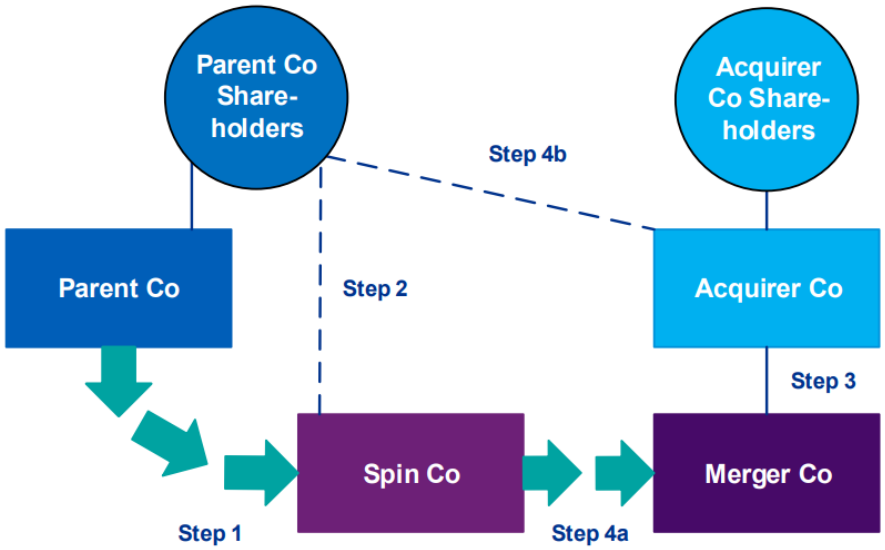
divested business obtaining a majority interest in the combined entity. These structures are used because of the beneficial tax treatment on disposition. The steps in a typical RMT transaction are:

- Step 1 – Parent Co establishes a Spin Co and transfers the division or business to be divested.
- Step 2 – Parent Co distributes its shares of Spin Co to its shareholders.
- Step 3 – Acquirer Co creates a Merger Co subsidiary to merge with Spin Co.
- Step 4a – Spin Co merges with Merger Co with Spin Co surviving the merger.
- Step 4b – Parent Co shareholders receive a majority of Acquirer Co shares in the merger.



4.022d Parent Co shareholders typically acquire the majority of Acquirer Co shares. However, in most RMT transactions, Acquirer Co is considered the acquirer for accounting purposes and SpinCo is the acquiree. This is the case when Acquirer Co's management remains in place for the combined entity and Acquirer Co's shareholders appoint a majority of the board members. However, each transaction's facts and circumstances must be carefully considered using the framework discussed in paragraphs 4.008 through 4.020b and different circumstances could result in a different conclusion.

BUSINESS COMBINATIONS ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

4.023 Business combinations may occur without the transfer of consideration. For example, an acquiree might repurchase a sufficient number of its own shares for an existing investor to obtain control, minority veto rights that previously kept the holder of a majority voting interest from controlling an investee might lapse, or control might be achieved by contract alone. These transactions are business combinations, and the entity that acquires control as a result is the acquirer.

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4.024 Many business combinations achieved by contract alone result in the formation of a VIE. In these situations, the primary beneficiary of the VIE is the accounting acquirer, regardless of whether the entity has adopted ASU 2025-03, because these types of transactions are not effected primarily by exchanging equity interests.

See the guidance immediately following, and *Business Combinations Achieved without the Transfer of Consideration,* beginning at Paragraph 9.003.

VARIABLE INTEREST ENTITIES

4.025 As noted in ASC paragraph 810-10-15-14(b), if interests other than the equity investment at risk provide the holders of those interests with the three characteristics in ASC paragraph 810-10-15-14(b) or if interests other than the equity investment at risk prevent the equity holders from having the characteristics in ASC paragraph 810-10-15-14(b), the entity is a VIE. ASC Subtopic 810-10 requires a reporting entity to determine whether it is the primary beneficiary of a VIE at the time the reporting entity becomes involved with the VIE, and to reconsider that determination on a continuous basis. ASC Subtopic 810-10 also includes guidance about when to reconsider whether an entity in which a reporting entity holds a variable interest has become, or ceased to be, a VIE.

4.026 ASC Subtopic 810-10 specifies that the initial consolidation of a VIE that is a business (as defined in the ASC Master Glossary) in which the primary beneficiary is the accounting acquirer is a business combination. Even if the reporting entity was previously involved with the VIE but was not the primary beneficiary, a business combination has occurred and the acquisition method of accounting must be applied.

However, when a VIE and its primary beneficiary are under common control, ASC Subtopic 810-10 provides specific guidance (see discussion in Paragraph 1.007). For guidance on determining whether entities are under common control or have a high degree of common ownership, see Section 28. In addition, for guidance where a new entity is formed and acquires an interest in a VIE in an exchange that lacks substance, see Paragraph 4.020d.

4.026a After adoption of ASU 2025-03, in a business combination in which a VIE is acquired, the primary beneficiary of the VIE is the accounting acquirer unless the business combination is effected primarily by exchanging equity interests. If a business combination in which a VIE is acquired is effected primarily through the exchange of equity interests, the factors outlined in ASC 805-10-55-12 through 55-15 are considered to determine the accounting acquirer.

- If these factors indicate that the VIE is the accounting acquirer and the accounting acquiree meets the definition of a business, the transaction is accounted for as a reverse acquisition in accordance with Subtopic 805-40. See the discussion of *Reverse Acquisitions* in Paragraph 4.029.
- If these factors indicate that the VIE is the accounting acquirer but the accounting acquiree does not meet the definition of a business, the transaction is a reverse asset acquisition or in some cases considered a reverse

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capitalization. See the discussion of *Reverse Capitalization* beginning at Paragraph 9.031.

See Paragraph 4.002 for guidance before the adoption of ASU 2025-03.

4.026b Upon initial consolidation by the primary beneficiary, the assets, liabilities, and noncontrolling interests of a VIE are recognized and measured at their acquisition-date fair values, subject to the exceptions to the recognition and measurement principles of ASC Topic 805.

Example 4.7: Initial Consolidation of a VIE

In 20X7, Company A began its involvement with Entity B, a VIE. Entity B is a business, as defined in ASC Topic 805. At the time of Company A's initial involvement with Entity B, Company A determined that it was not the primary beneficiary of Entity B and, accordingly, has not consolidated Entity B. However, on July 1, 20X9, the governing documents and contractual arrangements among the parties involved with Entity B are revised, such that the power to direct the activities that most significantly impact Entity B's economic performance is changed. As required by ASC Subtopic 810-10, Company A continuously reassesses whether changes in facts and circumstances result in a change in the determination of the primary beneficiary. As a result of the changes to the governing documents and contractual arrangements, Company A determines that it is now the primary beneficiary of Entity B and the transaction was not effected by exchanging equity interests.

This event is a business combination under ASC Topic 805 and, accordingly, at the acquisition date (July 1, 20X9), Company A must apply the acquisition method to its investment in Entity B, and include Entity B in its consolidated financial statements from that date forward. Thus, as of July 1, 20X9, Company A:

(1) Remeasures its previously held interest in Entity B (using appropriate valuation techniques – see *Business Combinations Achieved without the Transfer of Consideration* in Section 9) at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings;

(2) Recognizes and measures the full amount of the identified assets acquired, the liabilities assumed, and the noncontrolling interest in Entity B under the recognition and measurement principles of ASC Topic 805; and

(3) Recognizes and measures goodwill or a gain from a bargain purchase.

Business Combinations Achieved by Contract Alone Often Result in the Formation of Variable Interest Entities

4.027 In many business combinations achieved by contract alone, the acquiree's equity-at-risk investors would lack at least one of the three characteristics in ASC paragraph 810-10-15-14(b) and the acquiree would be a VIE. Those characteristics include:

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(1) The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance.

(i) For legal entities other than limited partnerships, if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly affect the entity's economic performance, kick-out rights or participating rights held by the holders of the equity investment at risk will not prevent interests other than the equity investment from having this characteristic unless a single party, or its related parties and de facto agents, has the unilateral ability to exercise such rights.

(ii) For limited partnerships and similar entities, partners lack the power if a simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is not able to exercise substantive kick out rights or participating rights through voting interests over the general partner.

(2) The obligation to absorb the expected losses of the entity.

(3) The right to receive the expected residual returns of the entity.

4.028 In these situations, the primary beneficiary of the VIE is the accounting acquirer regardless of whether the entity has adopted ASU 2025-03, because business combinations achieved by contract alone are not effected primarily by exchanging equity interests. See the discussion of *A Business Combination Achieved by Contract Alone* beginning at Paragraph 9.008.

REVERSE ACQUISITIONS

4.029 In most business combinations effected through an exchange of equity interests, the entity that issues the equity interests is usually the acquirer. However, in some business combinations, referred to as *reverse acquisitions,* application of the guidance in ASC paragraph 805-10-55-12 results in the identification of the legal acquirer (i.e., the entity that issues the securities) as the accounting acquiree. In these situations, the transaction is accounted for as a business combination only if the accounting acquiree meets the definition of a business. See the discussion of *Reverse Acquisitions* beginning at Paragraph 9.012.

Endnote

[1] ASU 2025-03, *Determining the Acquirer in the Acquisition of a Variable Interest Entity*, amends the framework for identifying the accounting acquirer when the legal acquiree is a VIE. Under the amended framework, entities consider the general accounting acquirer factors in ASC 805 when the transaction is primarily effected by the exchange of equity interests. The ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2026. Early adoption is permitted.

[2] Control premium may also be referred to as a Market Participant Acquisition Premium (MPAP).

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Section 5 - Determining the Acquisition Date

Detailed Contents

Acquisition Date Defined

Acquisition Occurs when Control Is Obtained

Designation of an Effective Acquisition Date Other Than the Actual Acquisition Date Is Not Permitted by ASC Topic 805

Step Acquisitions

Acquisitions of Noncontrolling Interests after Control Is Obtained

Acquisition Date Documentation

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ACQUISITION DATE DEFINED

ASC Paragraph 805-10-25-6

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

ASC Paragraph 805-10-25-7

The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree – the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

ACQUISITION OCCURS WHEN CONTROL IS OBTAINED

5.000 The *acquisition* date is the date on which the acquirer obtains control of the acquiree, and the obtaining of control results in a business combination. Thus, on the acquisition date, the acquirer accounts for the business combination by applying the acquisition method.

5.001 The FASB concluded that to faithfully represent an acquirer's financial position and results of operations, the acquirer's financial position should reflect the assets acquired and liabilities assumed at the acquisition date – and not before or after they are obtained or assumed, and that the acquirer's financial statements should include only the cash inflows and outflows, revenues and expenses, and other effects of the acquiree's operations after the acquisition date.

5.002 ASC Topic 805, *Business Combinations,* provides for the possibility that an acquirer might obtain control of an acquiree on a date either earlier or later than the closing date, indicating, for example, that the acquisition date precedes the closing date if a written agreement enables the acquirer to control the acquiree on a date before the closing date. However, situations where an acquirer obtains control of an acquiree on a date before the closing date will be unusual, because *control* for this purpose means control as defined and used in ASC Topic 810. See discussion of *Control* beginning at Paragraph 2.004.

5.002a In certain instances, shareholder or regulatory approval is required to consummate the business combination. Generally, the acquisition date does not precede the approval date because the acquirer does not obtain control before approval. However, when the only remaining contingency is shareholder approval, the acquisition date could precede that approval if it is considered perfunctory and the acquirer controls the acquiree through written agreement before the approval date. Shareholder approval would be perfunctory only if management and the board of directors control enough shareholder votes to approve the transaction.

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5.002b A business combination may have a closing in a time zone that is different from that of the acquirer's corporate headquarters, which could straddle different reporting dates. For purposes of determining the acquisition date, we believe it is acceptable to use either 1) the time zone of the acquirer's corporate headquarters or 2) the time zone where personnel that are authorized to execute the arrangement are located (e.g., the time zone of a foreign subsidiary that has personnel executing the contract).

DESIGNATION OF AN EFFECTIVE ACQUISITION DATE OTHER THAN THE ACTUAL ACQUISITION DATE IS NOT PERMITTED BY ASC TOPIC 805

5.003 Statement 141(R) (as codified by ASC Topic 805) eliminated the previous provision in Statement 141 (the *convenience exception*) that allowed the acquirer in a business combination, under certain circumstances, to designate an effective acquisition date (i.e., the end of an accounting period between the dates a business combination was initiated and consummated). Statement 141(R) also eliminated the previous provisions that permitted an acquirer to include a subsidiary that was purchased during the year in the acquirer's consolidated financial statements as though the subsidiary had been acquired at the beginning of the year and to deduct the preacquisition earnings of the subsidiary at the bottom of the consolidated income statement.

5.004 The FASB noted that the financial statement effects of eliminating the convenience exception are rarely likely to be material and that, unless events between the convenience date and the actual acquisition date result in material differences in the amounts recognized, an entity's practice to designate a convenience date complies with the requirements of ASC Topic 805 (see FASB Statement 141(R), Basis for Conclusions par. B110 for detailed discussion). An acquirer can designate an acquisition date that precedes the actual closing date under ASC Topic 805 only if it has determined that the effect of this non-GAAP accounting policy on its financial statements is immaterial, both in the period of the acquisition and in subsequent periods. Further, if a designated date is used on the basis of its immateriality, the *iron curtain* method of assessing materiality described in ASC paragraph 250-10-S99-2 requires the acquirer to have an unadjusted difference that will carry forward for a significant period of time and, in many instances, indefinitely.

STEP ACQUISITIONS

ASC Paragraph 805-10-25-9

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. This Topic refers to such a transaction as a *business combination achieved in stages*, sometimes also referred to as a step acquisition.

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ASC Paragraph 805-10-25-10

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

5.005 A business combination occurs whenever an entity obtains control over one or more businesses. In a step acquisition, an entity (the acquirer) acquires shares of another entity (the investee) in two or more transactions in which the acquirer ultimately gains control of the investee. On the date the acquirer obtains control over the acquiree, a business combination has occurred, and the acquirer accounts for the combination by the acquisition method on that date.

5.006 Acquisition by a parent of some or all of a noncontrolling interest in a subsidiary (that is a business) after it initially gains control is not a business combination, because control is not obtained as a result of this transaction (i.e., the parent had control over the subsidiary before the transaction). A business combination occurs only on the acquisition date (i.e., when control is obtained). See Appendix 4-1 in KPMG *Guide To Accounting For Foreign Currency,* for guidance on accounting for foreign currency translation adjustments in business combinations of foreign equity method investments achieved in stages.

ACQUISITIONS OF NONCONTROLLING INTERESTS AFTER CONTROL IS OBTAINED

5.007 Changes in the parent's ownership interest, as long as it continues to retain control, are accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners) under ASC Subtopic 810-10. Thus, no gains or losses with respect to these changes are recognized in net income or comprehensive income, nor are the carrying amounts of the assets and liabilities of the subsidiary adjusted (i.e., step acquisition accounting is not applied). Rather, the parent adjusts the carrying amount of the noncontrolling interest to reflect the change in its ownership interest in the subsidiary. See KPMG Handbook, Consolidation, for further discussion. See discussion of *Business Combinations Achieved in Stages (Step Acquisitions)* in Section 9.

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5.007a In cases where the parent acquires additional shares of a subsidiary from a third party or the subsidiary repurchases its own shares, resulting in an increased ownership interest for the parent without a change in control, the transaction is treated as an equity transaction. However, the reporting entity should also consider the guidance in ASC Subtopic 505-30, *Treasury Stock*, and section 5.8 of KPMG Handbook, Debt and equity financing, including how to allocate share repurchase amounts to other elements of the transaction when common shares are repurchased at an above-market price.

ACQUISITION DATE DOCUMENTATION

5.008 ASC Topic 350, *Intangibles -- Goodwill and Other,* requires that the assets acquired and liabilities assumed in a business combination, including goodwill, be assigned to reporting units as of the acquisition date. ASC Topic 350 also requires that the basis for and method of determining the fair value of the acquiree and other related factors (such as the underlying reasons for the acquisition and management's expectations related to dilution, synergies, and other financial measurements) be documented at the acquisition date. ASC paragraph 350-20-35-40

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Section 6 - Recognizing and Measuring the Consideration Transferred

Detailed Contents

Consideration Transferred Includes only the Consideration Exchanged by the Acquirer for the Acquiree
Consideration Transferred Is not Eligible for Hedge Accounting
Measurement of the Consideration Transferred
- Consideration in the Form of Equity Interests
  - Issuing Shares of a Nonpublic or Closely Held Entity
  - Preferred Shares Issued in a Business Combination
  - Convertible Preferred Shares and Other Convertible Instruments Issued in a Business Combination
- Liabilities Incurred to Former Owners of the Acquiree
- Contingent Consideration
- Assets or Liabilities Transferred by the Acquirer
  - Example 6.1: Consideration Includes a Cost Method Investment
  - Example 6.2: Consideration Includes a Technology License
  - Assets or Liabilities Transferred to an Acquiree That Remain Under the Control of the Acquirer Are Not Remeasured, and No Gain Or Loss Is Recognized
  - Example 6.3: Transfer of a Subsidiary to an Acquiree
  - Example 6.4: Shares of a Subsidiary Issued in a Business Combination
  - Example 6.5: Acquisition Achieved in Stages Through the Exchange of an Indirect Noncontrolling Interest in a Subsidiary, Including Payment of a Control Premium
- Share-Based Payment Awards Included in the Consideration Transferred

Contingent Consideration
- Working Capital
- Consideration Held in Escrow for General Representations and Warranties
- Forms of Contingent Consideration
- Initial Recognition of Contingent Consideration
- Statement of Cash Flows
- Determining the Classification of Contingent Consideration
  - Example 6.6: Cash-Settled Contingent Consideration Based on Earnings
  - Classification of Equity-Linked Contingent Consideration Arrangements That Are Within the Scope of ASC Subtopic 480-10

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Illustrations of Contingent Consideration Arrangements That Are Classified as Liabilities Under ASC Subtopic 480-10
Example 6.7: Contingent Consideration That Embodies a Written Put Option
Example 6.8: Contingent Consideration That Embodies a Guarantee of the Acquirer's Share Price
Example 6.9: Contingent Consideration in the Form of a Freestanding Financial Instrument
Example 6.10: Contingent Consideration Based on Earnings
Example 6.11: Fixed Minimum Payment and Contingent Consideration Based on Earnings
Classification of Equity-Linked Contingent Consideration Arrangements That Are Not Within the Scope of ASC Subtopic 480-10
Example 6.12: Contingent Consideration That Provides for Different Outcomes Involving the Issuance of Shares That Are Based on the Level of Revenues Achieved
Example 6.13: Reclassification of a Contingent Consideration Arrangement from Equity to a Liability
Example 6.14: Reclassification of a Contingent Consideration Arrangement from a Liability to Equity
Example 6.15: Contingent Consideration That Embodies a Net-Share Settled Written Call Option
Example 6.16: Contingent Consideration That Provides for the Issuance of a Fixed Number of Shares Payable on the Achievement of an Earnings Target
Example 6.17: Fixed Minimum Number of Shares and Contingent Consideration That Provides for the Issuance of a Fixed Number of Additional Shares Payable on the Achievement of an Earnings Target
Example 6.18: Contingent Consideration Based on the Acquirer's Stock Price
Determining the Unit(s) of Accounting for Contingent Consideration
Example 6.19: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 1
Example 6.20: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 2
Subsequent Issuance of Contingent Shares Based on Earnings in a Reverse Acquisition
Effect of Contingent Consideration on the Computation of Earnings Per Share
Effect of Contingency Based on Security Prices in Computing Earnings Per Share
Effect of Contingency Based on Both Future Earnings and Security Prices in Computing Earnings Per Share
Business Combinations in Which no Consideration Is Transferred
Measurement of Consideration Transferred in Combinations Involving Mutual Entities

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CONSIDERATION TRANSFERRED INCLUDES ONLY THE CONSIDERATION EXCHANGED BY THE ACQUIRER FOR THE ACQUIREE

ASC Paragraph 805-10-25-20

The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).

ASC Paragraph 805-10-25-21

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

a. A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see [ASC] paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree for future services (see [ASC] paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see [ASC] paragraph 805-10-25-23).

6.000 ASC Topic 805, *Business Combinations,* requires an acquirer to identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination. The acquiree accounts for separate transactions that do not represent consideration transferred for the acquiree in accordance with other relevant GAAP. Only the consideration transferred for the acquiree is included as consideration transferred in applying the acquisition method.

6.001 Amounts related to the settlement of preexisting relationships between an acquirer and an acquiree, a transaction that compensates employees or former owners of the acquiree for future services, and a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs, are examples of transactions that are not included in applying the acquisition method, but rather are accounted for as separate transactions in accordance with relevant GAAP. See *Determining What Is Part of the Business Combination Transaction* in Section 11.

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CONSIDERATION TRANSFERRED IS NOT ELIGIBLE FOR HEDGE ACCOUNTING

6.002 The measurement of the consideration transferred in a business combination is not affected by gains and losses from derivative or nonderivative financial instruments. A firm commitment to enter into a business combination is not eligible for designation as a hedged item in a fair value hedge. (ASC paragraph 815-20-25-43(c)(5)) In addition, a forecasted transaction (for which there is no firm commitment) that involves a business combination is not eligible for designation as a hedged transaction in a cash flow hedge. (ASC paragraph 815-20-25-15(g)) Thus, the costs and proceeds (including gains and losses) from financial instruments that are used to reduce the risks of a change in the value of the acquiree's net assets or the consideration to be issued by the acquirer before the date of acquisition are not part of the consideration transferred and should be recorded currently in earnings.

MEASUREMENT OF THE CONSIDERATION TRANSFERRED

ASC Paragraph 805-30-30-7

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. (However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's grantees that is included in consideration transferred in the business combination shall be measured in accordance with [ASC] paragraph 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:

a. Cash

b. Other assets

c. A business or a subsidiary of the acquirer

d. Contingent consideration (see [ASC] paragraphs 805-30-25-5 through 25-7)

e. Common or preferred equity instruments

f. Options

g. Warrants

h. Member interests of mutual entities.

6.003 Consideration may be issued in many forms and may include, for example, cash, noncash assets (such as a business or a subsidiary), debt issued to the former owners of the acquiree, equity interests issued (such as common or preferred equity instruments, options, warrants, or member interests of mutual entities), the portion of any share-based payment awards required to be issued by an acquirer to replace awards held by grantees of the acquiree (*replacement awards)* included in the consideration transferred, and

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contingent consideration. The consideration transferred in a business combination is measured at fair value, determined in accordance with ASC Topic 820, *Fair Value Measurement,* except for (i) assets and liabilities transferred that remain under the control of the acquiree after the business combination, and (ii) any portion of the acquirer's share-based replacement awards exchanged for awards held by the acquiree's grantees included in the consideration transferred, and is the sum of the following:

- The acquisition-date fair value of the equity interests issued by the acquirer (other than share-based payment awards included in the consideration transferred);
- The acquisition-date fair value of the liabilities incurred by the acquirer to former owners of the acquiree;
- The acquisition-date fair value of the assets transferred by the acquirer;
- The amount of the liability or equity instruments related to share-based replacement awards required to be issued by an acquirer and included in the consideration transferred, measured in accordance with ASC Topic 718, *Compensation—Stock Compensation.* ASC paragraph 805-20-30-21 refers to the results of amounts measured in this manner as the *fair-value-based measure* of the awards; and
- The acquisition-date fair value of contingent consideration issued by the acquirer.

6.004 Cash payments by an acquirer do not present measurement difficulties. However, the measurement of other forms of consideration can present varying degrees of difficulty and require judgment, and it may be necessary to obtain independent valuations of the consideration exchanged in some situations. This Section addresses measuring the consideration transferred in a business combination. See Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination,* for additional discussion.

CONSIDERATION IN THE FORM OF EQUITY INTERESTS

6.005 Equity interests issued as consideration in a business combination (other than share-based replacement awards) are measured at fair value at the acquisition date, determined in accordance with ASC Topic 820. Whenever available, the quoted price in an active market should be used to measure the fair value of equity securities issued to effect a business combination. If a quoted price in an active market is not available, other methods or techniques should be used.

Issuing Shares of a Nonpublic or Closely Held Entity

ASC Paragraph 805-30-30-2

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the

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> acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred.

6.006 The acquisition of a public entity by a nonpublic or closely held entity provides an example of where the acquisition-date fair value of an acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests issued to effect a business combination. In those situations, a nonpublic acquirer may look to the fair value of the acquiree's equity interests in determining the fair value of the shares issued to effect the combination.

Preferred Shares Issued in a Business Combination

6.007 When preferred shares are issued in a business combination to the shareholders of the acquiree and there is no quoted market price available to determine the fair value of those shares, the characteristics of the preferred shares (e.g., dividend rate, conversion features, or redemption features) should be incorporated into the fair value of the preferred shares. 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, the approach to determining the fair value of such shares may be similar to that used to determine the fair value of debt securities.

Convertible Preferred Shares and Other Convertible Instruments Issued in a Business Combination

6.008 If there is no quoted market price available to determine the fair value of convertible preferred shares or other convertible instruments issued in a business combination, the acquirer should use another method to determine fair value consistent with ASC Topic 820.

6.009 Paragraph not used.

LIABILITIES INCURRED TO FORMER OWNERS OF THE ACQUIREE

6.010 Liabilities that an acquirer incurs to former owners of an acquiree are part of the consideration transferred. These liabilities include amounts payable to dissenting shareholders. For guidance on presenting payments to former owners to settle those liabilities in the statement of cash flows, see chapter 18 of KPMG Handbook, Statement of cash flows.

CONTINGENT CONSIDERATION

6.011 Contingent consideration includes obligations to transfer additional consideration to the former owners of an acquiree if future events occur or conditions are met.

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Obligations of an acquirer under contingent consideration arrangements may be classified as equity (equity-classified contingent consideration) or a liability (liability-classified contingent consideration). See discussion beginning at Paragraph 6.019.

- Obligations to pay specified amounts at specified future dates are recognized and measured at fair value at the acquisition date and included in the consideration transferred. They are noncontingent obligations and thus are not subsequently remeasured.
- Equity-classified contingent consideration is recognized and measured at fair value at the acquisition date and included in the consideration transferred. Equity-classified contingent consideration is not remeasured following the acquisition date, and its subsequent settlement is accounted for within equity.
- Liability-classified contingent consideration is recognized and measured at fair value at the acquisition date and included in the consideration transferred, and subsequently remeasured to fair value each reporting period until the contingency is resolved. Adjustments resulting from remeasurement are recognized in earnings (unless the contingent consideration is a hedging instrument).

6.012 The nature of the arrangements determines whether payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions. See *Transactions That Compensate Employees or Former Owners of the Acquiree for Future Services* in Section 11.

6.013 In some business combinations, there may be a preexisting arrangement between the acquirer and acquiree that provides for a payment when a contingent event occurs. For example, the acquirer and acquiree could have a preexisting agreement that granted the acquirer distribution rights to the acquiree's products in a geographic region with payments by the acquirer to the acquiree depending on the sales made in that geographic region. In negotiating the acquisition agreement, if the two parties agree to carry forward the preexisting agreement without change, the payments contingently payable to the former owner of the acquiree under that agreement would be treated as contingent consideration in the acquisition, because the future payment was contemplated in the acquisition negotiations. In effect, the acquisition negotiations change the contingent payments from a contingent liability (preacquisition) to contingent consideration in the acquisition.

6.013a However, a *new* arrangement entered into in conjunction with a business combination may require future payments from the acquirer to the former owner of the acquiree with characteristics of both contingent consideration and compensation for future rights granted or services provided by the former owner to the acquirer or combined entity. The acquirer should carefully evaluate these arrangements when determining whether the future payments should be included as consideration transferred in applying the acquisition method or accounted for separately under other GAAP. For example, a buyer and seller may negotiate contingent consideration in the form of an earnout based on revenue or profits as part of the transaction price when they cannot

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agree on the transaction price. Conversely, the buyer and seller of a distribution business may enter a new arrangement that includes a long-term, non-cancelable sales or earnings-based royalty payment to the seller for the buyer's future use of a trademark or distribution within a geographic area. The royalty payments are customary in the seller's industry and set at market rates. In this case, the royalty arrangement is not contingent consideration in the business combination and is accounted for separately as an expense in the period(s) payments are accruable. In addition to the factors discussed in Section 11, *Determining What Is Part of the Business Combination Transaction,* the following factors indicate that these future payments are not part of consideration transferred in a business combination:

- The payments are customary in the industry and set at market rates;
- The payment period coincides with the duration of the future services to be provided or rights granted by the former owner of the acquiree;
- The royalty or similar arrangement did not exist before the business combination;
- The resulting consideration transferred in the business combination (excluding the fair value of the future payments) is reasonable relative to the valuation of the business acquired.

ASSETS OR LIABILITIES TRANSFERRED BY THE ACQUIRER

ASC Paragraph 805-30-30-8

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, nonmonetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognize the resulting gains or losses, if any, in earnings. However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognize a gain or loss in earnings on assets or liabilities it controls both before and after the business combination.

6.014 ASC paragraph 805-30-30-7 requires that consideration transferred in a business combination is measured at the acquisition-date fair value. If the fair value of assets or liabilities recognized as consideration transferred is different from the carrying amount of those assets or liabilities, a gain or loss is recognized in earnings. However, this guidance applies only if the acquirer does not retain control of the assets or liabilities transferred after the acquisition.

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Example 6.1: Consideration Includes a Cost Method Investment

ABC Corp. acquires a business from DEF Corp., and in exchange transfers cash and a cost method investment in an unrelated entity to DEF. How should ABC measure the consideration transferred?

ABC should include the fair value of the cost method investment as part of the consideration transferred. To the extent the fair value differs from the book value of the investment, ABC recognizes a gain or loss in earnings for the difference.

Example 6.2: Consideration Includes a Technology License

ABC Corp. acquires a business from DEF Corp., and in exchange transfers cash and grants a software license for one of ABC's products to DEF. How should ABC measure the consideration transferred?

ABC should include the fair value of the license as part of the consideration transferred. ABC would follow the appropriate revenue recognition guidance in GAAP to determine when revenue recognition would be appropriate.

Assets or Liabilities Transferred to an Acquiree That Remain Under the Control of the Acquirer Are Not Remeasured, and No Gain Or Loss Is Recognized

6.015 An acquirer may transfer a business or a subsidiary to the acquiree as consideration in a business combination. Other forms of consideration transferred may include assets and liabilities of a subsidiary, or other assets of the acquirer. Regardless of the structure of the transaction, if the acquirer retains control of the transferred assets or liabilities after the acquisition, it recognizes no gain or loss and measures those assets and liabilities at their carrying amounts immediately before the acquisition.

6.016 Additionally, if an acquirer transfers an equity interest in a subsidiary, but continues to hold a controlling financial interest in the subsidiary after the transfer, the change in the parent's ownership interest in the subsidiary is accounted for as an equity transaction, and no gain or loss is recognized. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted, is recognized in equity attributable to the parent. (ASC paragraph 810-10-45-23). See Chapter 7 of KPMG Handbook, Consolidation, for further discussion.

6.017 The following are examples of business combinations in which an acquirer retains control of assets and liabilities transferred in connection with a business combination. These examples illustrate that, regardless of how a business combination is structured, if the acquirer retains control of the assets and liabilities transferred after the acquisition, no gain or loss is recognized.

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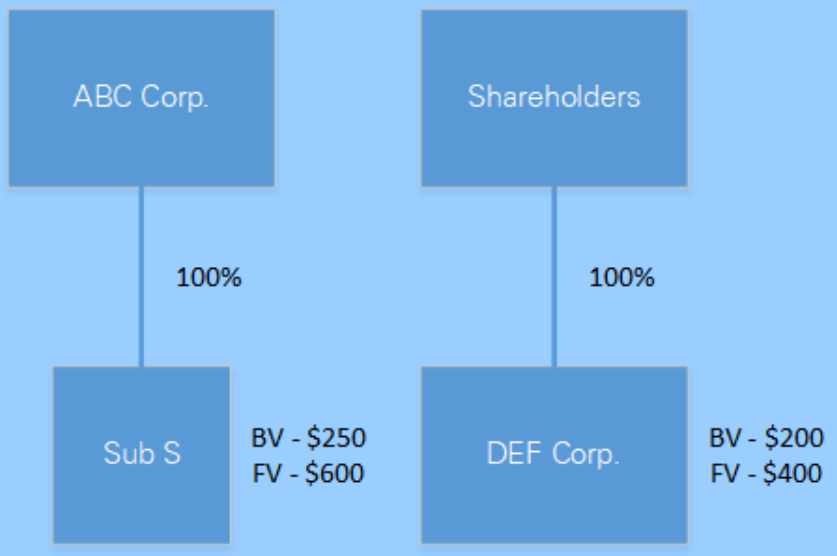
Example 6.3: Transfer of a Subsidiary to an Acquiree

ABC Corp. transfers its wholly owned Subsidiary S to DEF Corp. in exchange for 60% of the common shares of DEF. Subsidiary S and DEF are both businesses. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). It was also determined that there is no minority discount or control premium in this transaction.

(1) How should ABC account for this transaction in its consolidated financial statements?

(2) How should DEF account for this transaction in its consolidated financial statements?

Before Transaction



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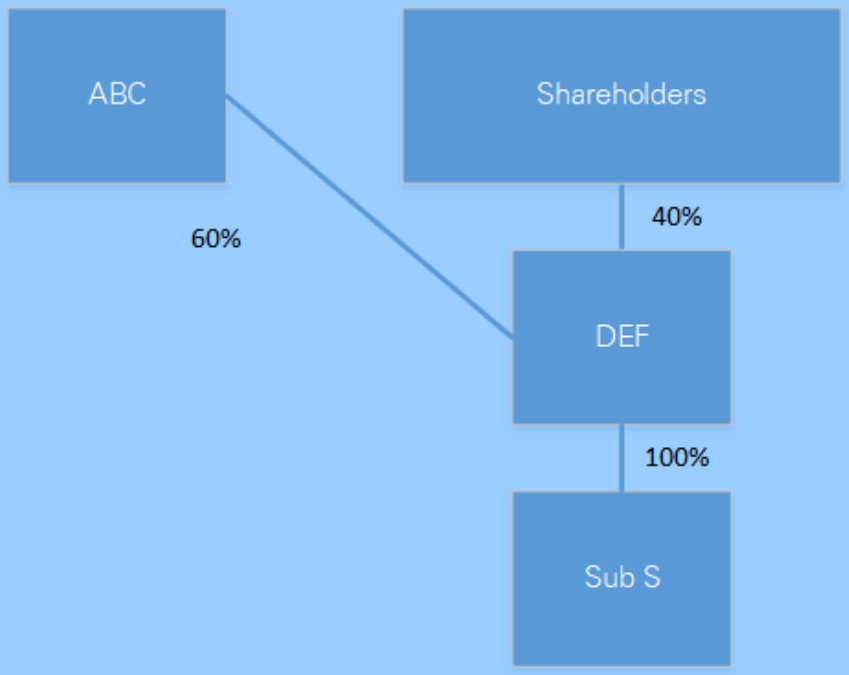
After Transaction



(1) Accounting for the transaction in ABC's consolidated financial statements

ABC has effectively acquired a controlling financial interest in DEF in exchange for issuing a noncontrolling interest in Sub S. The acquisition of DEF by ABC is a business combination under ASC Topic 805, in which ABC is the acquirer and DEF is the acquiree. In applying the acquisition method to the transaction:

- ABC recognizes and measures the net assets of DEF based on the recognition and measurement requirements of ASC Topic 805.
- ABC continues to measure the assets and liabilities of Subsidiary S following its acquisition of DEF at their carrying amounts immediately before the acquisition because ABC controls Subsidiary S directly before the transaction, and indirectly after the transaction (through its control of DEF).
- ABC does not recognize a gain or a loss in earnings on the transfer of a 40% indirect ownership interest in Subsidiary S to the former owners of DEF (consistent with the guidance in ASC paragraph 805-30-30-8).
- The consideration transferred by ABC is measured based on the fair value of the indirect 40% interest in Subsidiary S. That transaction is accounted for as an equity transaction in ABC's consolidated financial statements in accordance with ASC paragraph 810-10-45-23.

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Consequently, this transaction is recognized in ABC's consolidated financial statements as follows:

- ABC recognizes the net assets of its newly acquired subsidiary, DEF, in the amount of $400, which equals the acquisition-date fair value of DEF (including goodwill, if any).
- ABC recognizes the noncontrolling interest in the combined DEF entity of $260, which is equal to 40% of the historical carrying amount of Subsidiary S's net assets immediately preceding the acquisition of DEF (40% × $250, or $100), plus 40% of the fair value of DEF (including goodwill, if any) at the acquisition date (40% × $400, or $160).
- The transfer of a 40% indirect interest in Subsidiary S to Shareholders is accounted for as an equity transaction. Thus, the excess of the fair value of the amount transferred (40% × $600, or $240) over the historical carrying amount of the indirect interest transferred (40% × $250, or $100), or $140, is credited to paid-in capital.

ABC will record the following entries in its consolidated financial statements to reflect the acquisition of DEF:

	Debit	Credit
Net assets of DEF (including goodwill, if any)	400	
Noncontrolling interest in DEF		260
Paid-in capital		140

(2) Accounting for the transaction in DEF's consolidated financial statements

Because the former shareholder of Subsidiary S (ABC) obtains control of the combined entity (which includes Subsidiary S and DEF), and assuming no other evidence indicates that DEF is the acquirer, this transaction should be accounted for as the acquisition of DEF by Subsidiary S (i.e., a reverse acquisition in which Subsidiary S effectively issues consideration equal to a 40% ownership interest in Subsidiary S in exchange for the acquisition of a 60% ownership interest in DEF). See discussion of reverse acquisitions starting at Paragraph 9.012.

Thus, a business combination has occurred, with Subsidiary S being the accounting acquirer and DEF the accounting acquiree. In DEF's consolidated financial statements:

- The net assets of DEF are recognized and measured at their acquisition-date fair value (including goodwill, if any), thus requiring an increase in their carrying amount of $200 ($400 fair value less $200 book value).
- The net assets of Subsidiary S are recognized at their historical carrying amount of $250.

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The net assets recorded at DEF (including any goodwill) would have the same basis as those in ABC's consolidated financial statements.

DEF's consolidated financial statements should present the historical financial statements of Subsidiary S before the acquisition as the historical financial statements. Thus, the results of operations of DEF are included in the financial statements of the consolidated entity only for periods after the acquisition date.

Although the equity of Subsidiary S (the accounting acquirer) is presented as the equity of the combined entity, the capital stock account must be adjusted to reflect the outstanding stock of DEF (the surviving entity). That is:

- The retained earnings of Subsidiary S would be presented as the retained earnings of the combined entity.
- The capital stock account of the combined entity would reflect the par value of DEF's stock.

The additional paid-in capital account of Subsidiary S would be adjusted for the difference between the capital stock account of Subsidiary S and the capital stock account of DEF, and that adjusted amount would be presented as additional paid-in capital of the combined entity.

Example 6.3 presumes that both the entities are businesses. See Question 2.1.30 in KPMG Handbook, *Asset acquisitions*, for guidance that addresses transactions involving entities that do not meet the definition of a business.

Example 6.4: Shares of a Subsidiary Issued in a Business Combination

ABC Corp.'s wholly owned Subsidiary S issues new common shares representing a 40% interest to shareholders of DEF Corp. in exchange for all of the common shares of DEF. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). It was also determined that there is no minority discount or control premium in this transaction.

How should ABC account for this transaction in its consolidated financial statements?

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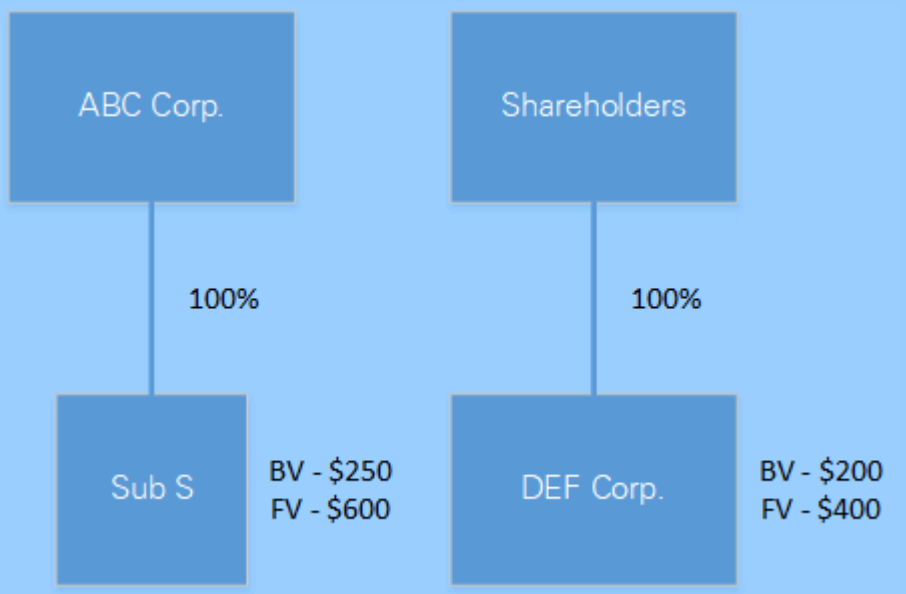
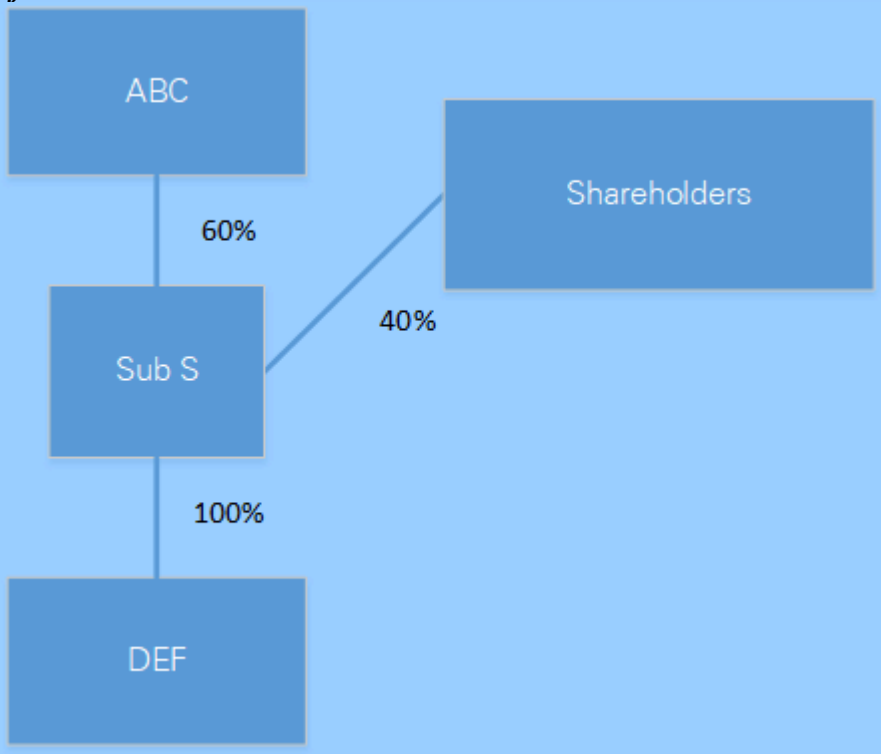
Before Transaction



After Transaction



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The acquisition of control of DEF by ABC is a business combination under ASC Topic 805, in which Subsidiary S (ABC's subsidiary) is the acquirer and DEF is the acquiree. In applying the acquisition method to the transaction, Subsidiary S recognizes and measures the assets acquired and liabilities assumed based on the recognition and measurement principles of ASC Topic 805. However, no gain or loss is recognized on the transaction:

- ABC controls Subsidiary S both before and after the business combination. Therefore, ABC continues to measure the assets and liabilities of Subsidiary S following its acquisition of DEF at their carrying amounts immediately before the acquisition, and does not recognize a gain or loss on the transfer of a 40% noncontrolling interest in Subsidiary S to the former owners of DEF (consistent with the guidance in ASC paragraph 805-30-30-8).
- Subsidiary S recognizes the net assets (including goodwill, if any) acquired in the acquisition of DEF at their fair value of $400, and a corresponding increase in equity to reflect the fair value of the shares issued to effect the acquisition. In consolidation, ABC also recognizes the net assets acquired at their fair value of $400.
- This transaction also involves a reduction in the parent's (ABC's) ownership interest in Subsidiary S (from 100% to 60%). However, because ABC continues to control Subsidiary S after the transaction, the issuance of shares by Subsidiary S to the noncontrolling interest (the former owners of DEF) is accounted for by ABC as an equity transaction under ASC paragraph 810-10-45-23, and no gain or loss is recognized on the issuance of the additional shares of Subsidiary S to the former owners of DEF.

Consequently, this transaction is recognized in ABC's consolidated financial statements as follows:

- Subsidiary S recognizes the net assets (including goodwill, if any) resulting from the acquisition of DEF at their fair value of $400, and ABC recognizes an increase in its investment in Subsidiary S in the same amount. ABC continues to recognize its preexisting investment in Subsidiary S at its historical carrying amount of $250 immediately preceding the transaction, resulting in an investment in Subsidiary S of $650 ($400 + $250) after the transaction.
- ABC recognizes the noncontrolling interest in Subsidiary S of $260, which is equal to 40% of the historical carrying amount of Subsidiary S immediately before the acquisition of DEF by Subsidiary S (40% × $250, or $100), plus 40% of the fair value of DEF at the acquisition date (40% × $400, or $160).
- Because ABC retains control of Subsidiary S after the transaction, the transfer of a 40% interest in Subsidiary S to the noncontrolling interest in Subsidiary S (the former owners of DEF) is accounted for as an equity transaction. Thus, the excess of the fair value of the acquired interest in DEF (60% × $400, or $240) over the historical carrying amount of the interest transferred (40% ×

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$250, or $100), which nets to $140, is credited to paid-in capital. The $140 credit to paid-in capital may be viewed as the gain resulting from the transaction with the noncontrolling interest, equal to the excess of the fair value received of $240 over the carrying amount of the of the interest transferred of $100.

ABC will record the following entries in its consolidated financial statements to reflect the acquisition of DEF by Subsidiary S:

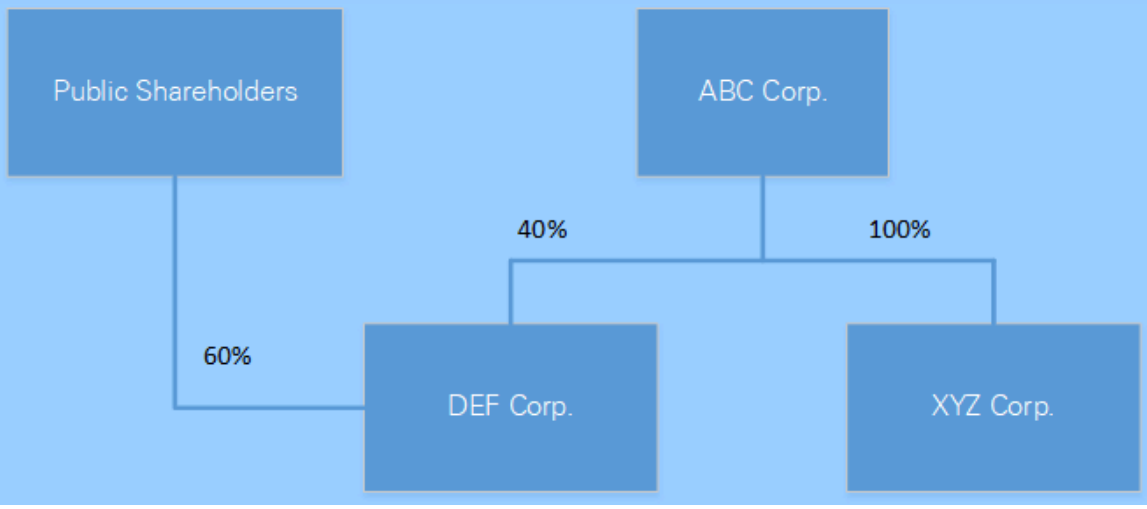
	Debit	Credit
Net assets of Subsidiary S	400	
Noncontrolling interest in DEF		260
Paid-in capital		140

Example 6.5: Acquisition Achieved in Stages Through the Exchange of an Indirect Noncontrolling Interest in a Subsidiary, Including Payment of a Control Premium

ABC Corp. owns 40% of the outstanding common stock of DEF Corp. (the carrying amount of ABC's investment in DEF was equal to 40% of the book value of DEF). Public shareholders own the remaining 60% of DEF's shares. DEF issues additional shares of its common stock to ABC in exchange for 40% of the common stock of XYZ Corp. (a wholly owned subsidiary of ABC). After the transaction, ABC owns a controlling interest in DEF of 60%; the remaining 40% is owned by the public shareholders. The fair value of the consideration transferred is equal to the fair value of the consideration received (i.e., there is no bargain purchase). ABC pays a $20 control premium to the public shareholders of DEF on this transaction, as explained below.

How should ABC account for this transaction in its consolidated financial statements?

Before Transaction



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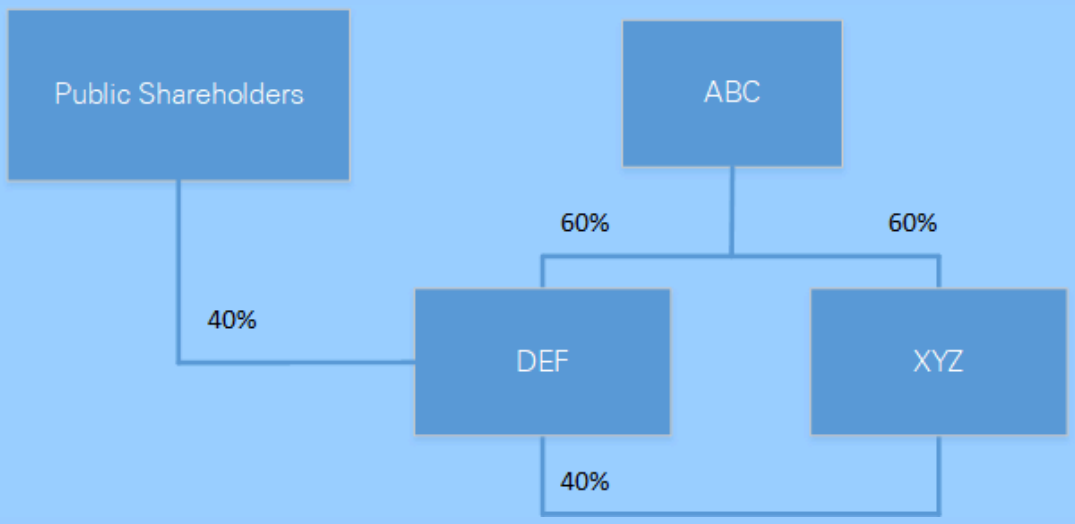
	DEF	XYZ
Book value	$ 150	250
Fair value:		
Excluding control premium	$ 200	375
Control premium	0 [1]	75
Total fair value	**$ 200**	**450**

[1] There is no control premium in the fair value determined for DEF before this transaction.
A control premium with respect to DEF arises as a result of this transaction, by which ABC obtains control of DEF.

After Transaction



	DEF	XYZ
Fair value:		
Excluding control premium	$ 350	375
Control premium	20	75
Total fair value	**$ 370**	**450**

The acquisition of control of DEF by ABC is a business combination under ASC Topic 805, in which ABC is the acquirer and DEF is the acquiree. In applying the acquisition method to this transaction, ABC recognizes and measures the DEF assets acquired and liabilities assumed in accordance with the recognition and measurement requirements of ASC Topic 805.

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In this transaction, ABC effectively acquired a 20% additional interest in DEF from the public shareholders in exchange for a 16% indirect interest in XYZ (effected by the transfer of a 40% interest in XYZ to DEF, which is 40% owned by the public shareholders on completion of the transaction; 40% × 40% =16%). ABC also pays a control premium on this transaction of $20 as a result of its obtaining control of DEF. It has been determined that the fair value of the control premium is $20.[1]

[1] The following analysis demonstrates that ABC has paid and received equivalent consideration:

Fair value of equity interest in XYZ that ABC transferred ($375 × 16%)	$ 60
Fair value of additional equity interest in DEF received by ABC:	
Excluding control premium (20% × $200)	$ 40
Control premium	20
Fair value received by ABC (including ability to control DEF)	$ 60

Because ABC held a 40% interest in DEF before this transaction, the acquisition of control of DEF results in a business combination achieved in stages (also referred to as a step acquisition). In a business combination achieved in stages, the acquirer remeasures its previously held equity interest in the acquiree at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings. See discussion of *Business Combinations Achieved in Stages (Step Acquisitions)* in Section 9.

This transaction also results in a reduction of ABC's direct controlling ownership of XYZ (from 100% to 60%), offset by an increase in ABC's indirect ownership of XYZ of 24% (through its 60% ownership of DEF and DEF's ownership of 40% of XYZ on completion of the transaction; 60% × 40% = 24%), and a transfer of a 16% indirect ownership interest in XYZ to the public shareholders of DEF (through the public shareholders' ownership of 40% of DEF and DEF's ownership of 40% of XYZ on completion of the transaction; 40% × 40% = 16%). However, ABC continues to control XYZ after the transaction (through its 60% direct ownership interest and its 24% indirect ownership interest). Thus, ABC accounts for its exchange of a 16% interest in XYZ as an equity transaction under ASC paragraph 810-10-45-23, with no gain or loss recognized in income on the exchange.

ABC records the following entries in its consolidated financial statements:

- ABC remeasures its 40% interest in DEF immediately preceding this transaction at its acquisition-date fair value of $80 ($40% × $200), and recognizes the resulting gain of $20 in earnings. The $20 gain is equal to the excess of the fair value of ABC's 40% interest of $80 over its carrying amount of $60 (40% × $150).
- ABC recognizes the net assets of its newly acquired subsidiary, DEF, at their acquisition-date fair value (including goodwill, if any) of $220 (which includes the $20 control premium). Note that ABC continues to consolidate the net assets of XYZ, and separately recognizes the noncontrolling interest in

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XYZ resulting from the transfer of a 16% indirect interest in XYZ to the public shareholders of DEF (see below).

- ABC eliminates the carrying amount of its investment in DEF of $80 before the acquisition (the sum of the historical carrying amount of its investment before this transaction ($60), plus the $20 gain recognized from the remeasurement of that investment to fair value).
- ABC recognizes the noncontrolling interest in DEF of $120, which is equal to 40% of the historical carrying amount of the 40% interest in XYZ that was transferred to DEF (40% × $100), or $40, plus 40% of the fair value (including goodwill, if any) of DEF at the acquisition date, exclusive of the control premium, all of which is ascribable to ABC (40% × $200), or $80).
- Because ABC retains control of XYZ after the transaction, it accounts for the transfer of a 16% indirect interest in XYZ to the public shareholders of DEF as an equity transaction, with no gain or loss recognized in income. Thus, the excess of the fair value of the acquired 20% interest in DEF of $60 (20% × the fair value of DEF of $200, or $40, plus the control premium of $20), over the historical carrying amount of the 16% indirect interest transferred to the public shareholders of $40 (16% × $250), which nets to $20, is credited to paid-in capital. The $20 credit to paid-in capital can be viewed as the gain resulting from the transaction with the noncontrolling interest, equal to the excess of the fair value received of $60 over the $40 carrying amount of the consideration transferred.

ABC would record the following entries in its consolidated financial statements to reflect this transaction:

	Debit	Credit
Investment in affiliate - DEF	20	
Gain		20
Net assets of DEF (including goodwill, if any)	220	
Investment in affiliate - DEF		80
Noncontrolling interest in DEF		120
Paid-in capital		20

Control Premium Realized by Public Shareholders

Note that the public shareholders of DEF have realized the benefit of the $20 control premium paid by ABC:

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	Fair Value of Public Shareholders' Interests
Before the transaction:	
60% interest × $200 fair value of DEF	$ 120
After the transaction:	
40% interest × $200 fair value of DEF (exclusive of the control premium which is ascribable to ABC)	$ 80
16% indirect interest × $375 fair value of XYZ	60
	$ 140
Net premium received by public shareholders	$ 20

The $20 control premium is equal to the difference between the fair value of the 16% indirect interest in XYZ received by the public shareholders (16% × $375), or $60, and the 20% of the fair value of DEF effectively sold to ABC (20% × $200), or $40. Although the fair value of the noncontrolling interest in DEF is $140 (40% × $350), ABC recognizes this in its consolidated financial statements at $120, due to the measurement of DEF's interest in XYZ using ABC's carryover basis.

SHARE-BASED PAYMENT AWARDS INCLUDED IN THE CONSIDERATION TRANSFERRED

ASC Paragraph 805-30-30-9

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. This Topic refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with [ASC] Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree's awards if replacement is required by any of the following:

a. The terms of the acquisition agreement

b. The terms of the acquiree's awards

c. Applicable laws or regulations.

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ASC Paragraph 805-30-30-10

In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the postcombination financial statements. That is, none of the fair-value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

6.018 See discussion of *Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree* in Section 11.

CONTINGENT CONSIDERATION

ASC Master Glossary: Contingent Consideration

Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

ASC Paragraph 805-30-25-5

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

ASC Paragraph 805-30-25-6

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with [ASC] Subtopics 480-10 [*Distinguishing Liabilities from Equity - Overall]* and [ASC] 815-40 [*Derivatives and Hedging - Contracts in Entity's Own Equity]* or other applicable generally accepted accounting principles (GAAP). For example, [ASC] Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer's shares issued in the business combination.

ASC Paragraph 805-30-25-7

The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

6.019 Contingent consideration refers to a payment that is contingent upon meeting certain conditions or the occurrence of a particular event. When negotiating the transaction price of a business, contingent consideration is often used to bridge the price gap between what the seller would like to receive and what the buyer is willing to pay. For example, additional consideration may be paid if the acquired business meets certain financial targets (e.g., revenue, EBITDA, operating profit), passes regulatory reviews,

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achieves certain litigation outcomes, or develops a product. Contingent consideration can also be used as a means of deferred financing or incentive for management performance (see Section 11 for accounting for transactions that compensate employees or former owners of the acquiree for future service). Contingent consideration is usually paid in the form of cash or equity. Additionally, if the acquired business had contingent consideration arrangements from acquisitions it made before its acquisition by the acquirer, the acquiree's preexisting contingent consideration becomes contingent consideration for the acquirer. However, unlike consideration of the acquirer, preexisting contingent consideration is accounted for as an assumed liability (or asset acquired) in the business combination rather than part of consideration transferred.

6.020 If the business combination requires a stated minimum amount of additional consideration to be paid to the former owners of the acquiree after the acquisition date, this obligation is defined and not contingent and should not be accounted for as part of a contingent consideration arrangement, regardless of how the acquisition agreement characterizes the obligation. Noncontingent obligations should be measured at fair value at the acquisition date as part of the consideration transferred. The acquirer should measure and account for a noncontingent obligation to deliver a minimum level of additional consideration in the future based on other applicable GAAP, depending on the nature of the obligation. ASC Subtopic 835-30, *Interest - Imputation of Interest,* provides guidance on the subsequent measurement of debt obligations. Examples 6.11 and 6.17 involve both (a) an obligation to deliver a minimum amount of consideration in the future and (b) an obligation under a contingent consideration arrangement.

WORKING CAPITAL

6.020a Adjustments to the consideration transferred based on net working capital at the acquisition date are not contingent consideration arrangements, because they relate to conditions that existed at the acquisition date and do not depend on future events. Working capital adjustments paid or received during the measurement period would be adjustments to the consideration transferred in accordance with the measurement period guidance in ASC subparagraph 805-10-25-15(b). However, working capital adjustments paid or received after the close of the measurement period would be recorded to income.

CONSIDERATION HELD IN ESCROW FOR GENERAL REPRESENTATIONS AND WARRANTIES

6.020b Many business combination agreements require consideration to be held in an escrow account pending the seller's satisfaction of general representations and warranties (i.e., those not related to a specific asset or liability). Typically, general representations and warranties are expected to be valid and relate to conditions that exist as of the acquisition date rather than contingent on a future event. Therefore, settlements of general representations and warranties are not contingent consideration and any consideration held in escrow for this purpose is typically part of the consideration transferred.

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6.020c In addition, the acquirer would need to assess the escrow agreement to determine whether the escrowed funds continue to qualify as an asset on its balance sheet, and if so, recognize a corresponding liability for any funds expected to be paid to the sellers.

6.020d See Paragraph 7.168 for discussion about whether reimbursement for general representations and warranties should be accounted for as an indemnification asset. See Paragraph 12.033 for a discussion of evaluating contingencies that arise from disputes around the purchase price, including when seeking enforcement of an escrow arrangement.

FORMS OF CONTINGENT CONSIDERATION

6.021 Contingent consideration may include the issuance of additional securities or distribution of other consideration on resolution of contingencies based on post-combination earnings, post-combination security prices, or other factors.

6.022 Examples of contingent consideration include the following:

- **Contingent Consideration Based on Earnings.** Consideration may be contingent on maintaining or achieving specified earnings levels in future periods. An acquirer may be required to issue additional shares of its common shares to the former shareholders of the acquiree if earnings of the acquiree reach a certain level for a specified period.
- **Contingent Consideration Based on Components of Earnings.** Consideration could be contingent on components of earnings such as revenue growth, cost containment, or EBITDA. An acquirer may be required to pay additional consideration to the acquiree's previous owners based on the number of units or dollar amount of sales of specified products sold by the acquirer for the five-year period following the acquisition date.
- **Contingent Consideration That Represents a Guarantee of Security Price.** Contingent consideration is sometimes issued to guarantee the price of securities issued by the acquirer in an acquisition. This type of guarantee is generally in the form of an agreement by the acquirer to issue additional shares of shares, cash, or other consideration if the market (fair) value of the acquirer's securities issued to the former shareholders of the acquiree does not reach the guaranteed value by a specified date or maintain the guaranteed value for a stipulated period of time.
- **Redeemable Preferred Shares and Put Options.** A guarantee of the value of shares issued as consideration in a business combination may be embedded in the securities, i.e., the shares unconditionally issued at the date of acquisition are puttable for the guaranteed value at the option of the holder (i.e., the holder may demand cash in exchange for the shares). Alternatively, in addition to the shares issued to effect the combination, an acquirer could issue put options that give the holder the right to return the shares to the acquirer for the guaranteed value.

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- **Below-Market Guarantee.** A purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller that guarantees a minimum value or security price at a future date that is less than the value or security price at the date the securities are issued (below-market guarantee).
- **Contingent Consideration That Does Not Guarantee Security Price.** The purchase agreement may include an arrangement for the acquirer to issue additional consideration to the seller based on security prices at a future date, but does not result in a guarantee of the total value of the consideration issued by the acquirer. An acquirer may agree to issue a fixed amount of additional shares should the fair value of the shares originally issued be less than a target value at a specified future date.

INITIAL RECOGNITION OF CONTINGENT CONSIDERATION

6.023 While the amount of future payments by the acquirer resulting from contingent consideration issued in an acquisition is conditional based on future events, the acquirer's obligation regarding the contingent consideration is unconditional. Contingent consideration issued by an acquirer in a transaction accounted for as a business combination is recognized at the acquisition date at its acquisition-date fair value as part of the consideration transferred in the acquisition. (ASC paragraph 805-30-25-5) See Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination,* for additional discussion.

6.024 Contingent consideration issued in a business combination is classified at the acquisition date as either equity, or as an asset or a liability, based on applicable GAAP. The accounting for contingent consideration after an acquisition depends on whether the obligation for contingent consideration is classified as equity or as a liability (or in some cases, as an asset).

- Contingent consideration classified as equity is not remeasured after the acquisition date, and subsequent settlement is accounted for within equity.
- Contingent consideration classified as a liability (or an asset) is remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings (see *Subsequent Measurement of Contingent Consideration* in Section 12) unless the arrangement is a derivative that has been designated as a hedging instrument in a cash flow hedging relationship for which ASC Topic 815, requires the changes to be initially recognized in other comprehensive income.

6.025 See the discussion of the initial measurement of contingent consideration in Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination,* and the discussion of the subsequent accounting for contingent consideration in Section 12, *Subsequent Measurement and Accounting.*

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STATEMENT OF CASH FLOWS

6.026 See chapter 18 of KPMG Handbook, Statement of cash flows.

6.026a Paragraph not used.

Examples 6.5a and 6.5b Not used.

DETERMINING THE CLASSIFICATION OF CONTINGENT CONSIDERATION

6.027 ASC paragraphs 805-30-25-6 and 25-7 require an acquirer to classify an obligation to pay contingent consideration as a liability or as equity based on ASC Subtopic 480-10, ASC Subtopic 815-40, or other applicable GAAP. The guidance in these and other relevant pronouncements should be considered in determining the classification of contingent consideration issued in a business combination.

6.028 ASC Subtopics 480-10 and 815-40 generally apply to financial instruments (a) for which the payoff to the counterparty is based, in whole or in part, on variations in the fair value of the issuer's own shares (or the shares of a consolidated subsidiary of the issuer) or (b) that are potentially settled in the issuer's own shares (or the shares of a consolidated subsidiary of the issuer). The first step in the determination of whether a contingent consideration arrangement is classified as a liability or equity requires a determination of whether the arrangement has either of those characteristics. If neither of those characteristics is present, the contingent consideration arrangement is a liability under ASC Topic 805 and no further analysis of classification is necessary. However, if either of those characteristics is applicable to the contingent consideration arrangement, the guidance in this Section should be applied to determine the arrangement's classification. Contingent consideration arrangements that meet either of those characteristics are referred to herein as equity-linked contingent consideration arrangements.

Example 6.6: Cash-Settled Contingent Consideration Based on Earnings

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid in cash two years after the acquisition date. The value of that consideration ranges between $0 and $20 million and is calculated according to an earnings-based formula.

Analysis. This example does not involve an equity-linked contingent consideration arrangement, so there is no GAAP that could potentially result in equity classification. The arrangement should be classified as a liability.

6.029 ASC Subtopics 480-10 and 815-40 are complex, and a complete discussion of those standards is beyond the scope of this publication. However, an overview of those standards and their application to contingent consideration arrangements is presented below. For a more detailed discussion of these and related standards, refer to the following KPMG Handbooks.

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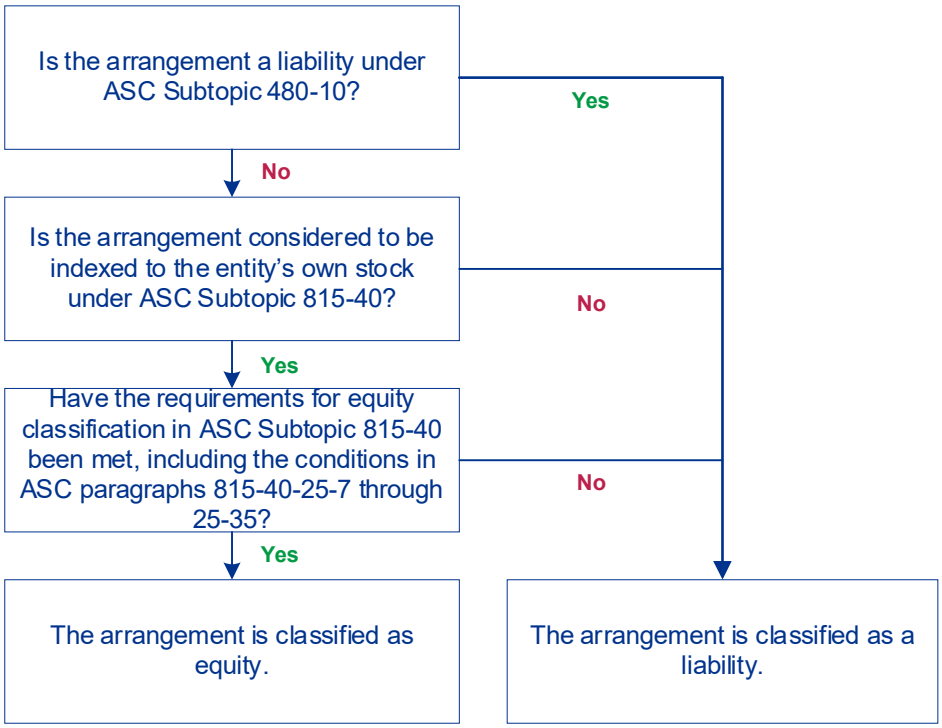
- Debt and equity financing
- Derivatives and hedging, Chapters 2 and 3

6.030 This flowchart illustrates the process for evaluating whether to classify an obligation to pay contingent consideration as a liability or as equity in accordance with ASC Subtopics 480-10 and 815-40:



6.031 We believe that certain business combinations may contain multiple contingent consideration arrangements. In those circumstances, the guidance in ASC Subtopics 480-10 and 815-40, and other U.S. GAAP would be applied to each arrangement and the classification of each of those individual arrangements as liabilities or equity may differ. See additional discussion in the subsection titled Determining the Unit(s) of Accounting When a Business Combination Potentially Involves More Than One Contingent Consideration Arrangement.

Classification of Equity-Linked Contingent Consideration Arrangements That Are Within the Scope of ASC Subtopic 480-10

6.032 ASC paragraph 480-10-35-4A requires that financial instruments within its scope that are issued as consideration in a business combination be classified as liabilities (or in some instances, assets). ASC Subtopic 480-10 applies to the following three classes of freestanding financial instruments that embody obligations for the issuer:

(1) **Mandatorily Redeemable Financial Instruments (ASC paragraphs 480-10-25-4 through 25-7).** A mandatorily redeemable financial instrument is a

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financial instrument issued in the form of shares that embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or on an event certain to occur. Mandatorily redeemable financial instruments are not classified as liabilities if redemption is only required to occur on the liquidation or termination of the reporting entity. Similarly, mandatorily redeemable noncontrolling interests in a consolidated subsidiary are not classified as liabilities in the consolidated financial statements of the parent if redemption is only required to occur on the liquidation or termination of the subsidiary, even if the parent entity will not be liquidated or terminated at the redemption date. Additionally, for non-SEC registrants only, mandatorily redeemable financial instruments are not classified as liabilities unless they are redeemable on fixed dates for amounts that are fixed or determined by reference to specified indices. (See ASC paragraphs 480-10-15-7E to 15-7F for additional information about noncontrolling interests that are mandatorily redeemable only on liquidation of the subsidiary and certain mandatorily redeemable financial instruments issued by non-SEC registrants.)

(2) **Obligations to Repurchase the Issuer's Shares by Transferring Assets (ASC paragraphs 480-10-25-8 through 25-13).** A financial instrument, other than an outstanding share, that, at inception, (a) embodies an obligation to repurchase the issuer's equity shares or is based on variations in the fair value of the obligation, and (b) requires or may require the issuer to settle the obligation by transferring assets, is within the scope of ASC Subtopic 480-10. Examples include forward purchase contracts or written put options on the issuer's equity shares that are physically settled or net-cash-settled, put warrants, and warrants on shares that are redeemable.

(3) **Certain Obligations to Issue a Variable Number of Shares (ASC paragraph 480-10-25-14).** A financial instrument that embodies an unconditional obligation (or a financial instrument other than an outstanding share that embodies a conditional obligation) that the issuer must or may settle by issuing a variable number of its equity shares is within the scope of ASC Subtopic 480-10 and is classified as a liability (or an asset in some instances) if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following:

(a) A fixed monetary amount known at inception (e.g., share-settled debt),

(b) Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's shares), or

(c) Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled).

6.033 ASC Subtopic 480-10 applies to freestanding financial instruments, including those that comprise more than one option or forward contract, and its guidance applies to an

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instrument in its entirety (i.e., ASC Subtopic 480-10 does not apply to embedded features). A *freestanding financial instrument* is a financial instrument that is entered into separately and apart from the entity's other financial instruments or equity transactions, or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable. In determining whether a feature is a freestanding financial instrument within the scope of ASC Subtopic 480-10 or an embedded feature, significant judgment is often required. However, ASC Topic 805 always requires a contingent consideration arrangement issued in a business combination to be recognized as a separate unit of accounting (i.e., either as a liability or equity). ASC paragraph 805-30-25-6 specifies that the analysis of whether a contingent consideration arrangement is a liability requires that the arrangement be evaluated based on the classification guidance contained in ASC Subtopics 480-10 and 815-40, and other relevant GAAP. Based on that guidance, we believe that the evaluation of whether a contingent consideration arrangement should be classified as a liability or as equity would require consideration of the classification requirements in ASC Subtopic 480-10, regardless of whether the arrangement is otherwise considered to be embedded in the related acquisition agreement.

6.034 Although ASC Subtopic 480-10 specifies certain types of financial instruments that are required to be classified as liabilities (or assets in some instances), it does not provide guidance on determining whether a financial instrument should be classified as equity. Consequently, if the guidance in ASC Subtopic 480-10 does not require a contingent consideration arrangement to be classified as a liability, further analysis of other applicable guidance (e.g., ASC Subtopic 815-40) is required to determine the arrangement's classification as a liability or equity.

For further guidance about financial instruments that are required to be classified as liabilities (or assets) under ASC Subtopic 480-10, see KPMG Handbook, Debt and equity financing, chapter 6, Distinguishing liabilities from equity.

Illustrations of Contingent Consideration Arrangements That Are Classified as Liabilities Under ASC Subtopic 480-10

6.035 The following examples illustrate the evaluation of whether contingent consideration arrangements are required to be classified as liabilities under ASC Subtopic 480-10.

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Example 6.7: Contingent Consideration That Embodies a Written Put Option

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $50 million ($50 per share). Under the terms of the acquisition agreement, the former shareholders of DEF can require ABC to repurchase those common shares at the end of 4 years for $50 per share. In lieu of purchasing the shares, ABC can elect to satisfy its obligation by making a cash payment equal to 1 million times the excess of $50 over ABC's share price at the end of the 4-year period.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-8. In this example, the contingent consideration arrangement (a) is not an outstanding share, (b) embodies an obligation to repurchase its equity shares (in this case it is a conditional obligation), and (c) may require ABC to settle the obligation by transferring assets (i.e., ABC can either repurchase 1 million shares for $50 million or make a cash payment equal to 1 million times the excess of $50 over ABC's share price).

Example 6.8: Contingent Consideration That Embodies a Guarantee of the Acquirer's Share Price

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $30 million ($30 per share). ABC also agrees to issue additional shares if the fair value of its common shares is less than $50 per share at the end of 4 years such that the value of the shares issued to acquire DEF will be at least $50 million.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(c). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) the issuer must settle the obligation by delivering a variable number of common shares (i.e., if ABC's share price is less than $50 per share at the end of 4 years), and (c) has a monetary value, at inception, that is based on variations inversely related to changes in the fair value of its common shares (i.e., the monetary value of the consideration that must be delivered to the former shareholders of DEF increases as ABC's stock price declines).

Example 6.9: Contingent Consideration in the Form of a Freestanding Financial Instrument

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. ABC also issues a freestanding written put option to the former shareholders of DEF that permits those holders to sell (put) 500,000 shares of ABC's

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common shares to ABC in exchange for $25 million ($50 per share) at the end of 4 years. At ABC's option, the put option can either be physically settled or it can be net-cash settled by making a cash payment equal to 500,000 times the excess of $50 over ABC's share price.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-8. In this example, the contingent consideration arrangement (a) is not an outstanding share, (b) embodies an obligation of the issuer to repurchase its equity shares (in this case it is a conditional obligation), and (c) may require ABC to settle the obligation by transferring assets (i.e., ABC can either repurchase 500,000 shares for $25 million or make a cash payment equal to 500,000 times the excess of $50 over ABC's share price).

Example 6.10: Contingent Consideration Based on Earnings

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid two years after the acquisition date. The value of that consideration ranges between $0 and $20 million and is calculated based on an earnings-based formula. ABC can elect to settle its obligation under the contingent consideration arrangement in cash or a variable number of its common shares with an equivalent value.

Analysis. The contingent consideration arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(b). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) may be settled by delivering a variable number of common shares, and (c) has a monetary value, at inception, that is based on variations in something other than the issuer's stock price. ABC's earnings are the sole basis for the monetary value of the obligation. Although ABC's share price affects the *number* of shares delivered at settlement, its stock price does not affect the *monetary value* of that consideration.

Example 6.11: Fixed Minimum Payment and Contingent Consideration Based on Earnings

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for additional consideration to be paid two years after the acquisition date. The value of that additional consideration ranges between $30 million and $50 million and is calculated according to an earnings-based formula. ABC can elect to settle its obligation under the arrangement in cash or a variable number of its common shares with an equivalent value.

Analysis. Regardless of how the acquisition agreement characterizes the arrangement, the $30 million minimum consideration to be transferred at the end of 2 years is noncontingent and should not be accounted for as contingent consideration. Rather, the

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obligation to deliver cash or a variable number of shares worth $30 million in 2 years represents a separate accounting unit and should be recognized as a debt obligation at the acquisition date and initially measured at fair value, with the resulting debt discount amortized to interest expense using the effective interest method over the 2-year period.

The contingent consideration arrangement represents the conditional obligation to remit up to $20 million of additional consideration (i.e., the amount in excess of the $30 million minimum) at the end of 2 years based on an earnings formula. That arrangement should be classified as a liability based on the classification guidance in ASC paragraph 480-10-25-14(b). In this example, the contingent consideration arrangement (a) embodies a conditional obligation and is not an outstanding share, (b) may be settled by delivering a variable number of common shares, and (c) has a monetary value, at inception, that is based on variations in something other than the issuer's stock price. ABC's earnings are the sole basis of the monetary value of the obligation. Although ABC's stock price affects the *number* of shares delivered at settlement, its stock price does not affect the *monetary value* of that consideration.

Classification of Equity-Linked Contingent Consideration Arrangements That Are Not Within the Scope of ASC Subtopic 480-10

6.036 For an equity-linked contingent consideration arrangement issued in a business combination that is not required to be classified as a liability in accordance with ASC Subtopic 480-10, other GAAP that provides guidance on the classification of equity-linked contracts must be applied to determine the classification of the arrangement. Applying the guidance in other GAAP requires that **both** of the following two criteria be met for a contingent consideration arrangement to be classified as equity:

(a) The arrangement must be considered to be *indexed to the entity's own stock* based on the guidance in ASC paragraphs 815-40-15-5 through 15-8; and

(b) The arrangement must meet the conditions for equity classification in ASC Section 815-40-25.

6.037 If the contingent consideration arrangement does not meet either of these criteria, it would be classified as a liability, regardless of whether the arrangement has all the characteristics of a derivative in ASC paragraphs 815-10-15-71, 15-83, 15-85, 15-89, 15-90, 15-92 through 15-96, 15-99, 15-100, 15-110, 15-119, 15-120, and 15-128.

For further guidance about classification of equity-linked contracts under Subtopic 815-40, see the following chapters of KPMG Handbook, Debt and equity financing.

- Chapter 8, Contracts in an entity's own equity

Determining Whether a Contingent Consideration Arrangement Is Indexed to an Entity's Own Stock under ASC Paragraphs 815-40-15-5 through 15-8

6.038 ASC paragraphs 815-40-15-5 through 15-8 establish a framework for determining whether an instrument (or embedded feature) is indexed to an entity's own stock. When

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an equity-linked contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10, the guidance in ASC paragraphs 815-40-15-5 through 15-8 is applied in determining whether it should be considered indexed to the entity's own stock, which is one of the requirements for the arrangement to be classified as equity.

6.039 The decision process for determining whether an equity-linked financial instrument is indexed to an entity's own stock under ASC paragraphs 815-40-15-5 through 15-8 is illustrated through a number of examples presented as illustrations in ASC paragraphs 815-40-55-26 through 55-48.

6.040 ASC paragraphs 815-40-15-5 through 15-8 require an entity to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using a two-step approach:

> Step 1: Evaluate the instrument's contingent exercise provisions, if any. (ASC paragraphs 815-40-15-7A and 15-7B)
>
> Step 2: Evaluate the instrument's settlement provisions. (ASC paragraphs 815-40-15-7C through 15-7H)

Step 1: Evaluate Contingent Exercise Provisions

6.041 In applying ASC paragraphs 815-40-15-5 through 15-8, an exercise contingency is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying (as defined in ASC Topic 815), including the occurrence (or nonoccurrence) of a specified event. An exercise contingency would not preclude an instrument from being considered indexed to an entity's own stock, provided that it is not based on:

(a) An observable market, other than the market for the issuer's stock (if applicable), or

(b) An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (e.g., sales revenue of the issuer, EBITDA (earnings before interest, taxes, depreciation, and amortization) of the issuer, net income of the issuer, or total equity of the issuer).

6.042 If the evaluation of Step 1 does not preclude a contingent consideration arrangement from being considered indexed to an entity's own stock under ASC paragraphs 815-40-15-7A and 15-7B, the analysis proceeds to Step 2 of that model (ASC paragraphs 815-40-15-7C through 15-7H).

6.043 For a contingent consideration arrangement, the guidance in Step 1 would apply to a contingency that causes the transfer of consideration to be triggered or that causes the arrangement to be terminated. However, if the *amount* of consideration to be transferred (or forfeited) is adjusted when an exercise contingency occurs, the exercise contingency would be evaluated under Step 1 and the potential adjustment to the amount of consideration would be evaluated under Step 2. For example, if the achievement of an earnings target for a specified period triggers payment under a contingent consideration

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arrangement and the amount of that payment varies based on the level of those earnings, then the arrangement should be evaluated under both Step 1 and Step 2 of the model (ASC paragraph 815-40-15-7). See Example 6.12 for an illustration of those circumstances.

Step 2: Evaluate Settlement Provisions

6.044 If an instrument's settlement provisions provide for a settlement amount equal to the difference between the fair value of a fixed number of an entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity, the instrument would be considered indexed to an entity's own stock under ASC paragraph 815-40-15-7C. An issued share option that gives the counterparty a right to buy a fixed number of an entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock. Certain *all or nothing* contingent consideration arrangements, as discussed below, would meet this fixed-for-fixed criterion and be considered indexed to an entity's own stock.

6.045 An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If an instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, but the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares, the instrument would still be considered indexed to an entity's own stock under ASC paragraph 815-40-15-7D.

6.046 The fair value inputs of a fixed-for-fixed forward or option on equity shares may include additional variables beyond the entity's stock price, such as the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position. Determinations and adjustments related to the settlement amount (including determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

All or Nothing Contingent Consideration Arrangements

6.047 Consistent with the preceding discussion, a contingent consideration arrangement that provides for a settlement amount based on the difference between the fair value of a fixed number of the acquirer's shares and a fixed monetary amount, which may be zero (i.e., an *all or nothing* arrangement) would meet the fixed-for-fixed criteria in Step 2 of

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the model (ASC paragraph 815-40-15-7E). If the contingency that triggers payment of the consideration (i.e., an exercise contingency) is based on an observable market other than the market for the issuer's stock (if applicable), or is based on an observable index other than an index calculated or measured solely by reference to the issuer's own operations, the arrangement would not be considered indexed to the acquirer's own stock under Step 1 and the arrangement would be classified as a liability. See Example 6.16 for an illustration of an all or nothing arrangement.

Illustration of the Application of ASC Subtopic 480-10 and ASC Paragraphs 815-40-15-5 through 15-8 to a Contingent Consideration Arrangement

6.048 The following example illustrates the evaluation of whether a contingent consideration arrangement is required to be classified as a liability under ASC Subtopic 480-10 and ASC paragraphs 815-40-15-5 through 15-8.

Example 6.12: Contingent Consideration That Provides for Different Outcomes Involving the Issuance of Shares That Are Based on the Level of Revenues Achieved

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares if the revenues of DEF are at least $10 million in the year following the acquisition or 150,000 additional shares if the revenues of DEF are at least $12 million for that year.

Analysis under ASC Subtopic 480-10. In this example, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. The determination of whether this contingent consideration arrangement should be classified as a liability under ASC paragraph 480-10-25-14 depends on the entity's assessment of the *predominant* nature of the monetary value that will be received by the counterparty at settlement.

The monetary value of the consideration to be delivered at settlement varies in the same direction as ABC's stock price (i.e., the monetary value of the consideration increases when the stock price increases, and vice versa). However, the monetary value of the consideration to be delivered at settlement also varies based on changes in something other than the fair value of ABC's equity shares (i.e., the monetary value of the consideration is affected by the entity's revenues, which determines the number of shares to be delivered at settlement). The monetary value of the consideration to be delivered at settlement is affected by a variable that would meet the characteristic in ASC paragraph 480-10-25-14(b) (i.e., its monetary value varies based on something other than the fair value of ABC's equity shares) if it were the sole variable affecting the monetary value of the obligation. Consequently, the entity must evaluate whether the overall monetary value of the obligation is predominantly based on variations in revenues. Significant judgment is often required when assessing predominance under ASC paragraph 480-10-25-14. If ABC concludes based on the relevant facts and

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circumstances that the monetary value of the arrangement is predominantly based on variations in something other than the fair value of its equity shares (i.e., the entity's revenues), the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10.

Analysis under ASC paragraphs 815-40-15-5 through 15-8. If ABC concludes based on the relevant facts and circumstances that the monetary value of the arrangement is not predominantly based on variations in something other than the fair value of its equity shares (i.e., the entity's revenues), the arrangement would not be within the scope of ASC Subtopic 480-10. However, the contingent consideration arrangement is not considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 and, therefore, is required to be classified as a liability based on the following evaluation:

Step 1. The exercise contingency (i.e., the accumulation of at least $10 million of revenues in the 3-year period following the acquisition) is an observable index. However, it can only be calculated or measured by reference to ABC's own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2. The consideration paid at settlement would not equal the difference between a fixed number of the entity's equity shares and a fixed strike price. Although the strike price to be received at settlement ($0) is fixed, the number of shares to be issued to the counterparty is not fixed (i.e., 100,000 shares if revenues are greater than $10 million but less than $12 million in the year following the acquisition and 150,000 shares if revenues for that year are at least $12 million). The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

Determining Whether a Contingent Consideration Arrangement Is Classified in Equity under ASC Section 815-40-25

6.049 ASC Section 815-40-25 addresses the classification and measurement of contracts that are indexed to, and potentially settled in, a company's own stock. If an entity concludes that (a) a contingent consideration issued in a business combination is not required to be classified as a liability under ASC Subtopic 480-10 and (b) the arrangement is indexed to the entity's own stock under ASC paragraphs 815-40-15-5 through 15-8, then the classification guidance in ASC Section 815-40-25 is applied to determine the arrangement's classification as a liability or equity.

6.050 ASC Section 815-40-25 generally bases classification on the concept that contracts that may require net-cash settlement are assets or liabilities and contracts that permit or require settlement in shares are equity. If a contract provides the entity with a choice of net-cash settlement or settlement in shares, settlement in shares is assumed; if a contract provides the counterparty with a choice of net-cash settlement or settlement in shares, settlement in cash is assumed. However, these general principles do not apply when the settlement alternatives do not have the same economic value or if one of the alternatives is fixed or has caps or floors. In that case, the economic substance of the transaction should be the basis for the classification. However, the principles do apply when the

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settlement alternatives have different economic values if the reason for the difference is a limit on the number of shares that the entity must deliver under a net-share settlement alternative.

6.051 Based on the model described in the preceding paragraph, a contingent consideration arrangement that is evaluated under ASC Section 815-40-25 (i.e., liability classification is not otherwise required under ASC Subtopic 480-10 or ASC paragraphs 815-40-15-5 through 15-8) would be classified as a liability or equity in the following circumstances unless the economic substance indicates otherwise:

Equity Classified

- Contracts that require physical settlement in shares (including gross or net-share settlement), provided that all of the conditions in ASC Section 815-40-25 are met; and
- Contracts that give the issuer a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement), provided that all of the conditions in ASC Section 815-40-25 are met.

Liability Classified

- Contracts that require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and that event is outside the control of the issuer); and
- Contracts that give the counterparty a choice of net-cash settlement or physical settlement in shares (gross settlement or net-share settlement).

ASC Section 815-40-25 specifies several additional conditions necessary for equity classification. If those conditions are not met, the entity may be forced to net-cash settle the equity-linked financial instrument, which typically causes an instrument to fail the requirements of the equity classification guidance.

Reclassifications of Contingent Consideration Arrangements

6.052 The classification of a contingent consideration arrangement that is evaluated under ASC Section 815-40-25 is reassessed at each balance sheet date, including the additional conditions that must be met for equity classification. If the classification of a contingent consideration arrangement changes as a result of events during the period, the arrangement should be reclassified as of the date of the event that caused the reclassification. There is no limit to the number of times an equity-linked contingent consideration arrangement may be reclassified. If an arrangement is reclassified from equity to a liability, the change in the fair value of the arrangement during the period(s) in which it was classified as equity should be accounted for as an adjustment to equity. The arrangement should subsequently be measured at fair value with changes in fair value reported in earnings (see *Subsequent Measurement of Contingent Consideration* in Section 12). If an arrangement is reclassified from a liability to equity, gains or losses recorded to account for the arrangement at fair value during the period(s) in which it was classified as a liability should not be reversed.

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Example 6.13: Reclassification of a Contingent Consideration Arrangement from Equity to a Liability

A contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10 and it is initially classified as equity based on the guidance in ASC paragraphs 815-40-15-5 through 15-8 and ASC Section 815-40-25. However, due to the issuance of shares in a subsequent period, the entity no longer has sufficient authorized and unissued shares available to settle its obligations under the arrangement.

Consequently, the arrangement no longer meets the condition for equity classification described in ASC paragraphs 815-40-25-19 through 25-24.

Analysis. The contingent consideration arrangement should be reclassified from equity to a liability as of the date that the requirements for equity classification were no longer met. The liability should be recorded at its fair value on the date of reclassification with an offsetting adjustment to equity. The arrangement should subsequently be measured at fair value with changes in fair value reported in earnings (see *Subsequent Measurement of Contingent Consideration* in Section 12).

Example 6.14: Reclassification of a Contingent Consideration Arrangement from a Liability to Equity

A contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10 and it is considered indexed to the entity's own stock under ASC paragraphs 815-40-15-5 through 15-8. However, the arrangement requires the entity to net-cash settle any obligations under the arrangement if registered shares are not available to satisfy the obligation. Consequently, the arrangement does not meet the conditions for equity classification described in ASC Section 815-40-25, and it is initially classified as a liability. The contingent consideration arrangement is subsequently amended to permit the entity to settle any obligations under the arrangement by delivering unregistered shares if registered shares are not available. Additionally, the amended arrangement does not include any provision that could require net-cash settlement, and the remaining conditions for equity classification in ASC Section 815-40-25 are met.

Analysis. The contingent consideration arrangement should be reclassified from a liability to equity at its carrying amount (i.e., its fair value) as of the reclassification date. Gains or losses previously recognized when the arrangement was classified as a liability should not be reversed.

Illustrations of the Application of ASC Subtopic 480-10, ASC Paragraphs 815-40-15-5 through 15-8, and ASC Section 815-40-25 to Contingent Consideration Arrangements

6.053 The following examples illustrate the evaluation of whether contingent consideration arrangements are required to be classified as liabilities or equity under ASC

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Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, and ASC Section 815-40-25.

Example 6.15: Contingent Consideration That Embodies a Net-Share Settled Written Call Option

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $50 million ($50 per share). Under the terms of the acquisition agreement, if ABC's share price exceeds $50 per share at the end of 4 years, ABC must deliver a variable number of registered shares with a fair value equal to 1 million times the amount of ABC's share price in excess of $50 to the former shareholders of DEF. The arrangement includes a provision that explicitly requires net-cash settlement if registered shares are not available to satisfy ABC's obligation, if any, at the end of 4 years.

Analysis under ASC Subtopic 480-10. ASC Subtopic 480-10 does not require the contingent consideration arrangement in this example to be classified as a liability. The arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. The arrangement (a) embodies a conditional obligation and is not an outstanding share, and (b) may require ABC to settle the obligation by delivering a variable number of its common shares (i.e., if ABC's share price exceeds $50 at the end of 4 years). However, the arrangement is not a liability under ASC paragraph 480-10-25-14, because the monetary value of that obligation, at inception, is based solely on variations directly related to changes in the fair value of its common shares.

Analysis under ASC paragraphs 815-40-15-5 through 15-8. The contingent consideration arrangement is considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The arrangement does not contain an exercise contingency. Proceed to Step 2.

Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity's equity shares (1 million shares) and a fixed strike price ($50 per share).

Analysis under ASC Section 815-40-25. The contingent consideration arrangement in this example explicitly requires net-cash settlement if ABC is unable to settle its obligation by delivering registered shares, which precludes equity classification under ASC Section 815-40-25.

Conclusion. The contingent consideration arrangement does not meet the conditions for equity classification in ASC Section 815-40-25, so it should be classified as a liability.

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Example 6.16: Contingent Consideration That Provides for the Issuance of a Fixed Number of Shares Payable on the Achievement of an Earnings Target

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares if the revenues of DEF are at least $10 million in the year following the acquisition. The arrangement does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC Section 815-40-25.

Analysis under ASC Subtopic 480-10. ASC Subtopic 480-10 does not require the contingent consideration arrangement in this example to be classified as a liability. The arrangement is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to the obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the arrangement is not a liability under ASC paragraph 480-10-25-14 because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (it embodies an obligation that ABC may be required to settle by delivering a fixed number of its shares).

Analysis under ASC paragraphs 815-40-15-5 through 15-8. The contingent consideration arrangement is considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The exercise contingency (i.e., the accumulation of at least $10 million of revenues) is an observable index. However, it can only be calculated or measured by reference to ABC's own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity's equity shares (100,000 shares) and a fixed strike price ($0).

Analysis under ASC Section 815-40-25. The arrangement in this example does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC Section 815-40-25.

Conclusion. The contingent consideration arrangement is not required to be classified as a liability under ASC Subtopic 480-10; it is considered indexed to the entity's own stock under ASC paragraphs 815-40-15-5 through 15-8, and it meets the conditions for equity classification in ASC Section 815-40-25. The arrangement should be classified as equity.

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Example 6.17: Fixed Minimum Number of Shares and Contingent Consideration That Provides for the Issuance of a Fixed Number of Additional Shares Payable on the Achievement of an Earnings Target

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. Under the terms of the acquisition agreement, ABC is required to issue 100,000 additional shares in 3 years to the former shareholders of DEF if total EBITDA of DEF for the 3-year period following the acquisition is less than $10 million. However, if total EBITDA for that period is at least $10 million, the number of shares to be delivered at the end of 3 years increases to 500,000. The arrangement does not include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC Section 815-40-25.

Analysis under ASC Subtopic 480-10. Regardless of how the arrangement is characterized in the acquisition agreement, the 100,000 minimum additional shares to be transferred at the end of 3 years is noncontingent and should not be accounted for as contingent consideration. Rather, the unconditional obligation to deliver 100,000 shares in 3 years represents a separate accounting unit. That obligation is not a liability under ASC paragraph 480-10-25-8 because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the unconditional obligation to deliver 100,000 shares in 3 years is not a liability under ASC paragraph 480-10-25-14, because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (that accounting unit embodies an obligation that ABC will be required to settle by delivering a fixed number of its shares).

The contingent consideration arrangement represents a conditional obligation to remit 400,000 of additional shares (i.e., the amount in excess of the 100,000 minimum) at the end of 3 years based on an EBITDA target. That arrangement is not a liability under ASC paragraph 480-10-25-8, because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets. Additionally, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-14, because it does not embody an obligation that ABC may settle by issuing a variable number of its shares (the contingent consideration arrangement embodies a conditional obligation that would be settled by delivering 400,000 of ABC's shares, a fixed number).

Analysis under ASC paragraphs 815-40-15-5 through 15-8. The unconditional obligation to deliver 100,000 shares in 3 years is considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The obligation to deliver 100,000 shares at the end of 3 years does not contain an exercise contingency. Proceed to Step 2.

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Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity's equity shares (100,000 shares) and a fixed strike price ($0).

The contingent consideration arrangement represents the conditional obligation to remit 400,000 of additional shares (i.e., the amount in excess of the 100,000 minimum) at the end of 3 years based on an EBITDA target. That arrangement is considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The exercise contingency (i.e., the accumulation of at least $10 million of total EBITDA in the 3-year period following the acquisition) is an observable index. However, it can only be calculated or measured by reference to ABC's own operations, so the evaluation of Step 1 does not preclude the arrangement from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2. The consideration paid at settlement would equal the difference between the fair value of a fixed number of the entity's equity shares (400,000 shares) and a fixed strike price ($0).

Analysis under ASC Section 815-40-25. Neither the fixed obligation to deliver 100,000 shares in 3 years nor the contingent consideration arrangement includes a provision that could require net-cash settlement. Additionally, those obligations meet the additional conditions for equity classification that are prescribed in ASC Section 815-40-25.

Conclusion. Neither the fixed obligation to deliver 100,000 shares in 3 years nor the contingent consideration arrangement is required to be classified as a liability under ASC Subtopic 480-10. In addition, they are both considered indexed to the entity's own stock under ASC paragraphs 815-40-15-5 through 15-8, and they both meet the conditions for equity classification in ASC Section 815-40-25. Both the fixed obligation to deliver 100,000 shares in 3 years and the contingent consideration arrangement should be classified as equity.

Example 6.18: Contingent Consideration Based on the Acquirer's Stock Price

ABC Corp. acquires DEF Corp. by unconditionally issuing 1 million common shares at the date of acquisition. The fair value of those shares at the date of acquisition is $30 million ($30 per share). ABC also agrees to issue additional shares to the former shareholders of DEF if the fair value of its common shares is less than $60 per share at the end of 4 years. If ABC's stock price is between $20 and $60 per share at the end of 4 years, ABC will issue a variable number of shares to achieve an overall target value of $60 million (including the fair value at the end of 4 years of the 1 million shares issued at acquisition). However, if ABC's stock price is less than $20 per share at the end of 4 years, 2 million additional shares will be issued. The arrangement does not

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include a provision that could require net-cash settlement and it meets the additional conditions for equity classification prescribed in ASC Section 815-40-25.

Analysis under ASC Subtopic 480-10. In this example, the contingent consideration arrangement is not a liability under ASC paragraph 480-10-25-8, because (a) it does not embody an obligation to repurchase the issuer's shares (nor is it indexed to such an obligation) and (b) it would not require the issuer to settle the obligation by transferring assets.

However, the determination of whether this contingent consideration arrangement should be classified as a liability under ASC paragraph 480-10-25-14 depends on the entity's assessment of the *predominant* nature of the monetary value of the consideration that would be transferred at settlement. If ABC's stock price is less than $20 per share at settlement, the holder is entitled to 2 million shares and the monetary value of that consideration varies in the same direction as changes in the fair value of the entity's shares. However, when ABC's stock price is greater than $20 but less than $60 at settlement, the holder is entitled to a variable number of shares with a monetary value that varies inversely with changes in the fair value of the entity's common shares. In other words, when ABC's stock price is between $20 and $60 per share, the monetary value of the shares that would be delivered at settlement moves in the opposite direction of its stock price. For example, if ABC's stock price is $30 at settlement, the counterparty would receive 1 million shares with a fair value of $30 million. However, if ABC's stock price is $50 at settlement, the counterparty would receive 200,000 shares with a fair value of $10 million. Because the contingent consideration arrangement is comprised of multiple options embodying obligations to issue shares and one of those component obligations meets the characteristics in ASC paragraph 480-10-25-14(c) (i.e., its monetary value varies inversely to changes in ABC's stock price), the entity must evaluate whether that component obligation is predominant relative to the other component obligations. Significant judgment is often required when assessing predominance under ASC paragraph 480-10-25-14. If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is predominant relative to the component obligation without that characteristic, the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10.

Analysis under ASC paragraphs 815-40-15-5 through 15-8. If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is not predominant relative to the component obligation(s) without that characteristic, the arrangement would not be a liability under ASC Subtopic 480-10. The contingent consideration arrangement is considered indexed to ABC's own stock under ASC paragraphs 815-40-15-5 through 15-8 based on the following evaluation:

Step 1. The arrangement does not contain an exercise contingency. Proceed to Step 2.

Step 2. The consideration paid at settlement would not equal the difference between a fixed number of the entity's equity shares and a fixed strike price. Although the strike price to be received at settlement ($0) is fixed, the number of shares to be issued to the

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counterparty varies based on ABC's stock price at the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option contract on equity shares, the arrangement is considered indexed to the entity's own stock.

Analysis under ASC Section 815-40-25. The arrangement in this example does not include a provision that could require net-cash settlement and it meets the conditions for equity classification that are prescribed in ASC Section 815-40-25.

Conclusion. As discussed above, classification of the contingent consideration arrangement in this example depends on the entity's evaluation of predominance for purposes of evaluating classification under ASC Subtopic 480-10. If ABC concludes based on the relevant facts and circumstances that the component obligation with a monetary value that varies inversely to its stock price is predominant relative to the component obligation(s) without that characteristic, the contingent consideration arrangement would be classified as a liability under ASC Subtopic 480-10. If not, the arrangement would be classified as equity because it is considered indexed to the entity's own stock under ASC paragraphs 815-40-15-5 through 15-8 and it meets the conditions for equity classification in ASC Section 815-40-25.

DETERMINING THE UNIT(S) OF ACCOUNTING FOR CONTINGENT CONSIDERATION

6.054 Contingent consideration in a business combination may contain multiple contingent payment triggers. ASC Topic 805 does not specify whether these payments should be viewed as multiple units of accounting or a single unit of accounting. The determination is important because it may affect the presentation as liabilities or equity under ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP. It also may affect the presentation in the statement of cash flows.

6.055 Whether contingent consideration in a business combination should be viewed as multiple units of accounting or a single unit of accounting is a matter of judgment that depends on the substance of the arrangement, rather than the manner in which the contingent consideration provisions are characterized in the related legal documents. Additionally, that determination is not affected by whether the contingent consideration provisions are prescribed in separate legal documents (i.e., papered separately) or within the same document.

6.055a We believe that payments with discrete risk exposures would be separate units of accounting. For example, if a business combination's contingent consideration provisions embody separate payment triggers applicable to multiple discrete reporting periods, and the consideration that would be delivered on the attainment of each trigger would not be affected by the outcome(s) of the payment triggers for other reporting periods, then it would be appropriate to conclude that the contingent consideration consists of separate units of accounting for each reporting period. In contrast, if in substance the contingent consideration is based on a single risk exposure, the arrangement would be viewed as a

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single unit of accounting, regardless of the payment structure. If there are multiple scheduled payments, ordinarily the interim payments would need to be subject to a clawback to conclude that there is only a single risk exposure and therefore a single unit of accounting.

Example 6.19: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 1

ABC Corp. acquires DEF Corp. and the terms of the acquisition agreement provide for contingent consideration to be paid to the former shareholders of DEF as follows: 100,000 shares of ABC's common shares if DEF's cumulative EBITDA for the 3-year period following the acquisition is more than $1 million but less than $2 million; 200,000 shares if cumulative EBITDA for the same 3-year period is at least $2 million but less than $3 million; and 300,000 shares if cumulative EBITDA for that 3-year period is at least $3 million.

Analysis. In this example, the contingent consideration provisions do not involve separate payment triggers based on discrete risk exposures. Rather, those provisions embody an obligation to deliver a variable number of shares that is determined based on cumulative EBITDA for the 3-year period following the acquisition. The contingent consideration arrangement should be viewed as a single unit of accounting and classification of the arrangement as a liability or equity should be determined based on the guidance in ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP. Under that guidance, the arrangement would be classified as a liability (see Example 6.12 for a detailed description of how a similar arrangement would be evaluated under ASC Subtopic 480-10 and ASC paragraphs 815-40-15-5 through 15-8).

Example 6.20: Determining the Unit(s) of Accounting for Contingent Consideration – Scenario 2

ABC Corp. acquires DEF Corp. in 20X5 and the terms of the acquisition agreement provide for contingent consideration to be paid to the former shareholders of DEF as follows: 100,000 shares of ABC's common shares if DEF's EBITDA is at least $1 million in 20X6; 100,000 shares if EBITDA is at least $1 million in 20X7; and 100,000 shares if EBITDA is at least $1 million in 20X8.

Analysis. In this example, the payment triggers are based on discrete risk exposures. Specifically, the contingent consideration provisions embody separate payment triggers based on DEF's EBITDA for three independent reporting periods. The outcome of the payment trigger for a particular reporting period does not affect the consideration to be transferred in other periods. The business combination can be viewed as having three separate contingent consideration arrangements for 20X6, 20X7, and 20X8, respectively. Each of those contingent consideration arrangements would represent a separate unit of accounting and the classification of those arrangements as liabilities or

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equity should be determined based on the guidance in ASC Subtopic 480-10, ASC paragraphs 815-40-15-5 through 15-8, ASC Section 815-40-25, and other relevant GAAP.

6.056 In some instances, the determination of the appropriate unit of accounting may not be clear. For example, contingent consideration provisions may provide for separate payment triggers for multiple reporting periods that would each require delivery of consideration that is not affected by the outcome of triggers in other periods; however, one or more of those payment triggers may be based on a cumulative performance measure that overlaps with the periods covered by earlier triggers. All facts and circumstances should be considered and judgment will be necessary when determining the appropriate unit(s) of accounting for contingent consideration.

SUBSEQUENT ISSUANCE OF CONTINGENT SHARES BASED ON EARNINGS IN A REVERSE ACQUISITION

6.057 Contingent shares issued to the stockholders of the accounting acquirer based on earnings in a reverse acquisition should be accounted for similar to a stock dividend and included in earnings per share from the date of issuance. Contingent shares issued to the former stockholders of the legal acquirer based on earnings in a reverse acquisition should be accounted for as contingent consideration.

Effect of Contingent Consideration on the Computation of Earnings Per Share

6.058 An agreement to provide consideration contingent on future earnings may affect an acquirer's computation of earnings per share during the contingency period if the agreement requires the issuance of additional common shares on resolution of the contingency.

6.059 ASC paragraph 260-10-45-13 indicates that shares issuable for little or no cash consideration on the satisfaction of certain conditions (contingently issuable shares) should be considered outstanding common shares and included in the computation of basic earnings per share (EPS) as of the date that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent). For instance, if the earnings level stipulated in the contingency agreement is being attained currently, the additional shares to be issued should not be considered outstanding for the purposes of basic EPS until the earnings level is attained and the end of the contingency period is reached, but the additional shares would be included in diluted EPS when the earnings level is being currently attained (see following paragraphs). If the earnings levels were not being attained currently, the contingently issuable shares would not be included in basic or diluted EPS. Contingently issuable shares include shares that (a) will be issued in the future on the satisfaction of specified conditions, (b) have been placed in escrow and all or part must be returned if specified conditions are not met, or (c) have been issued but the holder must return all or part if specified conditions are not met.

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6.060 ASC paragraphs 260-10-45-48 through 45-50 indicate that shares whose issuance is contingent on the satisfaction of certain conditions should be considered outstanding and included in the computation of diluted EPS as follows:

(a) If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares should be included as of the beginning of the period in which the conditions were satisfied.

(b) If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS should be based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (e.g., the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares should be included in the denominator of diluted EPS as of the beginning of the period (or the date of the acquisition if later).

6.061 A determination of whether contingently issuable shares are considered outstanding for the purposes of computing both basic and diluted EPS data should be made for each period, including interim periods, that EPS data are presented. Contingent shares included in previously presented diluted EPS data because the earnings level had been attained should not be included in computing diluted EPS for the current period if the specified earnings level is not being attained currently.

6.062 EPS data previously presented should not be restated to give retroactive effect to shares issued as a result of subsequently meeting the earnings level specified in the contingent consideration arrangement.

Effect of Contingency Based on Security Prices in Computing Earnings Per Share

6.063 ASC paragraph 260-10-45-52 provides guidance on the treatment of contingently issuable shares in EPS calculations when the number of contingently issuable shares depends on the market price of the stock at a future date. In that case, computations of diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive. If the condition is based on an average of market prices over a period of time, the average for that period should be used. Because the market price may change in a future period, basic EPS should not include such contingently issuable shares because all necessary conditions have not been satisfied.

Effect of Contingency Based on Both Future Earnings and Security Prices in Computing Earnings Per Share

6.064 ASC paragraph 260-10-45-53 provides guidance on computing EPS when contingently issuable shares depend on both future earnings and future market prices of the common stock. In that case, the determination of the number of shares included in diluted EPS should be based on both conditions, that is, earnings to date and current market price, as they exist at the end of each reporting period. If both conditions are not

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met at the end of the reporting period, no contingently issuable shares should be included in diluted EPS.

BUSINESS COMBINATIONS IN WHICH NO CONSIDERATION IS TRANSFERRED

6.065 In business combinations in which no consideration is transferred, an acquirer uses the acquisition-date fair value of its interest in the acquiree, determined using one or more valuation approaches, instead of the acquisition-date fair value of the consideration transferred to determine the amount of goodwill. See discussion of *Business Combinations Achieved without the Transfer of Consideration* in Section 9.

MEASUREMENT OF CONSIDERATION TRANSFERRED IN COMBINATIONS INVOLVING MUTUAL ENTITIES

ASC Paragraph 805-30-55-3

When two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, [ASC] paragraphs 805-30-30-2 through 30-3 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred as consideration. In addition, the acquirer in a combination of mutual entities shall recognize the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.

ASC Paragraph 805-30-55-4

Although they are similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

ASC Paragraph 805-30-55-5

A fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, an estimated cash flow model may be used to determine the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect

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reductions for member benefits, such as reduced fees charged for goods and services.

6.066 A *mutual entity* is an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants. For example, a mutual insurance company, a credit union, and a cooperative entity, are all mutual entities. ASC Section 805-10-20

6.067 When a business combination takes place between mutual entities, the acquisition method is applied. In a combination involving mutual entities, the acquirer and acquiree exchange only equity interests. If the fair value of the equity or member interests in the acquiree is more reliably measurable than the fair value of the member interests transferred by the acquirer, ASC Topic 805 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquirer's equity interests transferred as consideration.

6.068 The acquirer in a combination of mutual entities recognizes the acquiree's net assets as a direct addition to capital or equity in its balance sheet and not as an addition to retained earnings.

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Section 7 - Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

Detailed Contents

Recognition Principle
- Recognition Conditions
  - Assets and Liabilities: Concepts Statement 8
  - Example 7.1: Substantive Obligation of the Acquiree
  - Transactions That Are Not a Part of the Business Combination Transaction (*Separate Transactions*)

Classifying and Designating Identifiable Assets Acquired and Liabilities Assumed
- Classification Principle
- Exceptions to the Classification Principle
  - Classification of Leases
  - Insurance Entities

Accounting Policies Applicable to the Assets Acquired and Liabilities Assumed

Recognizing Particular Assets Acquired and Liabilities Assumed
- Contract Assets and Contract Liabilities
  - Example 7.1a: Acquired Revenue Contract – Different Estimates
  - Example 7.1b: Accounting for Royalties in a Customer Contract
  - Example 7.1c: Practical Expedients
- Contract Cost Assets (ASC Subtopic 340-40)
- Liabilities Associated with Restructuring or Exit Activities of the Acquiree
- Restructuring or Exit Activities of the Acquirer and Integration Costs an Acquirer Expects to Incur as a Result of an Acquisition
  - Restructuring and Exit Activities of the Acquirer
  - Integration Costs the Acquirer Expects to Incur
  - Example 7.2: Costs to Prepare Acquired Equipment for Its Intended Use
- Recognition of Prepayment Penalties Associated with Debt Assumed in a Business Combination
- Recognition of Intangible Assets Separately from Goodwill
  - Contractual-Legal Criterion
  - Separability Criterion

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Example 7.7: Depositor Relationships

Example 7.8: Registered Trademarks

Items That Are Not Identifiable

Illustrative List of Intangible Assets That Are Identifiable

Marketing-Related Intangible Assets

Customer-Related Intangible Assets

Example 7.9: Order Backlog

Example 7.10: Customer Relationships (No Existing Contracts)

Example 7.11: Customer Relationships—Contractual-Legal Criterion

Example 7.12: Customer Relationships—More Than One Relationship with a Single Customer

Example 7.13: Customer Relationships—Contractual-Legal Criterion

Example 7.14: Customer Relationships Not Recognized (Contractual-Legal Criterion Not Met) and Customer List Not Recognized Due to Confidentiality Restrictions)

Example 7.15: Customer Relationships—Overlapping Customer Relationships – Scenario 1

Example 7.16: Customer Relationships—Overlapping Customer Relationships – Scenario 2

Example 7.17: Acquiree's Preexisting Customer Relationship With Acquirer Is Not Recognized as a Customer Relationship Intangible Asset by the Acquirer

Q&A 7.0: Customer Relationships - Healthcare Patient Relationships

Artistic-Related Intangible Assets

Contract-Based Intangible Assets

Example 7.18: Supply Contracts

Technology-Based Intangible Assets

Research And Development Assets

Example 7.19: Activities That Typically Would Be Included in Research and Development Activities

Example 7.20: Activities That Typically Would Be Excluded from Research and Development Activities

In-Process Research And Development Activities

Q&A 7.1: Initial Measurement – IPR&D in a Development Arrangement

Q&A 7.2: Subsequent Measurement – IPR&D in a Development Arrangement

Example 7.21: The IPR&D Guide Q&A, par. 2.60: Specific R&D Projects – Incompleteness

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Example 7.22: The IPR&D Guide Q&A, par. 2.61: Specific R&D Projects – Incompleteness
Example 7.23: The IPR&D Guide Q&A, par. 2.62: Specific R&D Projects – Incompleteness
Example 7.24: The IPR&D Guide Q&A, par. 2.63: Specific R&D Projects – Incompleteness
Example 7.25: The IPR&D Guide Q&A, par. 2.51: Specific R&D Projects – Substance
Example 7.26: The IPR&D Guide Q&A, par. 2.52: Specific R&D Projects – Substance
Example 7.27: The IPR&D Guide Q&A par. 2.53: Specific R&D Projects – Substance
Example 7.27a: The IPR&D Guide Q&A par. 2.21: Unit of account for IPR&D
Crypto Assets
Considerations for Financial Services Entities – Customer-Related Intangible Assets
Recognizing Any Noncontrolling Interest in an Acquiree
Example 7.28: Recognizing Noncontrolling Interest at Fair Value
Measurement Principle
Application Guidance Related to Measuring the Fair Values of Particular Identifiable Assets and a Noncontrolling Interest in an Acquiree
Assets with Uncertain Cash Flows (Valuation Allowances)
Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use
Example 7.30: Acquirer Does Not Intend to Use Acquired Trade Name
Example 7.31: Acquired IPR&D the Acquirer Does Not Intend to Use
Contingent Consideration Arrangements of an Acquiree Assumed by the Acquirer
Self-Insured Risks
Measuring the Fair Value of a Noncontrolling Interest in an Acquiree
Exceptions to the Recognition and Measurement Principles
Assets and Liabilities Arising from Contingencies
Deferred Tax Assets and Liabilities and Tax Uncertainties
Employee Benefits
Example 7.32: Funded Status of a Single-Employer Defined Benefit Pension Plan of an Acquiree before and after a Business Combination
Example 7.33: Plan Amendments an Acquirer Is Not Required to Make
Example 7.34: Employees of Acquiree Included in Pension Plan of Acquirer

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Example 7.35: Postretirement Benefit Plan That Will Be Amended as a Condition of the Acquisition Agreement

Indemnification Assets

Example 7.36: Indemnification Asset Related to Noncontractual Contingency

Exceptions to the Measurement Principle

Reacquired Rights

Example 7.37: Reacquired Right

Share-Based Payment Awards

Assets Held for Sale

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7.000 ASC Topic 805, *Business Combinations,* requires an acquirer to recognize, separately from goodwill, the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree, and to measure these items at their acquisition-date fair values, with limited exceptions. ASC Topic 805 does not provide guidance on how to measure fair value, but instead refers to the fair value measurement requirements of ASC Subtopic 820-10, *Fair Value Measurement - Overall.* ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value, and establishes disclosure requirements related to fair value measurements.

7.001 This Section provides guidance on the recognition and measurement of the assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree, including those subject to the exceptions to the fair value measurement principle. Sections 16 through 21 on Fair Value Measurements provide additional guidance on the estimation of the fair value of assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree.

7.002 Subsequent measurement and accounting for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination are based on other applicable GAAP. However, ASC Topic 805 does provide guidance on the subsequent measurement and accounting for certain assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination. See Section 12 for a discussion of *Subsequent Measurement and Accounting.*

RECOGNITION PRINCIPLE

ASC Paragraph 805-20-25-1

As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in [ASC] paragraphs 805-20-25-2 through 25-3. However, an entity (the acquirer) within the scope of ASC paragraph 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination as described in ASC paragraphs 805-20-25-29 through 25-33.

RECOGNITION CONDITIONS

ASC Paragraph 805-20-25-2

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must exist at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its

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postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

ASC Paragraph 805-20-25-3

In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in [ASC] paragraphs 805-10-25-20 through 25-23 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.**7.003** Two conditions are required to be met before identifiable assets acquired and liabilities assumed can be recognized in a business combination. These conditions state that identifiable assets acquired and liabilities assumed:

- Must exist *at the acquisition date;* and
- Are part of what the acquirer and acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions. See the discussion of *Determining What Is Part of the Business Combination Transaction* in Section 11.

7.004 See the discussion of Exceptions to Both the Recognition and Measurement Principles. In addition, Section 26, *Private Company and Not-for-Profit Accounting Alternatives*, discusses additional exceptions for private companies and not-for-profit entities.

Assets and Liabilities: Concepts Statement 8

7.005 Under Concepts Statement 8, an asset is defined as the present right of an entity to an economic benefit, and a liability is defined as the present obligation of an entity to transfer an economic benefit. Paragraph E50 of Concepts Statement 8, Chapter 4 further clarifies that some liabilities arise from constructive obligations rather than being contracted by agreement with another party or imposed by government.

Example 7.1: Substantive Obligation of the Acquiree

ABC Corp. acquires DEF Corp. in a business combination. DEF had a widely published policy that it historically honored product defects after the warranty expiration period. DEF determined that it had a substantive obligation to continue its historical practice and recorded a liability related to this historical practice before its acquisition by ABC. ABC reviews this matter in connection with its accounting for the acquisition of DEF, and also concludes that DEF had a substantive obligation to continue its historical practice. ABC therefore recognizes a liability for DEF's substantive obligation at the acquisition date, measured at fair value, because the obligation meets the definition of a liability.

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7.006 Applying the recognition provisions of ASC Topic 805 may result in the acquirer recognizing some assets and liabilities that the acquiree had previously not recognized as assets and liabilities in its financial statements. For example, the acquirer would recognize the acquired identifiable intangible assets such as in-process research and development, brand names, patents, and customer relationships, even if the acquiree did not recognize these assets because they were developed internally and the related costs were charged to expense.

7.007 Under ASC Topic 805, transaction costs for services received in connection with a business combination, such as legal fees, other professional and consulting fees, and due diligence fees, would not be considered an asset acquired at the date of acquisition and are not part of the fair value of the consideration transferred to the seller. Those costs would be expensed as incurred, unless they are costs related to the issuance of debt or equity instruments, in which case they are accounted for under applicable GAAP. (ASC paragraph 805-20-25-2; Statement 141(R), par. B114) See discussion of Acquisition-Related Costs and *Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred* in Section 11.

7.007a -7.012 Paragraphs not used.

Transactions That Are Not a Part of the Business Combination Transaction (*Separate Transactions*)

7.013 Amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in a business combination are not recognized as assets acquired or liabilities assumed in the business combination. For example, amounts related to the settlement of preexisting relationships between an acquirer and an acquiree, a transaction that compensates employees or former owners of the acquiree for future services, and a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs are not part of the accounting for the acquisition, but rather are accounted for as separate transactions based on other relevant GAAP. See the discussion of *Determining What Is Part of the Business Combination Transaction* in Section 11.

CLASSIFYING AND DESIGNATING IDENTIFIABLE ASSETS ACQUIRED AND LIABILITIES ASSUMED

CLASSIFICATION PRINCIPLE

ASC Paragraph 805-20-25-6

At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

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7.014 The accounting for a particular asset or liability subsequent to an acquisition may differ depending on how it is classified or designated. ASC Topic 805 requires the acquirer to classify and designate assets acquired and liabilities assumed in an acquisition at the acquisition date as required to enable it to apply other GAAP, based on the contractual terms, economic conditions, the acquirer's accounting policies, and other pertinent conditions at the acquisition date. ASC paragraph 805-20-25-7 provides three examples of classifications required to be made by the acquirer at the acquisition date:

a. Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with ASC Section 320-10-25;

b. Designation of a derivative instrument as a hedging instrument in accordance with ASC paragraph 815-10-05-4; and

c. Assessment of whether an embedded derivative should be separated from the host contract in accordance with ASC Section 815-15-25 (which is a matter of classification as used in ASC Subtopic 805-20).

7.015 The above examples are not all-inclusive. For example:

- **Long-Lived Assets or Disposal Groups.** An acquirer may intend, at the acquisition date, to dispose of a long-lived asset (or disposal group) of the acquiree. In these instances, the acquirer would follow the guidance in ASC paragraphs 360-10-35-37 through 35-43 and 45-9 through 45-14 in determining the classification and presentation of the long-lived asset (or disposal group) in the acquirer's post-combination consolidated financial statements.
- **Fair Value Option.** The acquirer may elect the fair value option for eligible items included in the assets acquired or liabilities assumed in a business combination. The classification of and subsequent accounting for these items are determined in accordance with ASC paragraphs 825-10-15-3 through 15-7 and 25-4.

EXCEPTIONS TO THE CLASSIFICATION PRINCIPLE

7.016 ASC Topic 805 includes two exceptions to the principle discussed above in classifying or designating assets acquired and liabilities assumed where the acquiree classification is retained. Those exceptions are (a) classification of a lease contract under ASC Topic 842, *Leases,* and (b) classification of a contract written by an entity that is in the scope of ASC Topic 944, *Financial Services—Insurance.* ASC paragraph 805-20-25-8

7.017-7.018 Paragraphs not used.

Classification of Leases

7.019 For guidance on classifying an assumed lease, see chapter 11 of KPMG Handbook, Leases.

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Insurance Entities

7.020 ASC Subtopic 944-805 provides guidance to insurance entities in the scope of ASC Topic 944 on accounting for business combinations. The acquirer is required to classify insurance and reinsurance contracts acquired on the basis of the contractual terms and other factors at the inception of the contract (or the modification date). As a result, the acquirer carries forward the acquiree's classification of an acquired contract as an insurance, reinsurance or deposit contract. Classification is determined based on an understanding of (a) the acquired contract's contractual terms, (b) any related contracts or agreements at the inception of the contract and (c) if the terms were subsequently modified in a manner that would change the classification, the contract's modification date (which may be the acquisition date).

7.020a Consistent with the basic principle of ASC Topic 944, insurance entities do not offset insurance contracts and reinsurance contracts acquired in a business combination unless the reinsurance agreement relieves the insurance entity of its primary obligation (i.e., legal liability) to the contract holder.

7.021 While the acquirer retains the acquiree's classification of acquired insurance and reinsurance contracts, the related assets and liabilities are measured at fair value at the acquisition date. The fair value of those assets and liabilities are then recognized in two components based on the guidance in ASC paragraph 944-805-30-1.

- First, assets and liabilities are measured using the acquirer's accounting policies for insurance and reinsurance contracts it issues or holds. For example, the contractual assets acquired could include a reinsurance recoverable and the liabilities assumed could include liabilities to pay both (a) incurred contract claims and claims expenses not yet paid and (b) future contract claims and claims expenses on the unexpired portion of the acquired contracts. The acquirer follows the guidance in ASC Topic 944 in determining the assumptions used to measure these assets and liabilities, as applicable. However, the assets acquired and liabilities assumed do not include the acquiree's deferred acquisition costs and unearned premiums that do not represent future cash flows.
- Next, the acquirer measures an intangible asset (or occasionally another liability) that represents the difference between the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed and the amount determined in the first component - i.e., using the acquirer's accounting policies for insurance and reinsurance contracts it issues or holds.

7.022 Contracts that are not insurance or reinsurance contracts are measured at the acquisition date in accordance with the guidance in ASC Topic 805, generally at fair value. For example, a contingent commission arrangement is a contingency accounted for in accordance with ASC paragraphs 805-20-25-18A through 25-20B and 805-20-30-9.

7.023 ASC paragraph 944-805-30-1 does not specify the balance sheet presentation for the intangible asset (or liability) from acquired insurance and ceded reinsurance contracts.

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We believe it is acceptable to present the intangible asset (or liability) using any of the following approaches. Regardless of which approach is used, we believe the acquirer discloses its accounting policy for intangible asset (or liability) presentation in its notes to the financial statements.

- Recording the intangible asset (or liability) net in one caption. The guidance in ASC paragraph 944-805-30-1(b) references "an intangible asset (or occasionally another liability)" that is calculated by comparing the fair value of contractual insurance and ceded reinsurance assets acquired and liabilities assumed to the same balances accounted for under the acquirer's accounting policies. We believe this presentation is acceptable because one view is that the guidance supports one intangible asset (or liability) on the balance sheet since it is the difference between two calculated numbers for all insurance and reinsurance contracts.
- Splitting the intangible asset (or liability) into components and separately presenting those related to the insurance contracts (direct balances), assumed reinsurance contracts (assumed balances), and ceded reinsurance contracts (ceded balances). This approach is supported by the ASC paragraph 805-20-30-1 requirement that an entity measure all identifiable assets acquired and liabilities assumed at their acquisition-date fair value. For insurance and reinsurance contracts, the FASB bifurcated the fair value component as an intangible asset (or a liability) so that pre- and post-acquisition blocks of business would be measured using consistent accounting policies. We believe this presentation is acceptable if an entity discloses the components of the recorded intangible asset (or liability) in the notes to its financial statements.
- Splitting the intangible asset (or liability) into its components and presenting them as two separate captions on the balance sheet - one for an intangible asset and one for another liability. We believe this presentation is acceptable because there would be separate presentation and disclosure of the components in the notes to the financial statements.

7.023a For subsequent measurement, the acquirer measures the intangible asset (or liability) on a basis consistent with the related insurance or reinsurance liability (or asset) in accordance with the guidance in ASC paragraph 944-805-35-1. The amortization (or accretion) method(s) are disclosed in the notes to the financial statements.

7.023b To determine the amortization (or accretion) method(s) to be used for subsequent measurement, the acquirer evaluates the key recognition drivers of "the related insurance or reinsurance liability (or asset)." In making this evaluation, the acquirer may need to disaggregate the intangible asset (or liability) because the underlying accounts or underlying transactions are expected to have different recognition patterns. For example:

- The intangible asset (or liability) may have been created from various underlying accounts that are expected to have different recognition patterns – e.g., direct unearned premiums that represent future cash flows and direct insurance liabilities for claims and claims expenses. In this situation, the

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acquirer may determine that the related intangible asset (or liability) should be disaggregated at the underlying account level to determine the appropriate amortization (or accretion) method(s).

- The underlying transactions may include both direct insurance contracts and ceded reinsurance agreements with different terms – e.g., a non-proportionate reinsurance agreement. In this situation, the recognition pattern of these transactions may be significantly different, and the acquirer may determine that the related intangible asset (or liability) should be disaggregated between the direct insurance contracts and the related ceded reinsurance agreements to determine the appropriate amortization or accretion method(s).

ACCOUNTING POLICIES APPLICABLE TO THE ASSETS ACQUIRED AND LIABILITIES ASSUMED

7.024 See Paragraph 12.030 for discussion of accounting policies applicable to assets acquired and liabilities assumed.

RECOGNIZING PARTICULAR ASSETS ACQUIRED AND LIABILITIES ASSUMED

7.025 This section discusses recognition considerations related to certain assets acquired and liabilities assumed in a business combination. The following sections discuss measurement considerations and the exceptions to the recognition and measurement principles.

7.025a–7.025c Paragraphs not used.

CONTRACT ASSETS AND CONTRACT LIABILITIES

ASC Paragraph 805-20-25-28C

The acquirer shall recognize a contract asset or contract liability in accordance with [ASC] Topic 606 on revenue from contracts with customers. This includes a contract asset or contract liability from the following:

a. Contracts with customers

b. Other contracts to which the provisions of Topic 606 apply.

ASC Paragraph 805-20-30-27

The acquirer shall measure a contract asset or contract liability in accordance with [ASC] Topic 606 on revenue from contracts with customers. This includes a contract asset or contract liability from the following:

a. Contracts with customers

b. Other contracts to which the provisions of [ASC] Topic 606 apply.

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ASC Paragraph 805-20-30-28

An acquirer shall measure the contract assets and contract liabilities of the acquired contract as if the acquirer had originated the acquired contract. [ASC] Topic 606 specifies when certain assessments and estimates should be made, for example, as of contract inception or on a recurring basis. At the acquisition date, the acquirer shall make those assessments as of the dates required by [ASC] Topic 606.

ASC Paragraph 805-20-30-29

An acquirer may use one or more of the following practical expedients when applying paragraphs 805-20-30-27 through 30-28 at the acquisition date:

a. For contracts that were modified before the acquisition date, an acquirer may reflect the aggregate effect of all modifications that occur before the acquisition when:

1. Identifying the satisfied and unsatisfied performance obligations

2. Determining the transaction price

3. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

b. For all contracts, for purposes of allocating the transaction price, an acquirer may determine the standalone selling price at the acquisition date (instead of the contract inception date) of each performance obligation in the contract.

ASC Paragraph 805-20-30-30

For any of the practical expedients in paragraph 805-20-30-29 that an acquirer uses, the acquirer shall apply that expedient on an acquisition-by-acquisition basis. Each practical expedient that is elected shall be applied consistently to all contracts acquired in the same business combination. In addition, the acquirer shall provide the disclosures in paragraph 805-20-50-5.

7.025d Entities record (i.e., recognize and measure) contract assets and liabilities acquired in a business combination in accordance with ASC Topic 606. This is an exception to the general recognition and measurement provisions in ASC Topic 805 that require a fair value measurement.

7.025e This exception applies only to contract assets and liabilities in contracts with customers (i.e., contracts in the scope of ASC Topic 606) or contract assets and liabilities arising from other contracts that apply the provisions of ASC Topic 606 (e.g., contracts in the scope of ASC Subtopic 610-20 on the derecognition of nonfinancial assets). This exception even applies to contract assets and liabilities the acquiree had previously recorded at fair value in a previous business combination (i.e., the acquiree had not yet adopted ASU 2021-08 at the time of the previous acquisition).

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7.025ee This exception does not apply to other assets or liabilities arising from customer contracts that do not meet the definition of a contract asset or contract liability. Examples include refund liabilities, certain capitalized costs for upfront payments to customers that are not contract assets (see Question 5.7.60 of KPMG Handbook, Revenue Recognition), customer-related intangibles, provisions for loss contracts and off-market intangible assets or liabilities. The accounting for those assets and liabilities continues to follow the general recognition and measurement (i.e., fair value) principles of ASC Topic 805. See the discussion beginning in Paragraph 17.081 that discusses the different units of account in a revenue contract arising from a business combination and the different measurement attributes. Similarly, this exception does not apply to contract cost assets accounted for under ASC Subtopic 340-40 (see Paragraph 7.025i).

7.025f To determine the amounts to record under ASC Topic 606, the acquirer records a contract asset or contract liability for acquired revenue contracts as if it had originated the contract. This means the acquirer needs to apply its accounting policies, estimates and judgments to acquired revenue contracts beginning at contract inception to determine the appropriate amount to recognize at the acquisition date. The FASB observed in paragraph 33 of its Basis for Conclusions to ASU 2021-08, that the requirements were not the same as carryover basis because of potential differences in policies, estimates, judgments or errors in the acquiree's application of ASC Topic 606. See KPMG Handbook, Revenue Recognition, for discussion of the ASC Topic 606 requirements.

Example 7.1a: Acquired Revenue Contract – Different Estimates

KCL Construction (KCL) enters into a contract on January 1, 20X1 to construct a commercial building for a customer for $3.5 million paid on completion. Construction is expected to take two years, and KCL determines the contract has a single performance obligation satisfied over time.

KCL determines that the input measure, based on cost incurred, provides an appropriate measure of progress toward satisfaction of the performance obligation. At December 31, 20X1, KCL estimates that total construction costs will be $3 million and the construction is 55% complete based on $1.65 million costs incurred to date. KCL records a contract asset of $1.925 million ($3.5 million × 55%) because payments are conditional on reaching milestones subsequent to year-end.

On January 1, 20X2, ABC Corp (ABC) acquires KCL and estimates that the total cost for this project will be $2.8 million (i.e., $1.65 million incurred pre-acquisition and $1.15 million to complete post-acquisition) due to a more favorable cost structure at ABC. ABC's estimate indicates 59% progress (i.e., $1.65 million incurred to date divided by $2.8 million updated estimate). ABC records a contract asset of $2.065 million ($3.5 million × 59%) on the acquisition date, because this amount represents the contract asset that ABC would have recognized if it had originated the customer contract.

7.025g When applying ASC Topic 606 to acquired contracts, the acquirer applies all of its provisions, including the variable consideration and royalty recognition constraints.

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Applying either constraint may preclude the acquirer from recognizing an acquisition date contract asset even when it expects the contract to generate positive future cash flows. If, or when, the variable amounts become unconstrained in the post-acquisition period, the variable amounts would affect post-acquisition revenue. Nevertheless, the constrained cash flows would still be factored into the valuation of other intangible assets (e.g., backlog asset, customer relationships, technology). See chapter 5 of KPMG Handbook, Revenue Recognition, for a discussion of the variable consideration constraint and chapter 10 for a discussion of the royalty recognition constraint.

Example 7.1b: Accounting for Royalties in a Customer Contract

ABC Corp. (ABC) acquires XYZ Corp. (XYZ) in a business combination on April 30, 20X9. XYZ is a technology company that had entered into a seven-year license of a patent to a customer on January 1, 20X7 and is collecting sales-based royalties. XYZ transferred control of the license to its customer at contract inception. The royalty rate is considered at-market on the acquisition date.

ABC evaluates the accounting for the license under ASC Topic 606 as if it originated the contract. Under ASC Topic 606, sales and usage-based royalties are recognized at the later of when the subsequent sale/usage occurs or the performance obligation has been satisfied (i.e., the royalty constraint). Under ASC Topic 606, the nature of the performance obligation is a license of functional intellectual property that was satisfied at contract inception. Therefore, the royalty revenue would be recognized as the sales occur.

ABC would not record a contract asset at the acquisition date even though there are no remaining performance obligations in the contract because of the royalty constraint. Instead, ABC would record the royalties as revenue in the post-acquisition period as sales occur.

ABC would factor the royalty cash flow stream into its valuation of other intangible assets such as the customer relationship and/or technology.

7.025h There are two practical expedients entities can apply to determine a contract asset or liability on a transaction-by-transaction basis:

- **Modification expedient**: the acquirer may reflect the aggregate effect of all modifications that occurred prior to the acquisition date when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations.
- **Stand-alone selling price expedient**: the acquirer may determine the stand-alone selling price at the acquisition date, instead of the contract inception date, of each performance obligation in the contract for the purposes of allocating the transaction price.

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When an entity elects a practical expedient for a transaction, it must be applied consistently to all contracts in that transaction. Entities are required to disclose the expedients used and discuss the effects they had on the financial statements.

Example 7.1c: Practical Expedients

On January 1, 20X1, ABC Corp (ABC) enters into a contract with a customer to provide its payment processing services for 3 years for $1,500 a month. The payment processing services are a single performance obligation comprising a series of distinct services.

The contract was modified on December 31, 20X1 to extend the payment processing services period by three years at $1,300 per month (for the extension period) and sell payment terminals for $500,000. The payment processing services and the payment terminals are separate performance obligations.

On June 30, 20X2, XYZ Corp (XYZ) acquires ABC and elects to apply both the modification expedient and stand-alone selling price expedient to the acquisition.

Using the modification expedient, the total transaction price at the acquisition date is $600,800[1], which includes the aggregate effect of the original contract and the modification.

XYZ allocates the $600,800 total transaction price to each of the performance obligations in the contract based on their stand-alone selling prices at the acquisition date.

[1] (3 years × $1,500 a month × 12 months) + (3 additional years × $1,300 a month × 12 months) + $500,000 payment terminals = $600,800

CONTRACT COST ASSETS (ASC SUBTOPIC 340-40)

7.025i Under ASC Subtopic 340-40, *Other Assets and Deferred Costs -- Contracts with Customers,* certain costs related to a contract with a customer are deferred and recognized as an asset. These costs may relate to incremental costs of obtaining a contract or certain costs to fulfill a contract. We believe the acquirer would not recognize an asset for such costs similar to debt issuance costs or deferred acquisition costs for insurance contracts. Instead, any fair value attributed to the acquired customer contracts would be included in the fair value of the customer-related intangible assets (see Paragraphs 7.085 through 7.093).

LIABILITIES ASSOCIATED WITH RESTRUCTURING OR EXIT ACTIVITIES OF THE ACQUIREE

7.026 Before the effective date of ASC Topic 805, EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination," specified that costs associated with an acquirer's plan to (a) exit an activity of an acquiree, (b) involuntarily terminate employees of an acquiree, or (c) relocate employees of an acquiree, should be

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recognized as liabilities assumed in a business combination if specified conditions were met.

7.027 However, in deliberating ASC Topic 805, the FASB noted that an exit or disposal plan by itself does not create a present obligation and that an entity's commitment to such a plan is not a sufficient condition for recognition of a liability. Accordingly, ASC Topic 805 nullified EITF 95-3. Under ASC Topic 805, an acquirer recognizes liabilities related to restructuring and exit activities of the acquiree only if they represent an existing substantive liability of the acquiree at the acquisition date and the acquiree has little or no discretion to avoid a settlement of the liability. For restructuring and exit activities of the acquiree that the acquirer initiates, the acquirer incurs a liability associated with the costs only after it gains control of the acquiree's business. ASC paragraph 805-20-25-2; Statement 141(R), pars. B132-133

7.028 Thus, an acquirer only recognizes the acquisition-date fair value of a liability associated with exit or disposal activities of the acquiree as part of a business combination if those costs meet the criteria for recognition under ASC Subtopic 420-10, *Exit or Disposal Cost Obligations - Overall,* as of the acquisition date.

7.029 If an exit or disposal activity is undertaken by an acquiree shortly before the date of acquisition, consideration should be given to whether the activity should be accounted for as part of the business combination, or as a separate transaction. If the exit or disposal activity is undertaken at the request of, and for the benefit of, the acquirer, the activity is not a part of the business combination and should be accounted for as a separate transaction.

7.030 An acquiree may undertake an exit or disposal activity that will be implemented only if a planned business combination occurs. ASC paragraphs 805-20-55-50 through 55-51 indicate that, if a company that has agreed to a business combination develops a plan to terminate certain employees, but the plan will be implemented only if the combination is consummated, a liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination should be recognized only when the business combination is consummated, even if consummation is probable at an earlier date. If the activity was undertaken at the request of the acquirer or was designed primarily for the economic benefit of the acquirer or the combined entity following the acquisition, the associated costs would not be a part of the accounting for the business combination and no liability would be recorded at the acquisition date. Instead, the activity would be accounted for as a separate transaction. See the discussion of *Determining What Is Part of the Business Combination Transaction* in Section 11.

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RESTRUCTURING OR EXIT ACTIVITIES OF THE ACQUIRER AND INTEGRATION COSTS AN ACQUIRER EXPECTS TO INCUR AS A RESULT OF AN ACQUISITION

Restructuring and Exit Activities of the Acquirer

7.031 An acquirer may expect to incur costs associated with restructuring or exit activities related to its preexisting operations as a result of an acquisition. These costs are not liabilities of the acquiree, and are not part of the accounting for the acquisition. Rather, such costs are accounted for in accordance with other applicable GAAP including but not limited to ASC paragraphs 715-30-25-8 through 25-13, ASC Subtopics 712-10 and 420-10.

Integration Costs the Acquirer Expects to Incur

7.032 Costs an acquirer expects to incur to integrate the activities of an acquiree into the acquirer's operations are neither liabilities of the acquiree nor part of the accounting for the acquisition. The combined entity would capitalize or expense these costs in its post-combination financial statements, based on the nature of the item and the acquirer's accounting policy for the costs. However, plans to incur certain integration costs may affect the determination of the fair value of assets of the acquired entity. If market participants would be expected to incur integration costs with respect to an asset acquired in a business combination, then the fair value of the asset would be determined giving consideration to such expectation. For example, if market participants would be expected to relocate specialized manufacturing activities of an acquiree to reduce freight costs, then the anticipated costs of relocating the specialized equipment used in the manufacturing process would be considered in determining the fair value of the machinery and equipment.

7.033 Examples of planned integration costs that would not be liabilities of an acquiree and would not be recognized in the accounting for the acquisition, but depending on the facts and circumstances, may be capitalized in the post-combination financial statements of the combined entity based on the acquirer's accounting policy for such costs, if they extend the useful life or enhance the service potential of the related assets, are:

- Costs to purchase new signs with the acquirer's logo to replace acquiree's existing signs;
- Costs to upgrade the acquiree's plant or store locations to meet specifications of the acquirer;
- Costs to upgrade the acquiree's computer software and hardware; and
- Costs to purchase new computers for the acquiree's location.

Example 7.2: Costs to Prepare Acquired Equipment for Its Intended Use

ABC Corp., a company involved in the mining industry, acquires DEF Corp. in a business combination. The assets acquired from DEF include mining equipment

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located in an abandoned mine in a remote location. There is no expectation that the mine will be reopened, nor is there a reasonable prospect that a market participant could use the equipment in the immediate surrounding area. ABC decided that, following the acquisition, it will dismantle the acquired mining equipment and transport it to one of its existing mining properties, where it will use the equipment together with existing mining equipment to increase output and lower extraction costs. ABC has also determined that other market participants would dismantle the mining equipment and employ it in a similar manner at mining activities in other locations.

In applying the acquisition method to this transaction, ABC recognizes the mining equipment as an asset, measured at its acquisition-date fair value. The acquisition-date fair value of the equipment might be determined based on observed prices for similar equipment, adjusted for dismantling costs, and differentials in the condition and location of the equipment and installation costs, such that the fair value measurement reflects the current condition and location of the equipment. The cost of dismantling, overhauling and reconditioning, relocating, and reassembling the mining equipment is not a liability at the acquisition date, and thus is not part of the accounting for the acquisition.

7.034 Examples of integration costs that would not be liabilities of an acquiree and would not be recognized in the accounting for the acquisition, and would be expensed as incurred are:

- Consulting fees to identify combined entity goals; and
- Advertising costs for a program to announce the acquisition or to promote the combined entity.

RECOGNITION OF PREPAYMENT PENALTIES ASSOCIATED WITH DEBT ASSUMED IN A BUSINESS COMBINATION

7.035 An acquirer recognizes a liability equal to the acquisition-date fair value of the acquiree's debt legally assumed by the acquirer as part of the acquisition. If the debt's terms require it to be extinguished as part of or immediately following a business combination, for example because of a change-in-control provision included in the debt agreement, the fair value of the debt should be determined giving consideration to the contractual provision of the debt agreement requiring prepayment in the event of a change-in-control. However, if the debt's terms do not require it to be extinguished as part of a business combination but the acquirer chooses to repay the debt on the acquisition date, the acquirer would evaluate whether a portion of the settlement should be recognized as an expense in the acquirer's postcombination financial statements if the settlement amount exceeds the acquisition date fair value of the debt.

7.036 If the acquirer does not legally assume the acquiree's debt as part of the business combination and the debt is extinguished on the acquisition date, any funds provided by the acquirer to fund the extinguishment of the acquiree's debt should be reflected by the acquirer as consideration transferred. For guidance on presenting payments to extinguish

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an acquiree's debt in the statement of cash flows, see chapter 18 of KPMG Handbook, Statement of cash flows. See Section 17 for a discussion of the fair value measurement of debt assumed by the acquirer in a business combination.

7.037–7.065 Paragraphs not used.

Examples 7.3–7.6 not used.

RECOGNITION OF INTANGIBLE ASSETS SEPARATELY FROM GOODWILL

7.066 ASC Section 805-10-20 defines an intangible asset as an asset (not including a financial asset) that lacks physical substance (see Section 26 for a discussion of alternatives available for nonpublic entities). As used in ASC Topic 805, the term *intangible asset* excludes goodwill.

7.067 An acquirer recognizes separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it either:

(1) Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (referred to as the separability criterion); or

(2) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (referred to as the contractual-legal criterion). ASC Section 805-10-20, ASC paragraph 805-20-25-10

7.068 The separability and contractual-legal criteria were originally developed and included in Statement 141. The issuance of explicit guidance to assist preparers in identifying such assets, and requiring that such assets be accounted for separately from goodwill, was deemed appropriate by the FASB in view of the various types of intangible assets that represent an increasing proportion of the assets of many entities. This guidance was carried forward to ASC Topic 805.

Contractual-Legal Criterion

ASC Paragraph 805-20-55-2

…An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations. For example:

a. An acquiree leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from

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goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract. See also [ASC] paragraphs 805-20-25-12 through 25-13.

b. An acquiree 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 separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize 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 acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

7.069 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 with customers or suppliers; and patents often protect technological and scientific innovations. The FASB concluded that an intangible asset arising from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill, and an acquired intangible asset with that characteristic should be recognized separately from goodwill. Statement 141(R), par. B163

7.070 All intangible assets acquired in a business combination that meet the contractual-legal criterion are recognized at the acquisition date. Some intangible assets that meet the contractual-legal criterion may also be separable; however, separability is not a required condition for an intangible asset that meets the contractual-legal requirement to be recognized.

Separability Criterion

ASC Paragraph 805-20-55-3

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it.

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ASC Paragraph 805-20-55-4

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 transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

7.071 An intangible asset meets the separability criterion if it is *capable* of being sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. Thus, only the *capability* of an asset to be separated from the entity and exchanged for something else of value is required, not management's intent to do so. If the sale, transfer, license, rent or exchange of an intangible asset is restricted by law or agreement, then the separability criterion has not been met.

7.072 If an intangible asset is not capable of being separated from the entity by itself, but can be combined with a related contract, identifiable asset, or liability and separated, the separability criterion is met. This provision is included in ASC Topic 805 to address the FASB's observation that some intangible assets are so closely related to another asset or liability that they are usually sold as a package; and if those intangible assets were subsumed into goodwill, gains might inappropriately be recognized if the intangible asset was later sold along with the related asset or obligation. However, *related contract, identifiable asset, or liability* requires a close relationship to the identified intangible asset (e.g., deposit liabilities and the related depositor relationship intangible asset), and does not extend to intangible assets that can only be separated as part of an asset group (ASC Section 360-10-20 defines *asset group* as "the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities"). Statement 141(R), pars. B166-B167 and B169

7.073 The following examples from ASC paragraph 805-20-55-5 illustrate the identification of acquired intangible assets that are separable from the acquiree only in combination with a related contract, asset, or liability.

Example 7.7: Depositor Relationships

Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognize a depositor relationship intangible asset separately from goodwill.

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Example 7.8: Registered Trademarks

An acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, 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 can be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Items That Are Not Identifiable

7.074 ASC Section 805-10-20 defines goodwill as "an asset representing the future economic benefits arising from other assets acquired in a business combination . . . that are not individually identified and separately recognized." An intangible asset that does not meet either the separability criterion or the legal-contractual criterion at the acquisition date is subsumed into goodwill. Likewise, any value attributable to items that do not qualify as assets at the acquisition date are subsumed into goodwill. See Section 22 for additional guidance on goodwill and other intangible assets and KPMG Handbook, Impairment of nonfinancial assets.

Assembled Workforce

7.075 An assembled workforce is an example of an item that is not an identifiable intangible asset, and thus is not recognized separately but is subsumed into goodwill. An assembled workforce is "an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date." ASC paragraph 805-20-55-6

7.076 The FASB noted that because an assembled workforce is a collection of employees, it does not arise from contractual or legal rights (although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract). The FASB also noted that an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset, or liability. An assembled workforce cannot be sold, transferred, licensed, rented, or otherwise exchanged without causing disruption to the acquirer's business. In contrast, an entity could continue to operate after transferring an identifiable asset. Statement 141(R), par. B178

7.077 We do not believe that a collective bargaining agreement would support recognition of an intangible asset for the workforce covered by the agreement. Such agreements normally do not obligate the covered employees to remain with the employer for a specified period. However, we believe the underlying contract, similar to other contractual agreements, could meet the criteria for identification as a separate intangible asset (favorable contract terms) or a liability (unfavorable contract terms), although we believe these situations would arise only in limited circumstances, such as those in which

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the existence of a collective bargaining agreement gives an acquiree a distinct advantage in its competitive marketplace.

7.078 We do not believe that a group of individual employment contracts entered into by an acquiree with a broad group of employees should be viewed, collectively, as an assembled workforce. However, the facts and circumstances in each situation should be evaluated. For example, noncompete provisions included in such contracts should be separately evaluated and recognized as identifiable intangible assets. See discussions of Noncompete Agreements and Employment Contracts in this Section.

Items That Do Not Qualify as Assets at the Acquisition Date

7.079 The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets (i.e., do not meet the definition of assets in Concepts Statement 8) at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective *new* customers at the acquisition date. Because the potential contracts are not themselves assets at the acquisition date, the acquirer does not recognize them separately from goodwill. The acquirer should not reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date. (ASC paragraph 805-20-55-7) See Section 10 for a discussion of the *Measurement Period*.

7.080 If potential contracts the acquiree was negotiating with new customers at the date of the acquisition were a significant consideration in negotiating and completing the acquisition, and the potential contracts are not obtained following the acquisition, consideration should be given as to whether the event is a change in events or circumstance that would more likely than not reduce the fair value of a reporting unit below its carrying amount and, thus, trigger an impairment test. See Section 22 and KPMG Handbook, Impairment of nonfinancial assets, for additional discussion on frequency of impairment testing.

Illustrative List of Intangible Assets That Are Identifiable

7.081 The following table lists intangible assets that meet the identifiable criteria (i.e., that either arise from contractual-legal rights or are separable) for recognition as intangible assets apart from goodwill. This list, compiled from ASC paragraphs 805-20-55-11 through 55-45 with the addition of in-process research and development and crypto assets, is not intended to be all-inclusive. Additional discussion and examples of intangible assets that would be recognized separately from goodwill are presented following the table. See Section 26 for more information.

	Contractual / Legal*	Separable**
Marketing-Related	Trademarks and trade names	
	Service marks, collective marks, and certification marks	

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	Trade dress (unique color, shape, or package design) Newspaper mastheads Internet domain names Noncompete agreements	
Customer-Related	Order or production backlog Customer contracts and related customer relationships	Customer lists Noncontractual customer relationships
Artistic-Related	Plays, operas, ballets Books, magazines, newspapers, and other literary works Musical works such as compositions, song lyrics, and advertising jingles Pictures and photographs Video and audiovisual material, including motion pictures or films, music videos, and television programs	
Contract-Based	Licensing, royalty, and standstill agreements Advertising, construction, management, service, or supply contracts Lease agreements (whether the acquiree is the lessee or the lessor) Construction permits Franchise agreements Operating and broadcast rights Use rights (e.g., drilling, water, air, mineral, timber cutting, and route authorities) Servicing contracts (e.g., mortgage servicing) Employment contracts	
Technology-Based	Patented technology Computer software and mask works Trade secrets (e.g., secret formulas, processes, and recipes)	Unpatented technology Databases (e.g., title plants) In-process research and development Crypto assets

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* Intangible assets arising from contractual or other legal rights without regard to separability. Assets meeting this criterion might also be separable, but separability is not a necessary condition for an asset to meet the contractual-legal criterion.
** Intangible assets arising because of an ability to separate. Customer lists would not meet the separability criterion to be recognized apart from goodwill if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging the asset. ASC paragraphs 805-20-55-3 through 55-4

Marketing-Related Intangible Assets

7.082 Marketing-related intangible assets are often protected through registration with governmental agencies or by other means and, in such instances, meet the contractual-legal criterion. If such assets do not meet the contractual-legal criterion, they are recognized separately from goodwill only if the separability criterion is met. ASC paragraphs 805-20-55-16 through 55-19 include a discussion of certain marketing-related intangible assets:

> **Trademarks, Trade Names, Service Marks, Collective Marks, and Certification Marks**
>
> **ASC Paragraph 805-20-55-16**
>
> Trademarks are words, names, symbols, or other devices used in trade to indicate the source of a 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 identify the goods or services of members of a group. Certification marks certify the geographical origin or other characteristics of a good or service.
>
> **ASC Paragraph 805-20-55-17**
>
> Trademarks, trade names, 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 it is protected legally through registration or other means, a trademark or other mark acquired in a business combination is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired in a business combination can be recognized separately from goodwill if the separability criterion is met, which normally it would be.
>
> **ASC Paragraph 805-20-55-18**
>
> The terms *brand* and *brand name*, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Statement does not preclude an entity from recognizing, as a single asset separately 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.

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Internet Domain Names

ASC Paragraph 805-20-55-19

An internet domain name is a unique alphanumeric name that is used to identify a particular numeric internet address. Registration of a domain name creates an association between that name and a designated computer on the internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination meets the contractual-legal criterion.

Noncompete Agreements

7.083 Noncompete agreements are agreements that place restrictions on a person's or a business' ability to compete with another entity and, as such, meet the contractual-legal criterion for recognition as intangible assets. The restrictions generally relate to specified markets and/or specified products or activities for some period of time. These agreements may be entered into on a stand-alone basis, or may be embedded in another agreement, such as an acquisition agreement or an employment contract.

7.084 The valuation of noncompete agreements is often difficult and requires consideration of many factors, including uncertainties about enforceability, the effect of competition absent the noncompete agreement, etc. See Section 17 for a discussion of the fair value measurement of noncompete agreements. Section 26 discusses the private company and not-for-profit accounting alternative related to recognition of noncompete agreements.

Customer-Related Intangible Assets

7.085 Customer-related intangible assets typically include intangible assets that meet the contractual-legal criterion and intangible assets that meet the separability criterion. See Section 26 for a discussion of the private company and not-for-profit accounting alternative related to recognition of certain customer-related intangible assets.

Customer Lists

7.086 A customer list consists of information about customers, such as names and contact information. A customer list also may be a database that includes other information about the customers, such as order histories and demographic information. Customer lists generally do not arise from contractual or other legal rights, but are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion. (ASC paragraph 805-20-55-21) If terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers, the acquired customer list would not meet the separability criterion. ASC paragraph 805-20-55-4

7.087 It is important to distinguish between a customer list and a customer base. A customer list includes specific information about the customer, such as name, contact information, order history, and demographic information. A customer base does not meet the criteria for recognition apart from goodwill because a customer base represents a

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group of customers that are neither known nor identifiable to the entity (e.g., the customers that visit a particular fast-food restaurant).

Order or Production Backlog

7.088 Order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable. ASC paragraph 805-20-55-22

Customer Contracts and Related Customer Relationships

7.089 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree. ASC paragraph 805-20-55-23

7.090 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ. ASC paragraph 805-20-55-24

7.091 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. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in ASC paragraph 805-20-55-22, an order or a production backlog arises from contracts such as purchase or sales orders and therefore is a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion. ASC paragraph 805-20-55-25

Example 7.9: Order Backlog

Acquirer Company (AC) acquires Target Company (TC) in a business combination on December 31, 20X5. TC does business with its customers solely through purchase and sales orders. At December 31, 20X5, TC has a backlog of customer purchase orders from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of TC's customers also are recurring customers. However, as of December 31, 20X5, TC has no open purchase orders or other contracts with those customers. Regardless of whether they are cancelable or not, the purchase orders from 60 percent of TC's customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 percent of its customers through contracts, not only the purchase orders but also TC's customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40

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percent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at December 31, 20X5. ASC paragraph 805-20-55-56

Example 7.10: Customer Relationships (No Existing Contracts)

An entity may acquire an acquiree involved in a seasonal business during its off-season when typical customer contracts do not exist. If the acquiree has a practice of establishing customer relationships through contracts at a time other than at the acquisition date, the acquiree's customer relationships are considered to arise from contractual rights.

7.092 Additional examples of customer contracts and related customer relationships intangible assets are presented below.

Example 7.11: Customer Relationships—Contractual-Legal Criterion

AC acquires TC in a business combination on December 31, 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable. The agreement, whether cancelable or not, meets the contractual-legal criterion.

Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC's customer relationship with Customer meet the contractual-legal criterion. ASC paragraph 805-20-55-54

Example 7.12: Customer Relationships—More Than One Relationship with a Single Customer

AC acquires TC in a business combination on December 31, 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancelable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC's relationship with Customer related to both sporting goods and electronics. However, if AC determines that the customer relationships with Customer for sporting

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goods and for electronics are separate from each other, AC would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset. ASC paragraph 805-20-55-55

Example 7.13: Customer Relationships—Contractual-Legal Criterion

AC acquires TC, an insurer, in a business combination on December 31, 20X5. TC has a portfolio of one-year motor insurance contracts that are cancelable by policyholders. Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. ASC Subtopic 350-30 applies to the customer relationship intangible asset. ASC paragraph 805-20-55-57

Example 7.14: Customer Relationships Not Recognized (Contractual-Legal Criterion Not Met) and Customer List Not Recognized Due to Confidentiality Restrictions)

ABC Corp. acquires DEF Corp., a medical testing facility, in a business combination on December 31, 20X5. DEF provides testing services to patients, such as blood screening, based on referrals from their physicians (i.e., DEF does not have a contractual relationship with its customers). DEF maintains a database with each patient's information, such as name, address, telephone number, doctor's name, insurer's name, and policy number. DEF's patients are Medicare patients, and patient information is protected by privacy rules (e.g., HIPPA).

ABC should not recognize a separate intangible asset for DEF's customer relationships because ABC determines that those relationships do not meet the contractual-legal criterion. Additionally, the customer list does not meet the separability criterion because privacy rules and regulations over patient information prevent selling, transferring, licensing, or exchanging patient information separately from the acquired entity.

Example 7.15: Customer Relationships—Overlapping Customer Relationships – Scenario 1

Q. ABC Corp. acquires DEF Corp. in a business combination. ABC and DEF operate in the same industry and both sell their products to Customer A. Assuming that the relationship meets the separability or legal-contractual criterion, should ABC recognize an intangible asset for DEF's relationship with Customer, in view of the fact that ABC already has a relationship with Customer A?

A. ABC should recognize a customer relationship intangible asset for DEF's relationship with Customer. However, the fair value of the asset depends on the

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specific facts and circumstances. For example, if other market participants are expected to have a customer relationship with Customer A and would not ascribe any value to DEF's relationship with Customer A as a result of the acquisition of DEF, the intangible asset may have very little value. However, if other market participants are not expected to have a customer relationship with Customer A, or would be expected to place additional value on the relationship as a result of the acquisition of DEF, ABC should recognize the acquired customer relationship as a separately identifiable intangible asset, measured at fair value, based on the assumptions market participants would use.

Example 7.16: Customer Relationships—Overlapping Customer Relationships – Scenario 2

Q. Assume the same fact pattern as Example 7.15, except ABC Corp. intends to discontinue selling the products that are the basis of DEF's relationship with Customer A. Should ABC recognize the relationship with Customer A as a separately identifiable intangible asset?

A. It depends. If market participants would also discontinue selling the products that are the basis of DEF's relationship with Customer A and would place no value on the relationship, then ABC would not recognize an intangible asset for DEF's relationship with Customer A. However, if market participants would continue selling the products that are the basis of DEF's relationship with Customer A, ABC should recognize the acquired customer relationship as a separately identifiable intangible asset measured at fair value, based on the assumptions market participants would use. See discussion of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use in this Section.

Example 7.17: Acquiree's Preexisting Customer Relationship With Acquirer Is Not Recognized as a Customer Relationship Intangible Asset by the Acquirer

ABC Corp. acquires DEF Corp., one of its suppliers, in a business combination. One of the strategic reasons for acquiring DEF is to gain access to DEF's customers (ABC is one DEF's customers). It would not be appropriate for ABC to include DEF's relationship with ABC in the measurement of the customer relationship intangible asset arising from the acquisition of DEF, because the asset cannot be disposed of and there are no future economic benefits from the customer relationship that the consolidated entity could realize with parties outside of the group. In addition, from the perspective of the consolidated group, the definition of an asset is not met.

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Q&A 7.0: Customer Relationships - Healthcare Patient Relationships

Q. Can an acquirer recognize intangible assets in an acquisition of a healthcare entity, such as a physician practice, related to patient relationships when there are regulatory restrictions?

A. Generally, no. An acquirer will not recognize an intangible asset related to customer relationships (i.e., patients) when acquiring a healthcare entity.

When assessing the separability and contractual-legal criteria in this scenario, a healthcare entity should consider the regulatory environment in which it operates. Certain laws and regulations (e.g., The Federal Anti-Kickback Statutes, the Stark Law and the privacy laws) were established to protect the patient and prevent fraud and abuse among healthcare organizations, providers, payors, manufacturers, and other entities receiving federal reimbursement through Medicare and Medicaid programs.

Therefore, a patient relationship intangible asset that is not capable of being sold, transferred, licensed, rented, or exchanged will not meet the separability criterion because doing so could indicate a potential violation of certain laws and regulations.

The legal environment in which healthcare entities operate prohibits actual or implied ongoing contracts with patients and any control by the healthcare entity over the future economic benefits of patient care. Therefore, generally there are no contractual or legal rights that arise in a combination between an acquirer and a healthcare entity (e.g., physician practice) for patient relationships (e.g., patient lists). Accordingly, the contractual legal criterion will not be met.

Noncontractual Customer Relationships

7.093 A customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of noncontractual customer relationship would provide evidence that the noncontractual customer relationship is separable. For example, relationships with depositors are frequently exchanged with the related deposits and therefore meet the criteria for recognition as an intangible asset separately from goodwill. ASC paragraph 805-20-55-27

Artistic-Related Intangible Assets

7.094 Artistic-related assets acquired in a business combination are identifiable if they arise from contractual or legal rights such as those provided by copyright. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. An acquirer is not precluded from recognizing a copyright intangible asset and any related assignments or license agreements as a single asset, provided they have similar useful lives. ASC paragraph 805-20-55-30

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Contract-Based Intangible Assets

7.095 Many contract-based intangible assets arise from noncancelable executory contracts. An asset or liability should be recognized as part of the accounting for the acquisition to the extent the terms of the noncancelable contract are favorable or unfavorable compared with the market terms of the same or similar items at the acquisition date.

7.096 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible asset. If the terms of a contract are favorable or unfavorable relative to market terms, the acquirer recognizes an intangible asset or a liability in its accounting for the acquisition. (ASC paragraph 805-20-55-31) If a separate favorable or unfavorable intangible asset or liability is recognized for a customer contract, we believe the amortization of that asset or liability should be classified as revenue in the income statement. Additionally, an at-market executory contract such as a revenue, lease or other type of contract may also have inherent fair value that gives rise to other identifiable intangible assets that should be recognized in the acquisition accounting. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship.

Licensing Agreements

7.097 Licensing agreements involve contractual arrangements under which the owner (licensor) of an asset (e.g., intellectual property, trademarks, or copyrighted works) grants permission to a licensee to use the asset, usually for a fee. Licensing agreements typically include terms relating to the fees to be paid by the licensee to the licensor, period of use, stipulations on use (e.g., geographic area), and renewal.

7.098 - 7.099 Paragraphs not used.

Purchase and Supply Contracts

7.100 Purchase and supply contracts for the acquisition of supplies or items used in the manufacturing and production process, and contracts for the sale of products, are executory contracts. To the extent the terms of a purchase or supply contract of an acquiree are favorable or unfavorable compared with the market terms for the same or similar items at the acquisition date, the acquirer should recognize an intangible asset or a liability.

Example 7.18: Supply Contracts

Q. An acquiree has several long-term supply contracts on which it is generating operating losses. The losses arise because the business is operating at less than full capacity, and because the selling prices in the contracts are below the market terms of the same or similar items at the acquisition date. All other terms of the contracts are consistent with current market terms for the same or similar contracts.

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Should the acquirer recognize a liability at the acquisition date for the supply contracts as part of the acquisition accounting?

A. Yes. The acquirer should recognize a liability for the unfavorable contracts. The amount recognized should be the fair value of the amount by which the terms of the supply contract are unfavorable relative to market terms. In this case, the determination of the liability to be recognized would be based on the fair value of the differential between the selling prices in the contracts and the current market terms for the same or similar items at the acquisition date. However, the acquirer should not recognize a liability for the inefficiencies of operating the plant at less than full capacity.

See Sections 16 through 21 for guidance on the measurement of intangible assets or liabilities arising from unfavorable contracts assumed in an acquisition.

7.101 Paragraph not used.

Franchise Agreements

7.102 Franchise agreements are contractual arrangements through which a party (the franchisor) grants rights to another party (the franchisee) to operate a franchised business for a specified period. The purpose of the agreement is the distribution of a product or service, or an entire business concept, within a particular market area. See ASC Topic 952, *Franchisors.* In addition to intangible assets or liabilities an acquirer recognizes as a result of terms of a franchise agreement entered into by an acquiree that are favorable or unfavorable relative to market terms, there may be additional intangible assets that the acquirer should recognize (e.g., customer list and/or customer contracts and related customer relationships intangible assets).

Use Rights

7.103 Use rights such as drilling, water, air, timber cutting, and route authorities are contract-based intangible assets that are accounted for separately from goodwill. However, certain use rights may have characteristics of tangible assets, rather than intangible assets. For example, certain mineral rights, defined as the right to explore, extract, and retain at least a portion of the benefits from mineral deposits, are tangible assets. Use rights should be accounted for based on their nature. ASC paragraph 805-20-55-37

Servicing Contracts

7.104 Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset (or liability) by one of the following:

(a) If the transfer of the servicer's financial assets meets the requirements for sale accounting; or

(b) Through the separate acquisition or assumption of a servicing obligation that does not relate to financial assets of the combined entity.

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7.105 ASC Subtopic 860-50, *Transfers and Servicing - Servicing Assets and Liabilities,* provides guidance on accounting for servicing contracts. ASC paragraphs 805-20-55-33 through 55-34

7.106 If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with the servicing obligation, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset. ASC paragraph 805-20-55-35

Employment Contracts

7.107 Employment contracts that are favorable to an acquiree (employer) because the pricing of the contracts is favorable (from the acquiree's perspective) relative to market terms (using a market participant's perspective) are recognized as intangible assets by the acquirer. (ASC paragraph 805-20-55-36) Employment contracts that are unfavorable to an acquiree (employer) are recognized as liabilities by the acquirer.

7.108 Identifying employment contracts of an acquiree that are favorable or unfavorable, and that would qualify for recognition as an intangible asset or a liability by an acquirer, will often prove difficult. For example, such identification will first require a determination as to the enforceability of the contract. The measurement of such contracts, if determined to be enforceable, may also prove difficult. For example, if an employment contract is identified as favorable and enforceable, little or no value may be assigned to the contract by the acquirer unless a market participant would be expected to enforce the contract. Similarly, if a contract is identified as unfavorable and enforceable, the measurement of the fair value of the unfavorable contract would take into consideration, among other things, the likelihood that the employee would seek enforcement of the contract, the likelihood that the contract could be settled, and other relevant considerations.

7.109 An example of a situation where favorable or unfavorable employment contracts might be recognized would be the acquisition of a professional sports team where player contracts prohibit or place limitations on players' ability to move to another team, and prohibit or place limitations of the sports team's ability to trade its player rights to another team. In such instances, there may be sufficient evidence to support the enforceability of both favorable and unfavorable player contracts and, in such event, an acquirer would recognize an intangible asset for favorable contracts and a liability for unfavorable contracts, based on the pricing of the contracts relative to market terms.

7.110 Employment contracts entered into by an acquiree may include noncompete provisions. Noncompete agreements should be separately recognized and measured by the acquirer. See Section 17 for a discussion of the measurement of favorable or unfavorable employment contracts and noncompete agreements.

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Technology-Based Intangible Assets

Patented and Unpatented Technology

7.111 Technology-related assets generally comprise a set of technical processes, intellectual property, and the institutional understanding within an organization with respect to various processes and products. Those assets generally can be classified as patented and unpatented technology. By definition, a patent is a right granted from the government or other public authorities that confers on the creator the sole right to make, use, or sell an invention for a set period of time. As some companies do not aggressively pursue patents, unpatented or proprietary technology also should be examined. Patented technology with legal protection meets the contractual-legal criterion for recognition as an intangible asset. Unpatented technology may meet the separability criterion to be recognized apart from goodwill unless there are restrictive terms that prohibit an entity from selling, leasing, or otherwise exchanging the technology.

Computer Software and Mask Works

7.112 Computer software and program formats acquired in a business combination that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets. Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works with legal protection that are acquired in a business combination meet the contractual-legal criterion for recognition as intangible assets separately from goodwill. ASC paragraphs 805-20-55-40 through 55-41

Trade Secrets (e.g., Secret Formulas, Processes, and Recipes)

7.113 A trade secret is "information, including a formula, pattern, recipe, 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."[1] If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination are identifiable only if the separability criterion is met, which is likely to be the case. However, if the trade secret is not legally protected, the fair value of the trade secret could be lower. ASC paragraph 805-20-55-45

Databases, Including Title Plants

7.114 Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. A database acquired in a business combination that is protected by copyright meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity's normal operations, such as customer lists, or specialized information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed, or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database

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acquired in a business combination meets the separability criterion. ASC paragraph 805-20-55-42

7.115 Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired in a business combination meet the separability criterion. ASC paragraph 805-20-55-43

Research And Development Assets

> **Statement 141(R)**
>
> B149. This Statement requires an acquirer to recognize all tangible and intangible research and development assets acquired in a business combination, as was proposed in the 2005 Exposure Draft. Previously, FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method,* required an acquirer to measure and immediately expense tangible and intangible assets to be used in research and development that had no alternative future use. A research and development asset was recognized as such only if it had an alternative future use. …
>
> B150. The FASB concluded that the requirement to immediately write off assets to be used in research and development activities if they have no alternative future use resulted in information that was not representationally faithful. In addition, eliminating that requirement furthers the goal of international convergence of accounting standards. Therefore, this Statement supersedes Interpretation 4 and requires research and development assets acquired in a business combination to be recognized regardless of whether they have an alternative future use.

7.116 Before the issuance of ASC Topic 805, FIN 4 required an acquirer to measure and immediately expense tangible and intangible assets of an acquiree to be used in research and development (R&D) activities, unless such assets had an alternative future use. ASC Topic 805 nullifies FIN 4 and requires all R&D assets acquired in a business combination to be recognized at the acquisition date at their acquisition-date fair value, regardless of whether they have an alternative future use. See the discussion of *Research and Development Activities* below and the discussion of the fair value measurement of research and development assets in Section 17.

Research and Development Activities

7.117 The ASC Master Glossary defines research and development as follows:

> *Research* is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as *product*) or a new process or technique (referred to as *process*) or in bringing about a significant improvement to an existing product or process.

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> *Development* is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

ASC paragraphs 730-10-15-4(d) through 15-4(e) state that it does not apply to routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though those alterations may represent improvements nor to market research or market testing activities.

7.118 ASC Section 730-10-55 provides the following examples of activities that typically would be included or excluded from R&D activities:

Example 7.19: Activities That Typically Would Be Included in Research and Development Activities

a. Laboratory research aimed at discovery of new knowledge.

b. Searching for applications of new research findings or other knowledge.

c. Conceptual formulation and design of possible product or process alternatives.

d. Testing in search for or evaluation of product or process alternatives.

e. Modification of the formulation or design of a product or process.

f. Design, construction, and testing of pre-production prototypes and models.

g. Design of tools, jigs, molds, and dies involving new technology.

h. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production.

i. Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.

j. Tools used to facilitate research and development or components of a product or process that are undergoing research and development activities.

ASC paragraph 730-10-55-1

Example 7.20: Activities That Typically Would Be Excluded from Research and Development Activities

a. Engineering follow-through in an early phase of commercial production.

b. Quality control during commercial production including routine testing of products.

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c. Trouble-shooting in connection with breakdowns during commercial production.

d. Routine, ongoing efforts to refine, enrich, or otherwise improve on the qualities of an existing product.

e. Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity.

f. Seasonal or other periodic design changes to existing products.

g. Routine design of tools, jigs, molds, and dies.

h. Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants, and (2) facilities or equipment whose sole use is for a particular research and development project.

i. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

ASC paragraph 730-10-55-2

Research Performed for Others under Contractual Arrangements

7.119 Costs associated with performing R&D activities for others under a contractual arrangement are not R&D activities within the scope of ASC Subtopic 730-10. Indirect costs that specifically are reimbursable under the terms of a contract also are excluded from the scope of ASC Subtopic 730-10. ASC paragraph 730-10-15-4(a)

Completed Research and Development Activities

7.120 Identifiable assets resulting from R&D activities of an acquiree might include patents received or applied for, blueprints, formulas, and specifications or designs for new products or processes. These assets also include assets referred to in practice as core technology and/or base technology. As discussed in this Section, the acquirer recognizes any such assets arising from an acquisition separately from goodwill, measured at their acquisition-date fair value.

In-Process Research And Development Activities

7.121 R&D projects that are underway but have not been completed are referred to as in-process research and development (IPR&D). Intangible assets used in IPR&D, including the IPR&D project itself, are known as IPR&D assets. Therefore, an IPR&D project is a type of IPR&D asset. Sometimes, one project can include multiple assets. For example, a project for one drug compound could include multiple jurisdictional IPR&D assets. See Paragraph 7.134a for additional discussion on units of account in an IPR&D project.

IPR&D Activities Are Subject to ASC Topic 805's Recognition Principle

7.122 ASC Topic 805 provides no exception to the recognition principle for IPR&D assets. IPR&D projects acquired in a business combination that meet the definition of an

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asset in Concepts Statement 8 at the acquisition date are recognized by the acquirer at their acquisition-date fair value.

7.123 Paragraph not used.

Identifying Research and Development Assets

7.124 Determining what constitutes an asset used in R&D and measuring its fair value can be difficult. To provide guidance in this area, the AICPA formed a Task Force to develop an AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities* (IPR&D Guide). The IPR&D Guide was issued in December 2013 to identify leading practices in the financial reporting of assets acquired to be used in R&D activities, including specific IPR&D projects. The Task Force noted that business combinations involving the software, electronic devices, and pharmaceutical industries have traditionally exhibited the greatest proportional amount (in terms of total value) of assets acquired to be used in R&D activities. Accordingly, the IPR&D Guide focuses on those industries. Although the IPR&D Guide has no authoritative status, its guidance has been used as a resource by preparers, valuation professionals, and auditors in all industries in identifying, valuing, and reporting IPR&D assets acquired in a business combination.

7.125 The IPR&D Guide reflects guidance in ASC Subtopic 820-10 and ASC Topic 805. ASC Subtopic 820-10 provides a framework for measuring fair value when accounting pronouncements require or permit fair value measurements. See Sections 16 through 21 for a discussion of fair value measurements in accordance with ASC Subtopic 820-10, including the fair value measurement of IPR&D. ASC Topic 805 addresses the accounting for business combinations, and as part of that guidance discusses R&D assets acquired in a business combination.

7.126 ASC Subtopic 820-10 requires a market participant perspective to be used in measuring fair value of assets acquired and liabilities assumed in a business combination. Therefore, it is helpful to consider a market participant's perspective when identifying IPR&D assets. We believe that if an IPR&D project of an acquiree is expected to have value to a market participant, it would most likely meet the definition of an asset and therefore qualify for recognition by the acquirer at the acquisition date.

Q&A 7.1: Initial Measurement – IPR&D in a Development Arrangement

In 20X7, BioTech Corp. acquires PharmaDev Corp., which has a development arrangement with LabTest, Inc. that entitles each party to 50% of any future cash flows associated with the development, marketing, and sale of a pharmaceutical product.

Q. Does the right to 50% of the future cash flows from the IPR&D project constitute an identifiable asset in a business combination?

A. Yes. ASC paragraph 805-20-25-10 states that an intangible asset is identifiable if it meets the separability criterion or the contractual-legal criterion described in the definition of identifiable in the glossary to ASC Topic 805. In this case, PharmaDev's

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right to 50% of the expected cash flows from IPR&D meets the contractual-legal criterion to be recognized as an identifiable intangible asset.

Q&A 7.2: Subsequent Measurement – IPR&D in a Development Arrangement

In 20X8, BioTech Corp. acquires LabTest, Inc., including the other 50% of the future cash flows associated with the IPR&D asset referenced in Q&A 7.1. The IPR&D project is an intangible asset that will be measured and recognized at fair value as of the 20X8 acquisition date.

Q. What effect, if any, will the 20X8 acquisition of the remaining rights to the IPR&D asset have on the existing carrying amount of PharmaDev Corp.'s IPR&D rights acquired in 20X7?

A. The initial intangible asset acquired in 20X7 and the intangible asset acquired in 20X8 should be evaluated as two distinct intangible assets. Specifically:

- A fair value for the additional 50% rights to IPR&D acquired in 20X8 *less* than the carrying amount of the 50% acquired in 20X7 is an indication that the carrying amount of the 20X7 intangible asset is not recoverable (triggering event) and should be evaluated for impairment.
- A fair value of the additional 50% right to IPR&D acquired in 20X8 *greater* than the carrying amount of the 50% acquired in 20X7 does not cause a revaluation (write-up) of the 20X7 IPR&D intangible.

7.127 Following is a discussion of additional guidance included in the IPR&D Guide and its relationship to the guidance in ASC Subtopic 820-10 and ASC Topic 805.

An IPR&D Asset Is Recognized Only if an IPR&D Project Has Substance and Is Incomplete

7.128 The IPR&D Guide indicates, in addition to satisfying the general recognition criteria applicable to assets acquired in a business combination to be used in R&D activities, if the asset to be used in R&D activities is a specific IPR&D project, persuasive evidence should exist that each acquired IPR&D project has substance and is incomplete:

- Substance - For a specific IPR&D project of an acquired company to give rise initially to an IPR&D asset, the acquired company has performed R&D activities that constitute more than insignificant efforts and that
  - Meet the definition of R&D under ASC Subtopic 730-10 and
  - Result in the creation of value
- Incompleteness - There are remaining risks (e.g., technological or engineering) or certain remaining regulatory approvals at the date of

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acquisition, Overcoming those risks or obtaining the approvals requires that additional R&D costs are expected to be incurred after the acquisition.

The IPR&D Guide indicates that, at some point before commercialization and possibly before the end of the development or the pre-production stage, the R&D project is no longer incomplete for accounting purposes. If the project is complete, it is an intangible asset separate and apart from R&D activities.

IPR&D Guide Q&As Illustrating the Assessment of Whether an IPR&D Project Is Incomplete

7.129 The following Q&As taken from the IPR&D Guide illustrate the assessment of whether an IPR&D project is incomplete.

Example 7.21: The IPR&D Guide Q&A, par. 2.60: Specific R&D Projects – Incompleteness

Q. Company T was acquired in a business combination and had an IPR&D project to develop the next generation of its microchip. The project was estimated to be 70 percent complete in terms of costs incurred. Although time-consuming and expensive technological and engineering hurdles remain, they are not believed to be high-risk development issues and are not considered particularly difficult to accomplish. In fact, in similar previous development efforts, Company T consistently demonstrated that it could accomplish the remaining tasks once it got to a similar stage of completion. However, the remaining tasks are of the type described as R&D activities in ASC paragraph 730-10-55-1, rather than of the type of activities described in ASC paragraph 730-10-55-2 that are not considered R&D activities. Is the project incomplete?

A. Yes, because first customer acceptance of the microchip has not occurred. Even though the likelihood of success in achieving first customer acceptance may seem high based on Company T's history, first customer acceptance has not occurred, and additional qualifying R&D costs will be incurred. Consequently, completion of the project has not occurred at the date of acquisition.

Example 7.22: The IPR&D Guide Q&A, par. 2.61: Specific R&D Projects – Incompleteness

Q. Company A acquires Company T in a business combination. At the acquisition date, Company T has an R&D project in process to develop the next generation of its job scheduling software. Company T has delivered a working model of the software to several of its customers as part of the beta test stage. As of the acquisition date, engineers are working to incorporate improvements discovered as a result of the beta testing. Company A expects to complete the development and market any resulting product in a manner generally consistent with the plans of Company T that existed at the acquisition date. Is the project incomplete?

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A. Yes. The Task Force notes that although the project may have reached technological feasibility as discussed in ASC Subtopic 985-20, in this fact pattern the project is still incomplete. As discussed in ASC paragraph 985-20-25-2, "the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements." Despite reaching technological feasibility, additional research or development, or both, may be required for the product to be available for general release to customers. Conversely, if after reaching technological feasibility, this project required only minor, routine modifications prior to general release to customers, and the general release was imminent, this project would generally be considered to be completed.

Example 7.23: The IPR&D Guide Q&A, par. 2.62: Specific R&D Projects – Incompleteness

Q. Company A acquires Company T in a business combination. At the acquisition date, Company T has an application to market a new drug pending FDA approval. Both Company A and Company T believe that Company T completed all necessary tasks related to the filing (including having obtained satisfactory test results), and they believe that they will ultimately obtain FDA approval. Is the project incomplete?

A. Yes. Industry experience shows that there are uncertainties about obtaining approval for a new drug on filing with the FDA. ASC Subtopic 730-10 does not specifically address whether costs of obtaining FDA approval are R&D; however, the Task Force believes that such future expenditures satisfy the condition that, to be considered incomplete, additional R&D costs must be expected to be incurred by the reporting entity.

Example 7.24: The IPR&D Guide Q&A, par. 2.63: Specific R&D Projects – Incompleteness

Q. Company T is acquired in a business combination and is involved in the design, manufacture, and marketing of consumer video communications devices. Company T has a successful product in the market and has been working on the next generation of the product, which involves significant improvements to features and functions. Given the target market of young retail consumers, Company T plans to debut the new product at an upcoming trade show, followed shortly after by a nationwide marketing campaign. For competitive reasons, Company T does not allow prototypes of the product outside of its facilities, although it does use focus groups representing its target market demographics for feedback on design and features, product and performance quality, and marketing approaches. As of the acquisition date, Company T has approved the design and specifications of the latest prototype of new product as being ready for commercial manufacture. As a result, Company T's production facilities are

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preparing to begin mass production of the product intended for commercial sale. However, Company T has yet to finalize specifications of the product shell (e.g., color, ergonomic design, and brand graphics), which are still being tested with focus groups. Commercial manufacturing has not yet begun, and no products have been sold. Is the project incomplete?

A. No. The R&D project related to the significant improvement of the existing product has been completed, and there are no remaining R&D costs to be incurred. The remaining tasks before commercial manufacture and product launch do not involve technological or engineering risks, and the associated costs would not qualify as R&D. Although first customer acceptance has not occurred, Company T has demonstrated an equivalent internal milestone based on its product development practices and life cycle.

7.130 An IPR&D Asset Must Have Substance. The IPR&D Guide indicates that an IPR&D asset will have *substance,* meaning that the acquirer performed more than insignificant efforts that (a) meet the definition of R&D under ASC Subtopic 730-10, and (b) result in the creation of value. We believe that the examples included in the IPR&D Guide show that the Task Force's objective in including this criterion was to specify a threshold at which sufficient work had been done for IPR&D to be separately identified. If that threshold is not met, the value otherwise attributable to IPR&D would be subsumed into goodwill unless it meets the general recognition criteria for intangible assets. See discussion of the contractual/legal and separability criteria in this Section under Recognition of Intangible Assets Separately from Goodwill.

7.131 The IPR&D Guide addresses four phases of a project's life cycle that might be helpful in determining when a project has substance or whether it has been completed. In the earlier phases, the attribute of substance evolves to the point at which substance can be demonstrated, while in the later phases the project gradually reaches a point at which it is no longer considered incomplete. The four phases of a project's life cycle identified in the IPR&D Guide include:

a. **Conceptualization.** This phase entails coming up with an idea, thought, new knowledge, or plan for a new product, service, or process, or for a significant improvement to an existing product, service, or process, or it may represent a decision by a company to focus its research activities within certain core competencies. Management might make an initial assessment of the potential market, cost, and technical issues for ideas, thoughts, or plans to determine whether the ideas can be developed to produce an economic benefit.

b. **Applied research.** This phase represents a planned search or critical investigation aimed at the discovery of additional knowledge in hopes that it will be useful in defining a new product, service, or process that will yield economic benefits, or significantly improve an existing product, service, or process that will yield economic benefits. In addition, work during this phase assesses the feasibility of completing successfully the project and the commercial viability of the resulting expected product, service, or process.

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c. **Development.** This phase represents the translation of research findings or other knowledge into a detailed plan or design for a new product, service, or process, or for a significant improvement to an existing product, service, or process, and carrying out development efforts pursuant to the plan.

d. **Pre-production.** This phase represents the business activities necessary to commercialize the asset resulting from R&D activities for the enterprise's economic benefit. The IPR&D Guide, par. 2.45

7.132 The IPR&D Guide lists factors that may demonstrate that a specific IPR&D project has substance:

- The business was acquired to obtain the project, or the project constituted a significant part of the business acquired.
- Management considered the impact of potential competition and other factors (i.e., existing patents that would block plans for further development and commercialization) on the potential economic benefits of the project.
- Management has approved continued project funding.
- Management can make reasonably reliable estimates of the project's completion date.
- Management can make reasonably reliable estimates of costs to complete the project.

7.133 No single factor is necessarily determinative and judgment will often be needed in evaluating whether a specific IPR&D project has substance.

The IPR&D Guide Q&As Illustrating the Assessment of Whether an IPR&D Project Has Substance:

7.134 The following IPR&D Guide Q&As illustrate the assessment of whether an IPR&D project has substance.

Example 7.25: The IPR&D Guide Q&A, par. 2.51: Specific R&D Projects – Substance

Q. Company A, a pharmaceutical company, acquires Company T, a biotechnology company engaged in cancer R&D, in a business combination. Company T is developing a small molecule compound thought to have a therapeutic application in the cancer market. Company T incurs R&D costs in (a) screening approximately 5,000 compounds, (b) identifying a lead compound, and (c) determining that the lead compound has the desired effect on the biological target (a part of the body, such as a protein, receptor, or gene, or something foreign to the body, such as a bacteria or virus, that appears to play an important role in causing certain diseases) whose function is understood and has been validated. The lead compound is considered a potential drug development candidate and Company T has gathered sufficient scientific data to decide to advance this compound to phase I clinical testing (i.e., testing in humans). Based on

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Company T's understanding of the biological target's function and scientific data available in the public domain, Company T is able to make general predictions on potential therapeutic benefits in treating several types of cancer and potential side effects of the compound, if successful. The activities already undertaken by Company T have resulted in R&D expenses incurred. A multi-tumor cancer drug represents a significant market opportunity. Although no detailed market research has been conducted, market projections have been prepared based on patient population and cancer incidence rates. Patent searches have been completed with no patents found that would block Company T's plans for further development and commercialization of the compound. In addition, Company T has filed for patent protection of this compound. Have sufficient R&D activities been undertaken for this small molecule program such that at the acquisition date the acquired IPR&D project has substance?

A. Yes. The compound that may lead to a possible drug development candidate has progressed far enough through the R&D life cycle to have substance. Company T has selected a specific biological target whose function is understood and has been well validated. Company T has determined that the lead compound has the desired effect on the biological target and does not interact with other tissues in the body. Consequently, it is reasonable to anticipate that this compound may lead to a drug for treating cancer. Company T has gathered enough scientific data to decide to advance this compound to phase I clinical testing. Market potential can be reasonably estimated because incidence of cancer by tumor type is well documented and tracked by several reputable independent organizations. Market share for a particular compound can be estimated by reviewing data currently available in the public domain that tracks patented programs by biologic target from preclinical testing through market launch. Thus, Company T can determine the number of competitors conducting research on a particular biologic target and estimate the potential order of entry, given the competitors' stages of development. When evaluating whether the acquired IPR&D project has substance, Company T would also need to consider other factors enumerated in Paragraph 7.132 and other relevant circumstances.

Example 7.26: The IPR&D Guide Q&A, par. 2.52: Specific R&D Projects – Substance

Q. Company A acquires Company T in a business combination. Company T designs and markets switches for sale to telecom companies, which use the switches to route telephone communications through their systems. Company T developed a routing technology for a switch that it believes will be pivotal in creating the next generation of switches to route Internet and video data over telephone systems (that is, it had completed the conceptualization and applied research phases of the project). Before the acquisition, Company T surveyed several telecom companies to assist in designing the specifications of the proposed switch. In addition, Company T had a documented plan for development of the switches, which it expected to be complete in 18 months. As of the date of the acquisition, the development of the switches was underway. Have

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sufficient R&D activities been undertaken such that, at the date of acquisition the specific IPR&D project has substance?

A. Yes. As of the date of the acquisition, Company T had completed the conceptualization and applied research phases of the project and was partially through development of the new switch. As a result, the project satisfied the attribute of substance.

Example 7.27: The IPR&D Guide Q&A par. 2.53: Specific R&D Projects – Substance

Q. Company A acquires Company T in a business combination. Company T is an established contract manufacturer of electronic components. An important aspect of its manufacturing process involves extruding copper wire into extremely fine strands. The R&D department of Company T has as one of its top priorities improving this aspect of the manufacturing process. The basic objective of the project would involve significant improvements to the current process that would further reduce the diameter of the copper strands without significantly increasing manufacturing costs (e.g., through lower yields of acceptable material or increased consumption of energy and indirect materials). As of the date of the acquisition, Company T's R&D personnel had begun studying possible technological improvements to the extrusion process by researching relevant technical and academic material in the public domain. Company T's R&D personnel also conducted an all-day brainstorming session in which a number of theoretical approaches were debated. As a result of that meeting, a consensus on the most promising approach was identified and a project plan was being drafted that would define expected timing, resource requirements, and key technical issues of the R&D project. Company T believes that the project has a fairly high likelihood of success. Have sufficient R&D activities been undertaken such that, at the acquisition date, the specific IPR&D project has substance?

A. No. At the date of the acquisition, Company T's R&D project had only been conceptualized. Company T had not expended a more than insignificant effort in R&D activities to advance existing knowledge and technology toward the project objective. As a result, although the project concept was promising, the project lacked substance at the acquisition date and would not qualify to be recognized as an asset.

Unit of Account for IPR&D Assets

7.134a ASC Topic 805 does not provide specific guidance on identifying the unit of account for IPR&D assets. However, the determination of the appropriate unit of account affects subsequent accounting, including impairment testing and assessing useful lives. Therefore, judgment is required to determine whether separately identifiable IPR&D assets are aggregated for recognition and valuation purposes.

As discussed in Paragraph 7.121, a single IPR&D project may consist of multiple IPR&D assets. These assets may be separable based on characteristics, such as geography or

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medical indication. In practice, separately identifiable IPR&D assets with similar characteristics are aggregated into a single unit of account because they are substantially the same. However, aggregation beyond the individual IPR&D project level (e.g., combining project 1 and project 2) is generally not appropriate.

Paragraph 2.20 of the IPR&D Guide provides some factors to consider when determining the unit of account of an IPR&D asset.

- The phase of development of the related IPR&D project.
- The nature of the activities and costs necessary to further develop the related IPR&D project.
- The risks associated with the further development of the related IPR&D project.
- The amount and timing of benefits expected to be derived in the future from the developed asset(s).
- The expected economic life of the developed asset(s).
- Whether there is an intent to manage costs for the developed asset(s) separately or on a combined basis in areas such as strategy, manufacturing, advertising, selling, etc.
- Whether the asset, which could be an incomplete or completed IPR&D project, would be transferred by itself or with other separately identifiable assets.

Example 7.27a: The IPR&D Guide Q&A par. 2.21: Unit of account for IPR&D

Company A acquires Company T in a business combination. At the acquisition date, Company T is developing a pharmaceutical compound that will be commercialized in several countries. Company A is planning to seek regulatory approval for the compound in each jurisdiction. Company A determines whether to recognize a single IPR&D asset (i.e., representing the compound) or separate jurisdictional IPR&D assets (i.e., representing the compound in each jurisdiction) by considering indicators in the table below.

Indicators of a single IPR&D asset	Indicators of separate jurisdictional IPR&D assets
Early development phase.	Later development phase, and development risks associated with different jurisdictions are known.

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The nature of the activities and costs necessary to further develop the IPR&D project are substantially the same for each jurisdiction. For example, the project will be developed centrally, with Company A incurring minimal costs for regulatory approvals in each jurisdiction during the later testing stages.	The nature of the activities and costs necessary to further develop the IPR&D project are substantially different for each jurisdiction. For example, regulatory approval costs are expected to make up a significant share of development costs.
The risks associated with the further development of the IPR&D project are expected to be substantially the same across jurisdictions. For example, it is likely that the project will either receive approval in all jurisdictions or in none, although the timing may differ.	The risks associated with the further development of the IPR&D project are expected to be substantially different for each jurisdiction. For example, each jurisdiction has different approval risks, and receiving approval in one does not affect the others.
The amount and timing of benefits from, and the economic life of, the developed asset are expected to be substantially the same. For example, the patent has a similar life in all jurisdictions.	The amount and timing of benefits from, and the economic life of, the developed asset are expected to be substantially different for each jurisdiction. For example, the patent has a different life in each jurisdiction.
Company A plans to manage costs from a global brand perspective, rather than tailoring them to each individual market.	Company A plans to manage costs separately in each jurisdiction.
If transferred, the compound would be transferred as a single asset.	If transferred, the compound would not be transferred as a single asset.

Outlicensing Arrangements Associated with R&D Activities

7.134b The classification of an acquired intangible asset associated with R&D activities that have been or will be outlicensed depends on the acquiring entity's intended level of involvement in the asset's ongoing development. If the acquirer intends to actively participate in the development of the outlicensed asset (e.g., through a collaborative arrangement), the asset is generally considered an IPR&D asset. Conversely, if the acquirer does not plan to be actively involved and the outlicensed asset is fully managed by a third party (e.g., the third party is responsible for all R&D activities, regulatory approvals, and commercialization), the asset would typically be classified as a contract-

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based intangible asset, provided it meets the recognition criteria under ASC Topic 805. This distinction is important because IPR&D assets are initially accounted for as indefinite-lived intangible assets, while contract-based intangibles are generally finite-lived and subject to amortization.

In-Process Research and Development Assets That an Acquirer Does Not Intend to Actively Use

> **ASC Paragraph 805-20-30-6**
>
> To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the nonfinancial asset in accordance with [ASC] Subtopic 820-10 assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

7.135 A business combination may result in the acquisition of IPR&D or other intangible assets that the acquirer does not intend to actively use (commonly referred to as *defensive intangible assets* or *locked-up assets).* While such assets are not being actively used, they are likely contributing to an increase in the value of other assets owned by the acquirer.

7.136 ASC Topic 805 and ASC Subtopic 820-10 require that defensive intangible assets be recognized at a value that reflects the asset's highest and best use based on market participant assumptions. See discussion of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use in this Section.

7.137 Subsequent to an acquisition, the acquirer accounts for acquired IPR&D assets in accordance with ASC paragraphs 350-30-35-15 through 35-17A. See the discussion of *Defensive Intangible Assets* in Section 12, *Subsequent Measurement and Accounting.*

Crypto Assets

7.137a While some digital assets may meet the definition of a financial instrument or financial asset, most digital assets that do not meet those definitions (e.g., bitcoin, ether, litecoin, bitcoin cash) generally meet the definition of an intangible asset as an asset (other than a financial asset or goodwill) that lacks physical substance and meets the asset recognition criteria in the FASB's Conceptual Framework. A crypto intangible asset acquired in a business combination is recognized and measured in the same manner as any other intangible asset acquired in a business combination (i.e., fair value). See the Cryptocurrencies and other digital assets Financial Reporting View topic page for more discussion on crypto assets.

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Considerations for Financial Services Entities – Customer-Related Intangible Assets

7.138 An acquisition of a financial institution may include many of the types of intangible assets discussed previously. Because services performed by financial institutions are based on contractual relationships with the institution's customers, there are many types of customer-related intangible assets present in acquisitions of financial institutions. To ensure that all identifiable intangible assets are recognized, careful consideration should be given to the customer relationship from which projected cash flows originate. Contractual- and noncontractual-based customer-related intangible assets unique to a financial institution include:

- Core Deposit
- Borrower Base
- Credit-Card Customer-Based
- Mortgage Loan Servicing Rights
- Trust Services
- Private Banking Customer
- Asset Management and Advisory
- Brokerage
- Customer Information Databases

RECOGNIZING ANY NONCONTROLLING INTEREST IN AN ACQUIREE

7.139 As discussed in Section 2, a business combination occurs when an acquirer obtains control of one or more businesses. Applying the acquisition method requires that, at the acquisition date, the identifiable assets acquired and liabilities assumed in an acquisition be recognized and measured by the acquirer in accordance with ASC Topic 805 (i.e., full step-up), and that any noncontrolling interest in the acquiree be measured and recognized at fair value. Noncontrolling interest includes only financial instruments issued by an acquired subsidiary that are classified as equity in the subsidiary's financial statements.

Example 7.28: Recognizing Noncontrolling Interest at Fair Value

On December 31, 20X0, ABC Corp. acquires 60% percent of DEF Corp. for cash of $1,100 (which includes a control premium). The amount of the identifiable net assets of DEF Corp., measured in accordance with ASC Topic 805, is $1,400. The fair value of the noncontrolling interest (i.e., the equity of DEF not acquired by ABC) is $600.

Under ASC Topic 805, ABC recognizes the identifiable net assets of DEF at $1,400 (full step-up to amounts measured in accordance with ASC Topic 805), the

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noncontrolling interest at its fair value of $600, and the resulting goodwill at $300 ($1,100 + $600 - $1,400). The net effect of the acquisition of DEF is recognized in ABC's consolidated financial statements as of December 31, 20X0 as follows:

	Debit	Credit
Identifiable net assets of DEF	1,400	
Goodwill*	300	
Equity (noncontrolling interest)		600
Cash		1,100

*Although presented as one financial statement caption on the parent's balance sheet, if goodwill is subsequently determined to be impaired, the impairment loss is required to be attributed to the parent and the noncontrolling interest on a rational basis. The goodwill attributable to ABC is $260 (($1,100 - (60% × $1,400)), and the goodwill attributable to the noncontrolling interest is $40 (($600 - (40% × $1,400). The subsequent impairment loss might be attributed to ABC on the basis of $260/$300, and to the noncontrolling interest on the basis of $40/$300. See KPMG Handbook, Impairment of nonfinancial assets, for further discussion on goodwill impairment testing and disposal of all or a portion of a reporting unit when the reporting unit is less than wholly owned.

MEASUREMENT PRINCIPLE

ASC Paragraph 805-20-30-1

The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.

7.140 ASC Topic 805 requires an acquirer to measure the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, with limited exceptions, which are discussed in this Section under Exceptions to the Recognition and Measurement Principles. ASC Topic 805 does not provide guidance on how to determine fair values, but instead states that fair value is determined in accordance with ASC Subtopic 820-10. See Sections 16 through 21 on Fair Value Measurements, for additional guidance on the fair value measurement of assets acquired and liabilities assumed and any noncontrolling interest in the acquiree.

7.141 In applying the fair value measurement guidance of ASC Subtopic 820-10, acquirer-specific intent on how an acquired asset will be used is not considered in determining its fair value. Rather, ASC Subtopic 820-10 requires that fair value be determined using a market participant's perspective, rather than the acquirer's specific planned use or non-use of an acquired asset. See discussion in this Section of Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use.

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APPLICATION GUIDANCE RELATED TO MEASURING THE FAIR VALUES OF PARTICULAR IDENTIFIABLE ASSETS AND A NONCONTROLLING INTEREST IN AN ACQUIREE

ASSETS WITH UNCERTAIN CASH FLOWS (VALUATION ALLOWANCES)

7.142 Based on the measurement principle, the acquirer does not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. However, purchased financial assets with credit deterioration (PCD assets) are an exception to the measurement principle in ASC Topic 805. PCD assets are initially recognized at their fair value plus an allowance for the estimate of expected credit losses determined in accordance with ASC Topic 326 (i.e., gross-up approach). See chapter 12A of KPMG Handbook, Credit impairment, for detailed guidance on measuring financial assets acquired in a business combination. ASC paragraph 805-20-30-4

7.143 Paragraph not used.

ASSETS THAT THE ACQUIRER INTENDS NOT TO USE OR TO USE IN A WAY OTHER THAN THEIR HIGHEST AND BEST USE

> **ASC Paragraph 805-20-30-6**
>
> To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the nonfinancial asset in accordance with [ASC] Subtopic 820-10 assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

7.144 A business combination may result in the acquisition of assets, including IPR&D or other intangible assets, that the acquirer does not intend to actively use, or intends to use in a way that is not its highest and best use (these assets are commonly referred to as *defensive assets* or *locked-up assets).* While such assets are not being actively used, they are likely contributing to an increase in the value of other assets owned by the acquirer.

7.145 Although defensive intangible assets are not actively used by the acquirer, ASC Topic 805 and ASC Subtopic 820-10 require that defensive intangible assets be recognized at a value that reflects the asset's highest and best use based on market participant assumptions.

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Example 7.30: Acquirer Does Not Intend to Use Acquired Trade Name

As part of a business combination, an entity acquires a trade name that it does not intend to use, but which would provide maximum value to market participants through its use in combination with other assets. The acquirer should recognize and measure the trade name at its acquisition-date fair value, using an in-use valuation premise, because in-use is the highest and best use by market participants.

Example 7.31: Acquired IPR&D the Acquirer Does Not Intend to Use

The reporting entity acquires an IPR&D project in a business combination. The reporting entity does not intend to complete the IPR&D project. If completed, the IPR&D project would compete with one of its own IPR&D projects (to provide the next generation of the reporting entity's commercialized technology). Instead, the reporting entity intends to hold (lock up) the IPR&D project to prevent its competitors from obtaining access to the technology. The IPR&D project is expected to provide defensive value, principally by improving the prospects for the reporting entity's own competing technology. For purposes of measuring the fair value of the IPR&D project at initial recognition, the highest and best use of the IPR&D project would be determined based on its use by market participants. See ASC paragraph 820-10-55-32 for additional analysis as to whether the highest and best use of the IPR&D would be *in-use* or *in-exchange*.

7.146 See the discussion of In-Process Research and Development Assets that an Acquirer Does Not Intend to Actively Use, in this Section, and the discussion of Defensive Intangible Assets in Section 12.

CONTINGENT CONSIDERATION ARRANGEMENTS OF AN ACQUIREE ASSUMED BY THE ACQUIRER

> **ASC Paragraph 805-20-30-9A**
>
> Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured initially at fair value in accordance with the guidance for contingent consideration arrangements in [ASC] paragraph 805-30-25-5.

7.147 The acquiree may have contingent consideration from one or more of its acquisitions before being acquired by the acquirer. ASC paragraph 805-20-30-9A specifies that this is recognized and measured in the same manner as any contingent consideration agreed to between the acquirer and the acquiree. However, unlike contingent consideration agreed to between the acquirer and acquiree, which is part of the consideration transferred (see Section 6), we believe that contingent consideration of the acquiree is treated as a liability assumed in the acquisition rather than as consideration

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transferred. See Paragraph 12.023 for discussion of subsequent accounting for contingent consideration arrangements of the acquiree assumed by the acquirer.

SELF-INSURED RISKS

7.147a Entities in all industries routinely face exposures to loss contingencies associated with a variety of risks for which they may choose not to obtain third-party insurance coverage. These risks are commonly referred to as self-insured risks and may be accounted for in accordance with ASC Subtopics 410-30 or 450-20. In a business combination, those risks are measured at the acquisition date in accordance with the guidance in ASC Topic 805, generally at fair value. For example, an employer's self-insured workers' compensation liability is measured at fair value in acquisition accounting rather than at an undiscounted amount, even if the acquiree's pre-acquisition policy had been to record its self-insured workers' compensation liability at an undiscounted amount.

MEASURING THE FAIR VALUE OF A NONCONTROLLING INTEREST IN AN ACQUIREE

ASC Paragraphs 805-20-30-7

[ASC] paragraph 805-20-30-1 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. An acquirer sometimes will be able to measure the acquisition-date fair value of a noncontrolling interest on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the noncontrolling interest using another valuation technique.

ASC Paragraph 805-20-30-8

The fair values of the acquirer's interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

7.148 Under ASC paragraph 805-20-30-1, noncontrolling interests are measured at fair value at the date of acquisition. See Section 19 for a discussion of the fair value measurement of noncontrolling interests.

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EXCEPTIONS TO THE RECOGNITION AND MEASUREMENT PRINCIPLES

7.149 ASC Topic 805 provides certain exceptions to the recognition and measurement principles that are applied at the acquisition date in recognizing and measuring the assets acquired, liabilities assumed, and any noncontrolling interest in an acquiree.

7.150 The exceptions to the recognition or measurement principles are as follows:

Exceptions to Both the Recognition and Measurement Principles	Exceptions to the Measurement Principle
Assets and liabilities arising from contingencies	Reacquired rights
Deferred tax assets and liabilities and tax uncertainties	Share-based payment awards
Employee benefits	Assets held for sale
Indemnification assets	
Contract assets and contract liabilities	Purchased financial assets with credit deterioration [2]
Leases	

For a discussion of contract assets and contract liabilities, see Paragraphs 7.025d through 7.025h. For guidance on recognition and measurement of lease contracts assumed in a business combination, see chapter 11 of KPMG Handbook, Leases. For a discussion of the accounting for credit losses in a business combination, see chapter 12A of KPMG Handbook, Credit impairment.

7.151 Assets acquired and liabilities assumed in an acquisition that are subject to these limited exceptions are recognized and measured in accordance with the specific guidance provided in ASC Topic 805, rather than based on the general recognition and measurement principles of ASC Topic 805. ASC paragraphs 805-20-25-16 and 30-10

7.152 Subsequent to a business combination, assets acquired and liabilities assumed or incurred, and equity instruments issued in the acquisition are generally measured and accounted for in accordance with the applicable GAAP. However, ASC Topic 805 provides specific guidance on the subsequent measurement and accounting for certain assets acquired, liabilities assumed, and equity instruments issued in a business combination, including guidance with respect to most of the items that are subject to the exceptions to the recognition and measurement principles of ASC Topic 805. See the discussion of *Subsequent Measurement and Accounting* in Section 12.

7.153 Paragraph not used.

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Assets and Liabilities Arising from Contingencies

ASC Paragraph 805-20-25-18A

The following recognition guidance in [ASC] paragraphs 805-20-25-19 through 25-20B applies to assets and liabilities meeting both of the following conditions:

a. Assets acquired and liabilities assumed that would be within the scope of [ASC] Topic 450 if not acquired or assumed in a business combination

b. Assets or liabilities arising from contingencies that are not otherwise subject to specific guidance in [ASC Subtopic 805-20].

ASC Paragraph 805-20-25-19

If the acquisition-date fair value of the asset or liability arising from a contingency can be determined during the measurement period, that asset or liability shall be recognized at the acquisition date. For example, the acquisition-date fair value of a warranty obligation often can be determined.

ASC Paragraph 805-20-25-20

If the acquisition-date fair value of the asset or liability arising from a contingency cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if both the following criteria are met:

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

b. The amount of the asset or liability can be reasonably estimated.

ASC Paragraph 805-20-25-20A

The criteria in the preceding paragraph shall be applied using the guidance in [ASC] Topic 450 for application of similar criteria in [ASC] paragraph 450-20-25-2.

ASC Paragraph 805-20-25-20B

If the recognition criteria in [ASC] paragraphs 805-20-25-19 through 25-20A are not met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date. In periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including [ASC] Topic 450, as appropriate.

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ASC Paragraph 805-20-30-9

[ASC] paragraphs 805-20-25-18A through 25-20B establish the requirements related to recognition of certain assets and liabilities arising from contingencies. Initial measurement of assets and liabilities meeting the recognition criteria in [ASC] paragraph 805-20-25-19 shall be at acquisition-date fair value. Guidance on the initial measurement of other assets and liabilities from contingencies not meeting the recognition criteria of that paragraph, but meeting the criteria in [ASC] paragraph 805-20-25-20 is at [ASC] paragraph 805-20-30-23.

ASC Paragraph 805-20-30-23

Initial measurement of assets and liabilities meeting the recognition criteria in [ASC] paragraph 805-20-25-20 shall be at the amount that can be reasonably estimated by applying the guidance in [ASC] Topic 450 for application of similar criteria in [ASC] paragraph 450-20-25-2.

7.154 Under ASC Topic 805, assets and liabilities arising from contingencies of an acquiree existing at the acquisition date are evaluated for recognition and measurement using a two-step process. First, the acquirer needs to consider whether the fair value of an asset or liability arising from a contingency is determinable. If so, then the asset or liability is recognized at its fair value at the acquisition date. In making this determination, the acquirer should consider all information available during the measurement period that bears on whether the fair value of the contingency was determinable as of the acquisition date.

7.155 ASC paragraph 805-20-25-19 indicates that the FASB believes that the fair value of a warranty obligation generally will be determinable and therefore it is expected that warranty obligations will be measured at fair value by the acquirer in most circumstances. Apart from warranty obligations, based on discussions with the FASB staff, we understand that the FASB did not intend to change the guidance on accounting for contingencies acquired or assumed in a business combination from that which existed under Statement 141.

7.156 Paragraph 40(a) of Statement 141 contained the following guidance on recognition of preacquisition contingencies at fair value:

> 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.

Additionally, footnote 14 attached to paragraph 40(a) stated: “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.”

7.157 In practice, the guidance in footnote 14 of Statement 141 is understood to mean that there is a high threshold to be met when evaluating whether fair value of such contingencies can be determined. However, paragraph B10 of FSP FAS 141(R)-1, “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination

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That Arise from Contingencies," states: "In the deliberations leading to this FSP, the Board decided to adopt a model similar to the guidance in Statement 141 to address the application issues raised by constituents." Accordingly, while the Board did not carry forward footnote 14 into ASC paragraph 805, we believe that the approach taken previously under Statement 141 continues to be applicable for contingencies arising in a business combination with the exception of warranty obligations.

7.158 If the fair value of an asset acquired or liability assumed arising from contingencies is not determinable as of the measurement date (including consideration of all information available during the measurement period), then the second step is to apply the probable and reasonably estimable criteria of ASC Topic 450 to the contingency. If those criteria are met, the contingency is recognized at its estimated amount, including consideration of the guidance in ASC paragraph 450-20-30-1. If, in applying the second step, it either is not probable that an asset or liability exists at the acquisition date or the amount is not reasonably estimable, then the contingency is not recognized in the acquisition accounting. Contingencies that arise as a result of the acquisition, did not exist at the acquisition date, or did not meet the recognition criteria at the acquisition date, are not part of the acquisition accounting and are accounted for separately in accordance with other applicable GAAP, including ASC Topic 450. See the discussion of *Subsequent Measurement and Accounting* in Section 12.

7.158a An entity may expect to incur post-acquisition legal costs related to a pre-acquisition contingent liability of an acquiree. If the contingent liability was recognized by the acquirer at the acquisition date fair value, then any expected future legal costs would be a factor in determining the liability's fair value. However, if a loss contingency model was applied, we believe the measurement of the liability should be consistent with the acquirer's accounting policy for future legal costs when estimating loss contingencies under ASC Topic 450. If the acquirer's policy is to expense these costs as incurred, the liability recorded in the business combination would exclude such costs. In contrast, if the acquirer's policy is to accrue future legal costs in its estimate of the liability, it would record those amounts in the liability.

Deferred Tax Assets and Liabilities and Tax Uncertainties

7.159 Deferred tax assets and liabilities that arise as a result of the assets acquired and liabilities assumed, as well as deductible temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, should be recognized and measured in accordance with ASC Topic 740, *Income Taxes*, including the guidance on uncertain income taxes. (ASC paragraphs 805-740-25-2 and 30-1) The FASB decided not to require measurement of deferred tax assets and liabilities at their acquisition-date fair values because of potential post-combination gains and losses that may result immediately following the acquisition when applying the measurement provisions of ASC Topic 740. (Statement 141(R), par. B281; ASC paragraphs 805-740-25-2 and 30-1) See KPMG Handbook, Accounting for Income Taxes, Section 6 for a discussion of income tax considerations in a business combination.

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Employee Benefits

ASC Paragraph 805-20-25-22

The acquirer shall recognize a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in [ASC] paragraphs 805-20-25-23 through 25-26 would be recognized in accordance with that guidance and as specified in those paragraphs.

ASC Paragraph 805-20-25-23

Guidance on defined benefit pension plans is presented in [ASC] Subtopic 715-30. If an acquiree sponsors a single-employer defined benefit pension plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see [ASC] paragraph 715-30-25-1). [ASC] paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan, and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with [ASC] Subtopic 450-20.

ASC Paragraph 805-20-25-24

The Settlements, Curtailments, and Certain Termination Benefits Subsections of [ASC] Sections 715-30-25 and 715-30-35 establish the recognition guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

ASC Paragraph 805-20-25-25

Guidance on defined benefit other postretirement plans is presented in [ASC] Subtopic 715-60. If an acquiree sponsors a single-employer defined benefit postretirement plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see [ASC] paragraph 715-60-25-1). [ASC] paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with [ASC] Subtopic 450-20.

ASC Paragraph 805-20-25-26

See also the recognition-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See [ASC] Section 420-10-25.

b. Compensated absences. See [ASC] Section 710-10-25.

c. Deferred compensation contracts. See [ASC] Section 710-10-25.

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d. Nonretirement postemployment benefits. See [ASC] Section 712-10-25.

ASC Paragraph 805-20-30-14

The acquirer shall measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in [ASC] paragraphs 805-20-30-15 through 30-17 would be measured in accordance with that guidance and as specified in those paragraphs.

ASC Paragraph 805-20-30-15

Guidance on defined benefit pension plans is presented in [ASC] Subtopic 715-30. Guidance on defined benefit other postretirement plans is presented in [ASC] Subtopic 715-60. ASC paragraphs 805-20-25-23 and 805-20-25-25 require an acquirer to recognize as part of a business combination an asset or a liability representing the funded status of a single-employer defined benefit pension or postretirement plan. In determining that funded status, the acquirer shall exclude the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make. The projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer's assessment of relevant future events.

ASC Paragraph 805-20-30-16

The Settlements, Curtailments, and Certain Termination Benefits Subsections of [ASC] Section 715-30-35 establish the measurement guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

ASC Paragraph 805-20-30-17

See also measurement-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See [ASC] Section 420-10-25.

b. Compensated absences. See [ASC] Section 710-10-25.

c. Deferred compensation contracts. See [ASC] Section 710-10-25.

d. Nonretirement postemployment benefits. See [ASC] Section 712-10-25.

7.160 In its deliberations of ASC Topic 805, the FASB concluded that it was not feasible to require all employee benefit obligations assumed in a business combination to be measured at their acquisition-date fair values without a comprehensive reconsideration of the relevant standards for those benefits. The FASB decided to require that such obligations and related assets be measured in accordance with other applicable standards. Statement 141(R), par. B299; ASC paragraphs 805-20-25-23 through 25-26

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7.161 Certain considerations in the application of other standards at the acquisition date related to the recognition and measurement of employee benefits as the result of an acquisition are discussed below.

Pension-Related Assets and Liabilities

Single-Employer Defined Benefit Plans

7.162 ASC Subtopic 715-30 requires the acquirer to recognize, as part of the accounting for the business combination, an asset or a liability representing the funded status of the plan. If, at the acquisition date, the fair value of the plan assets exceeds the projected benefit obligation, an asset is recognized; however, if the projected benefit obligation exceeds the fair value of the plan assets, a liability is recognized. ASC Subtopic 715-30 requires that the measurement of the funded status of the plan exclude the effects of expected plan amendments, terminations, or curtailments that the acquirer has no obligation to make at the acquisition date, and specifies that the projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer's assessment of relevant future events. ASC paragraph 805-20-30-15

7.163 An acquirer is required to determine the fair value of the plan assets and the projected benefit obligation at the acquisition date, and recognize in its accounting for the acquisition either an asset or a liability, equal to the difference between the fair value of the plan assets and the projected benefit obligation. The determination of the projected benefit obligation includes any necessary changes in assumptions based on the acquirer's assessment of relevant future events. These events include the actuarial assumptions necessary to measure the projected benefit obligation (e.g., the discount rate, mortality assumptions, turnover, and compensation increases).

Example 7.32: Funded Status of a Single-Employer Defined Benefit Pension Plan of an Acquiree before and after a Business Combination

ABC Corp. acquires DEF Corp. in a business combination on April 30, 20Y0. DEF sponsored a single-employer defined benefit pension plan. At December 31, 20X9, DEF's financial statements reflected a $300 net unfunded obligation and a debit balance in accumulated other comprehensive income of $100, which represented $75 of accumulated actuarial losses and $25 of prior service cost not yet recognized in earnings. In the 4 months ended April 30, 20Y0, DEF recorded $100 of net periodic pension cost in accordance with ASC Subtopic 715-30. This included $2 of amortization of prior service cost, no amortization of the actuarial loss (because the amount at the prior year-end was within the corridor) and $15 of expected return on plan assets. There were no benefits paid during the period. The funded status of DEF's plan at the most recent audited balance sheet date and a rollforward to the acquisition date is:

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	Projected Benefit Obligation	Plan Assets	Funded Status	AOCI
December 31, 20X9	($1,000)	$700	($300)	$100
Net periodic pension cost recorded by DEF in accordance with ASC Subtopic 715-30 from January 1, 20Y0 to April 30, 20Y0	($113)	$15	($98)	($2)
DEF's pension accounts as of April 30, 20Y0	($1,113)	$715	($398)	$98

The acquisition agreement provides that ABC will continue DEF's defined benefit pension plan without any changes. ABC engaged its actuaries to determine the projected benefit obligation of DEF's plan as of the acquisition date. Based on updated measurements of plan assets and benefit obligations, including appropriate changes to actuarial assumptions, as of April 30, 20Y0, the projected benefit obligation is $1,250. In addition, ABC obtained information from the plan trustee indicating that the fair value of plan assets as of that date is $750.

As a result of this information, ABC records a net unfunded pension obligation of $500 related to DEF's pension plan in its financial statements, comprised of a $1,250 projected benefit obligation and $750 fair value of plan assets. ABC does not record amounts in AOCI as of the acquisition date related to actuarial losses or prior service cost that previously were recorded in DEF's financial statements.

Example 7.33: Plan Amendments an Acquirer Is Not Required to Make

Assume the same facts as in Example 7.32, except that ABC Corp. plans to make certain amendments to the DEF plan after the acquisition; however, there is no obligation for ABC to make the planned amendments.

The determination of the asset or liability representing the funded status of DEF's plan, as illustrated in Example 7.32, is not affected by the planned amendments, because ABC has no obligation to make the amendments. Instead, the amendments, when made, are accounted for as plan amendments in accordance with ASC Subtopic 715-30. Therefore, an increase or decrease in the projected benefit obligation (i.e., prior service cost or negative prior service cost) as a result of the amendments would be initially offset by a charge or credit to other comprehensive income at the date of the amendment, and subsequently amortized as a component of net periodic pension cost in accordance with ASC Subtopic 715-30.

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Example 7.34: Employees of Acquiree Included in Pension Plan of Acquirer

Q. If the acquirer includes the employees of the acquiree (which did not have a pension plan) in its pension plan and grants them credit for prior service, how is the credit granted for prior service accounted for?

A. If the acquirer's granting of credit for prior service to the employees of the acquiree is required to complete the acquisition, it is part of the acquisition and is included in the acquisition accounting. If the granting of credit for prior service is not a requirement to complete the acquisition, it is not part of the acquisition and is not included in the acquisition accounting, but rather is accounted for as a plan amendment in the acquirer's post-combination financial statements.

If the credit granted for prior service is part of the acquisition, the debit offsetting the increase in the projected benefit obligation is an increase in goodwill (or a decrease in the gain from a bargain purchase) recognized in the acquisition accounting. If the credit granted for prior service is accounted for as a plan amendment in the acquirer's post-combination financial statements, the increase in the projected benefit obligation resulting from the amendment is included in the projected benefit obligation, with an offsetting charge to other comprehensive income as prior service cost, and subsequently amortized as a component of net periodic pension cost. ASC paragraphs 715-30-35-11 and 35-13

Multiemployer Pension Plans

7.164 If the acquiree in a business combination participates in a multiemployer pension plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer recognizes as part of the business combination a withdrawal liability in accordance with ASC Topic 450. ASC paragraph 805-20-25-23

Postretirement Benefits Other Than Pensions

7.165 ASC Subtopic 715-60 specifies the appropriate accounting for other postretirement benefits-related assets and liabilities of an acquiree. The accounting specified in ASC Subtopic 715-60 is similar to the accounting required by an acquirer under ASC Subtopic 715-30 when an acquiree sponsors a single-employer defined benefit plan.

Single-Employer Defined Benefit Postretirement Plans

7.166 If an acquiree sponsors a single-employer defined benefit postretirement plan, ASC Subtopic 715-60 requires the acquirer to recognize as part of the acquisition accounting an asset or a liability representing the funded status of the plan. The funded status of each plan is measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation. ASC Subtopic 715-60 was amended by ASC Topic 805 to specify that the measurement of the funded status of the plan excludes the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make, and requires that the accumulated

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postretirement benefit obligation assumed reflects any other necessary changes in assumptions based on the acquirer's assessment of relevant future events. ASC paragraph 805-20-30-15

Example 7.35: Postretirement Benefit Plan That Will Be Amended as a Condition of the Acquisition Agreement

ABC Corp. acquires DEF Corp. in a business combination. DEF sponsors a postretirement benefit plan that provides postretirement healthcare benefits to its employees, subject to a $500 annual deductible to be paid by the employees. As a condition of the acquisition agreement, DEF's plan is amended to reduce the deductible to be paid by DEF's employees to $200 annually.

Because the amendment is a requirement of the acquisition, it is part of the acquisition and is included in the acquisition accounting. The offset to the increase in the accumulated postretirement benefit obligation resulting from the amendment would be an increase in goodwill (or a decrease in the gain from a bargain purchase) recognized in the acquisition accounting.

Multiemployer Defined Benefit Postretirement Plans

7.167 If an acquiree participates in a multiemployer postretirement plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer recognizes a liability related to withdrawal from the multiemployer plan under ASC Topic 450. ASC paragraph 805-20-25-25

Indemnification Assets

ASC Topic 805-20-25-27

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

ASC Topic 805-20-30-18

. . . For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the

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fair value measure and a separate valuation allowance is not necessary as noted in [ASC] paragraph 805-20-30-4.

ASC Topic 805-20-25-28

In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in [ASC] paragraphs 805-20-25-18A through 25-19 at that date. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

ASC Topic 805-20-40-3

The acquirer shall derecognize an indemnification asset recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

7.168 The accounting discussed in this Section applies to indemnities related to a specific asset, liability or contingent liability of the acquiree. It generally does not apply to the accounting for general representations and warranties because these provisions typically do not relate to an uncertainty surrounding a specific asset or liability of the acquiree. See *Consideration Held in Escrow for General Representations and Warranties* starting at Paragraph 6.020b for additional discussion about general representations and warranties.

7.169 Acquisition agreements sometimes provide that the seller indemnifies the acquirer against a particular contingent liability outstanding at the acquisition date. A contingent liability could relate, for example, to a legal case of the acquiree for environmental pollution or a tax uncertainty. An indemnification asset arises from the seller's agreement to reimburse (indemnify) the acquirer for all or a portion of the ultimate liability resulting from the resolution of the legal case or the tax uncertainty.

7.170 When the seller is contractually obligated to indemnify a specific liability assumed by the acquirer, an indemnification asset should be recognized at the same time and measured using the same measurement basis as the liability, subject to the need for a valuation allowance for uncollectible amounts. The FASB included this requirement in ASC Topic 805 to avoid the potential recognition of offsetting gains and losses in different periods that otherwise might arise if indemnified items and the indemnification assets were accounted for on different bases. Thus, both the indemnification asset and the liability are measured on a consistent basis using similar assumptions, subject to any contractual limitations on the indemnified amount and management's assessment of collectibility of the indemnification asset. Therefore, an indemnification asset would be recognized as of the acquisition date only if the item to which the indemnification relates is recognized at that date.

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7.171 If the indemnification relates to an asset or liability that is recognized at the acquisition date and measured at fair value on that date, the acquirer also recognizes the indemnification asset at its acquisition-date fair value. Uncertainties related to collectibility of the indemnification asset are included in the fair value measurement, and a separate valuation allowance would not be necessary.

7.172 If the indemnification relates to an asset or liability that is an exception to the recognition or measurement principles, the indemnification asset is recognized and measured using assumptions consistent with those used to measure the indemnified item. For example, if a contingency that is subject to indemnification by the seller is not recognized at the acquisition date because its fair value is not determinable (which would be the typical case) and it is not probable and reasonably estimable that a liability existed at the acquisition date, the indemnification asset would also not be recognized at the acquisition date. Similarly, if the indemnification relates to an asset or liability that is measured on a basis other than fair value (e.g., an uncertain tax position that is recognized in accordance with ASC Topic 740, the related indemnification asset would be measured using assumptions consistent with those used to measure the indemnified item, adjusted for management's assessment of collectibility and any contractual limitations on the indemnification asset.

7.173 An indemnification asset initially recognized at the acquisition date is subsequently measured on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at fair value, management's assessment of the collectibility of the indemnification asset. An indemnification asset is derecognized only when the acquirer collects it, sells it, or otherwise loses the right to it. See discussion of *Indemnification Assets* in Section 12 for additional guidance on the subsequent measurement and accounting for indemnification assets.

7.173a We believe that indemnification assets are in the scope of ASC Subtopic 326-20, *Financial Instruments—Credit Losses,* only when the indemnified item is a financial asset measured at amortized cost; in that case, see KPMG Handbook, Credit impairment, for guidance on the recognition and measurement of credit losses. For indemnification assets that are outside the scope of ASC Subtopic 326-20 and are not measured at fair value, we believe the acquirer should use ASC Subtopic 450-20, *Contingencies - Loss Contingencies,* to account for credit losses.

Example 7.36: Indemnification Asset Related to Noncontractual Contingency

Q. ABC Corp. acquires DEF Corp. in a business combination. At the acquisition date, DEF is subject to a legal claim and indemnifies ABC for up to $2,500 in the event of an unfavorable outcome related to the contingency. ABC determines that, at the acquisition date, that a liability for the contingency does not meet the recognition criteria of ASC paragraphs 805-20-25-19 through 25-20. How should ABC account for the indemnification asset at the acquisition date?

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A. Because the contingency (the legal claim) does not meet the recognition criteria at the acquisition date, it is subject to the recognition exception, as discussed in ASC paragraph 805-20-25-20B and Paragraph 7.150. As a result, a liability for the contingency is not recognized at the acquisition date.

ASC Topic 805 requires that the indemnification asset be recognized at the same time it recognizes the indemnified item, measured on the same basis as the indemnified item (subject to the need for a valuation allowance for uncollectible amounts). Accordingly, because ABC does not recognize the indemnified item at the acquisition date, it would also not recognize the indemnification asset at that date.

If ABC subsequently recognizes a liability in its post-combination financial statements for the liability under ASC Topic 450, it would also recognize an indemnification asset at that time, measured using the same assumptions as the liability, subject to management's assessment of collectibility and contractual limitations on the indemnified amount. See discussion of *Indemnification Assets* in Section 12.

EXCEPTIONS TO THE MEASUREMENT PRINCIPLE

Reacquired Rights

> **ASC Paragraph 805-20-30-20**
>
> The acquirer shall measure the value of a reacquired right recognized as an intangible asset in accordance with [ASC] paragraph 805-20-25-14 on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

7.174 An acquirer's acquisition of a right that was granted previously to an acquiree to use one of the acquirer's assets (recognized or unrecognized) is a reacquired right. For example, the reacquisition in a business combination of a previously granted right to use the acquirer's trade name under a franchise agreement or the right to use the acquirer's technology are reacquired rights. A reacquired right represents an identifiable intangible asset that is recognized separately from goodwill as part of the acquisition accounting.

7.175 The FASB observed that a reacquired right is no longer a contract with a third party and that it would therefore not be appropriate to assume renewals of the contract. Accordingly, such rights are measured by taking into account only the remaining contractual terms of the related contract. Potential renewals are ignored even if a market participant considers potential contract renewals in the determination of fair value.

7.176 If the terms of the contract giving rise to a reacquired right are favorable or unfavorable relative to current market transactions for the same or similar items, the acquirer recognizes a gain or loss on the effective settlement of the preexisting relationship. (ASC paragraph 805-20-25-15) See discussion of *Preexisting Relationships* in Section 11.

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Example 7.37: Reacquired Right

On January 1, 20Y0, ABC Corp. granted DEF Corp. (which is a business) an exclusive right to sell products under ABC's brand name in a specified geographical area for 10 years. ABC subsequently acquires DEF on January 1, 20Y3. As a result, ABC has reacquired a right that it previously had granted to DEF, and ABC can now sell its products under its brand in the specified geographical area. ABC should recognize an intangible asset for this reacquired right at the acquisition date, measured at fair value based on the seven years remaining in the contract. Additionally, if the terms of the existing contract between ABC and DEF are favorable or unfavorable relative to market terms, a gain or loss on the effective settlement of the preexisting contract should also be recognized.

See Section 12 for a discussion of the subsequent accounting and measurement for reacquired rights.

Share-Based Payment Awards

> **ASC Paragraph 805-20-30-21**
>
> The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with the method in [ASC] Topic 718 [Compensation—Stock Compensation]. [ASC] Topic [805] refers to the result of that method as the fair-value-based measure of the award. [ASC] paragraphs 805-30-30-9 through 30-13 and 805-30-55-6 through 55-13 provide additional guidance.

7.177 Liabilities or equity instruments issued by an acquirer to replace share-based payment awards of an acquiree are measured in accordance with ASC Topic 718. The attribution of the fair-value-based measure of replacement awards to consideration transferred and/or post-combination vesting is based on a number of factors, including the vesting status of the awards and whether the acquirer is required to replace the acquiree awards. See the discussion of *Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree* in Section 11.

Assets Held for Sale

7.178 An acquirer is required to measure long-lived assets (or a disposal group), including intangible assets, that are classified as held for sale at the acquisition date in accordance with ASC Subtopic 360-10. ASC Subtopic 360-10 requires that such assets be measured at fair value less cost to sell. ASC paragraphs 805-20-30-22, 360-10-35-38 and 35-43

7.179 ASC Topic 805 and ASC Subtopic 820-10 exclude costs to sell in the measurement of fair value. However, ASC Subtopic 360-10 requires that assets classified as held for sale be measured at fair value less costs to sell. This inconsistency would have resulted in

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the recognition of a loss in the post-combination financial statements of the combined entity immediately following the acquisition, as an acquirer would have been required to remeasure the assets held for sale at fair value less costs to sell immediately following an acquisition. To deal with this inconsistency and avoid the recognition of a loss in the post-combination financial statements of the combined entity immediately following an acquisition, ASC Topic 805 provides for an exception to its fair value measurement principle for assets held for sale. Assets (or a disposal group) that are classified as held for sale at the acquisition date in accordance with ASC Subtopic 360-10 are measured at fair value less costs to sell. ASC paragraph 805-20-30-22

7.180 Paragraph not used.

Endnotes

[1] ASC paragraph 805-20-55-44: Melvin Simensky and Lanning Bryer, The New Role of Intellectual Property in Commercial Transactions (New York: John Wiley & Sons, 1998), 293.
[2] In June 2023, the FASB proposed an ASU that aimed to expand the application of the gross-up approach in ASC Topic 326 to include all financial assets acquired in a business combination, rather than just purchased credit deteriorated (PCD) assets. In April 2025, the Board tentatively decided to retain current accounting for PCD assets. Additionally, the Board tentatively decided that all loans acquired in a business combination and certain loans acquired in an asset acquisition would apply the gross-up approach. Entities should continue to monitor the FASB project for new developments.

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Section 8 - Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

Detailed Contents

Recognizing and Measuring Goodwill

Nature of Goodwill

Overpayments

Bargain Purchase

Example 8.1: A Business Combination in Which the Consideration Transferred for Less Than 100% of the Equity Interests in the Acquiree Is Less Than the Fair Value Received

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RECOGNIZING AND MEASURING GOODWILL

8.000 Under ASC Topic 805, *Business Combinations,* goodwill (or, in some instances a gain on a bargain purchase) is recognized at the acquisition date, and is measured as a residual. Goodwill previously recorded by an acquiree is not recorded as a separate asset by the acquirer. ASC paragraphs 805-30-25-1 and 30-1 discuss the components of the measurement of goodwill.

> **ASC Paragraph 805-30-30-1**
>
> The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b) below:
>
> a. The aggregate of the following:
>
> 1. The consideration transferred measured in accordance with [ASC Section 805-30-30], which generally requires acquisition-date fair value (see [ASC] paragraph 805-30-30-7)
>
> 2. The fair value of any noncontrolling interest in the acquiree
>
> 3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
>
> b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with [ASC Topic 805].

8.001 Guidance about recognition and measurement of the various components of the goodwill measurement (or the measurement of a gain from a bargain purchase) is included in the following Sections of this book:

(a)	The consideration transferred	Sections 6 and 18
(b)	Noncontrolling interest in the acquiree	Sections 7 and 19
(c)	For a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree	Sections 9 and 20
(d)	The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with ASC Topic 805	Sections 7 and 17

8.002 A gain on a bargain purchase is recognized in earnings at the acquisition date (see discussion below). Guidance on the accounting for goodwill subsequent to an acquisition is included in Section 22 and KPMG Handbook, Impairment of Nonfinancial Assets.

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NATURE OF GOODWILL

ASC Master Glossary: Goodwill

An asset representing the future economic benefits arising from other assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29.

8.003 Goodwill is an asset representing future economic benefits not attributable to other identifiable assets. This definition is consistent with the objective of not subsuming into goodwill amounts that should be separately recognized in a business combination. Thus, in applying the acquisition method, because goodwill is measured as a residual amount, it is important that all components of goodwill measurement (or the measurement of a gain from a bargain purchase) be recognized and measured based on the recognition and measurement principles (including the exceptions to such principles) of ASC Subtopic 805-30. For example, the failure of an acquirer to recognize and measure all identifiable assets acquired and liabilities assumed, such as technology-based intangible assets that were owned by the acquiree but not recognized in the acquiree's financial statements as of the acquisition date, would result in a misstatement of both the identifiable net assets acquired and an equal and offsetting misstatement of goodwill at the acquisition date. Likewise, following the acquisition, subsuming the identifiable intangible asset into goodwill could result in misstatements of amortization expense or impairment charges or both.

OVERPAYMENTS

8.004 While excess consideration transferred over the identifiable assets acquired and liabilities assumed could represent an overpayment for the acquirer's interest in the acquiree, the acquirer does not recognize a loss on a business combination at the acquisition date. The FASB concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date. Overpayments are thus subsumed into goodwill and addressed through subsequent impairment testing of goodwill. (Statement 141(R), par. B382) See discussion of *Goodwill and Other Intangible Assets* in Section 22 and KPMG Handbook, Impairment of Nonfinancial Assets.

BARGAIN PURCHASE

ASC Paragraph 805-30-25-2

Occasionally, an acquirer will make a *bargain purchase*, which is a business combination in which the amount in [ASC] paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in [ASC paragraph 805-30-30-1(a)]. If that excess remains after applying the requirements in [ASC] paragraph 805-30-25-4,

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the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. Example 1 (see [ASC] paragraph 805-30-55-14) provides an illustration of this guidance.

ASC Paragraph 805-30-25-3

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items identified in paragraphs 805-20-25-16, and 805-20-30-10 also may result in recognizing a gain (or change the amount of a recognized gain) on a bargain purchase.

ASC Paragraph 805-30-25-4

Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. See [ASC] paragraphs 805-30-30-4 through 30-6 for guidance on the review of measurement procedures in connection with a reassessment required by this paragraph.

ASC Paragraph 805-30-30-5

… As part of that required reassessment, the acquirer shall then review the procedures used to measure the amounts [ASC Topic 805] requires to be recognized at the acquisition date for all of the following:

a. The identifiable assets acquired and liabilities assumed

b. The noncontrolling interest in the acquiree, if any

c. For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree

d. The consideration transferred.

ASC Paragraph 805-30-30-6

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

8.005 Bargain purchases occur if the recognized amounts of the identifiable net assets exceed the sum of consideration transferred, noncontrolling interests in the acquiree, and the fair value of any previously held equity interests in the acquiree, in accordance with ASC paragraph 805-30-30-1(b) The measurement components of the gain on a bargain purchase are the same as the measurement components of goodwill. Because the components in the computation are measured at fair value (subject to exceptions for certain of the identifiable net assets), the FASB concluded that a bargain purchase represents an economic gain that should be immediately recognized by the acquirer in earnings.

8.006 Because an owner generally will not knowingly or willingly sell assets or businesses at prices below their fair values, this situation is expected to occur

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infrequently. Examples of transactions that could result in a bargain purchase are as follows:

- When the acquiree is under a forced liquidation or distress sale. However, evidence of a forced or distressed sale is not required for a gain on a bargain purchase to be recognized.
- When the acquirer and acquiree previously entered into a purchase option for the set that does not meet the definition of a derivative and the fair value of the set when the option is exercised exceeds the sum of the strike price and the premium paid for the option.
- When the acquiree needs to dispose of the business by a specified date and does not have sufficient time to market the business to several potential buyers. Similarly, if the acquiree is forced to sell the business at a less than optimal time such as during an economic downturn to meet liquidity needs.
- When the measurement requirements of ASC Topic 805 which require, in certain instances, measurement of the identifiable assets acquired and liabilities assumed at amounts other than fair value (see Section 7).

8.007 Nonetheless, to address concerns over the potential inappropriate recognition of gains from bargain purchases, the FASB included the requirement in ASC paragraphs 805-30-25-4 and 30-5 through 30-6 that the acquirer, before recognizing a gain on a bargain purchase, reassess whether it has correctly *identified* all of the assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, any previously held equity interest in the acquiree, and the consideration transferred. Following that reassessment, the acquirer must review the procedures used to *measure* the following amounts required to be recognized at the acquisition date to ensure that the measurements reflect consideration of all available information as of the acquisition date:

- The identifiable assets acquired and liabilities assumed;
- Any noncontrolling interest in the acquiree;
- For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- The consideration transferred.

Although not specifically mentioned in ASC paragraphs 805-30-25-4 and 30-5 through 30-6, we believe that the reassessment process that an acquirer is required to go through before recognizing a gain on a bargain purchase should also include a review of the process used to identify amounts that are not part of what the acquirer and acquiree exchanged in the business combination. For example, a business combination may result in the effective settlement of a preexisting relationship between the acquirer and the acquiree (such as a supply agreement or an operating lease arrangement), may include transactions that compensates employees or former owners of an acquiree for future services, or may include transactions that reimburse the acquiree or its former owners for paying the acquirer's acquisition-related costs. Such transactions are not part of the

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business combination transaction, and should therefore be accounted for as separate transactions. Accounting for such arrangements as separate transactions, rather than as part of the acquisition, affects the computation of goodwill or the gain from a bargain purchase that arises from the business combination. See discussion of *Determining What is Part of the Business Combination Transaction* in Section 11.

8.008 Any remaining gain from a bargain purchase after completing the reassessment is recognized as a gain by the acquirer at the acquisition date. We believe all of the gain should be attributed to the acquirer and no gain should be attributed to the noncontrolling interest, if any. ASC paragraph 220-20-45-1 should be considered in determining the classification in the income statement of any recognized gain from a bargain purchase. ASC paragraph 805-30-50-1(f) requires disclosure of the amount of any recognized gain from a bargain purchase, the line items in the income statement in which the gain is recognized, and a description of the reasons why the transaction resulted in a gain.

8.009 Example 8.1 illustrates the procedures an acquirer follows before recognizing a gain on a bargain purchase. This example is adapted from Example 1 appearing in ASC paragraphs 805-30-55-14 through 55-16.

Example 8.1: A Business Combination in Which the Consideration Transferred for Less Than 100% of the Equity Interests in the Acquiree Is Less Than the Fair Value Received

On January 1, 20X5, AC acquires 80% of the equity interests of TC, a private entity, in exchange for cash of $150. Because the former owners of TC needed to dispose of their investments in TC by a specified date, they lacked sufficient time to market TC to multiple potential buyers. AC initially measures the identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of ASC Topic 805. AC measures the identifiable assets at $250, and the liabilities assumed at $50. AC engages an independent consultant who determines that the fair value of the 20% noncontrolling interest in TC is $42. AC also performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination. The amount of TC's identifiable net assets ($200, calculated as $250 - $50) exceeds the fair value of the consideration transferred plus the fair value of the noncontrolling interest in TC, resulting in an initial indication of a gain on a bargain purchase. Therefore, AC reviews the procedures it used to identify and measure the assets acquired and liabilities assumed, to measure the fair value of both the noncontrolling interest in TC and the consideration transferred, and the process it used to identify transactions that were not part of the business combination. Following that review, AC concludes that the procedures followed and the resulting measurements were appropriate. AC measures the gain on its purchase of the 80% interest as follows:

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Identifiable net assets acquired ($250 - $50)	$ 200
Less:	
Fair value of the consideration transferred for AC 80% interest in TC	$ 150
Fair value of the noncontrolling interest in TC	$ 42
	$ 192
Gain on bargain purchase of 80% interest	$ 8

AC would record its acquisition of TC in its consolidated financial statements as follows:

	Debit	Credit
Identifiable assets acquired	250	
Cash		150
Liabilities assumed		50
Gain on a bargain purchase		8
Equity—noncontrolling interest in TC		42

ASC paragraphs 805-30-55-14 through 55-16

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Section 9 - Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations

Detailed Contents

Business Combinations Achieved in Stages (Step Acquisitions)

Example 9.1: Step Acquisition

Business Combinations Achieved Without the Transfer of Consideration

Measurement of Goodwill in a Business Combination Achieved without the Transfer of Consideration
A Business Combination Resulting from the Reacquisition by an Acquiree of Its Own Shares

Example 9.2: Control Obtained Through the Reacquisition of Shares by an Acquiree

A Business Combination Achieved Through Lapse of Minority Approval or Veto Rights

Example 9.3: Control Obtained on Lapse of Minority Veto Rights

A Business Combination Achieved by Contract Alone

Example 9.4: Physician Practice Management Entity Enters into a Management Agreement with a Physician Practice

Reverse Acquisitions

Reverse Acquisitions Involving a Shell Company
Measuring the Consideration Transferred
Preparation and Presentation of Consolidated Financial Statements

Example 9.5: Financial Statement Presentation

Example 9.6: Pre-combination Shareholdings of the Acquirer

Example 9.7: Presentation of Share-Based Payment Information for Periods Prior to the Acquisition for a Reverse Acquisition

Noncontrolling Interest in a Reverse Acquisition
Earnings per Share
Share-Based Payment Awards in a Reverse Acquisition

Example 9.8: Reverse Acquisition

SPAC Mergers

Accounting Acquirer

Example 9.9: Target Controlled by Same Parent

Example 9.10: SPAC Is Primary Beneficiary of VIE

Table 9.1: Key Factors in Determining Acquirer in a SPAC Transaction

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Example 9.11: Determining Accounting Acquirer in a SPAC Transaction

Reverse Recapitalizations

Table 9.2: Common Differences between Business Combinations and Reverse Recapitalizations in SPAC Transactions

Contingent Consideration in a Reverse Recapitalization

Compensatory Arrangements

Not Compensatory

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BUSINESS COMBINATIONS ACHIEVED IN STAGES (STEP ACQUISITIONS)

ASC Paragraph 805-10-25-9

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. [ASC Topic 805] refers to such a transaction as a *business combination achieved in stages,* sometimes also referred to as a step acquisition.

ASC Paragraph 805-10-25-10

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

9.000 A business combination occurs on the date the acquirer obtains control of the acquiree (i.e., the acquisition date). In a business combination achieved in stages, this is the date on which the acquirer purchases an additional equity interest and gains control of the acquiree. At that date, the acquirer applies the acquisition method to account for the combination. The acquirer remeasures its previously held equity interest in the acquiree at its acquisition-date fair value, and recognizes the resulting gain or loss in earnings (including changes in value that were previously recognized in accumulated other comprehensive income). Additionally, the consideration transferred is measured; the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree are recognized and measured; goodwill or, in some cases, a gain from a bargain purchase, is recognized and measured, and the accounting acquirer consolidates the acquiree. See the discussion of *The Acquisition Method* in Section 3. Refer to Appendix 4-1 in KPMG Handbook, Guide to Accounting for Foreign Currency for discussion of how to account for foreign currency translation adjustments in business combinations of foreign equity method investments achieved in stages.

9.001 The following example illustrates the accounting for a step acquisition.

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Example 9.1: Step Acquisition

On December 31, 20X1 ABC Corp. acquires 30% of the outstanding shares of DEF Corp. for $1,000 cash. The fair value of the identifiable net assets of DEF is $2,500. DEF has a breakeven net income and other comprehensive income of $100 for the year ended December 31, 20X2.

On December 31, 20X2, ABC acquires an additional 50% of the outstanding shares of DEF for $2,000 cash. At that date, the fair value of the identifiable net assets of DEF is $3,000. ABC determines that the acquisition-date fair value of its original investment and the noncontrolling interest in DEF at December 31, 20X2 is $1,050 and $700, respectively. The determination of the fair value of ABC's original investment does not reflect consideration of a control premium (i.e., control is associated only with ABC's acquisition of an additional 50% interest on December 31, 20X2).

ABC accounts for its investment in DEF during 20X2 by the equity method, and recognizes $30 (30% × $100) in other comprehensive income, and amortization expense of $20 related to the fair value adjustments recognized as of December 31, 20X1.

As a result of the acquisition of an additional 50% interest in DEF on December 31, 20X2, ABC obtains control of DEF. Thus, a business combination occurs as of that date and ABC accounts for the acquisition of DEF by the acquisition method. ABC determines the goodwill resulting from the acquisition and the gain on its previously held interest in DEF at the acquisition date as follows:

Goodwill:	
Fair value of consideration transferred	$ 2,000
Fair value of the noncontrolling interest	$ 700
Fair value of ABC's previously held equity interest	$ 1,050
Subtotal (a)	$ 3,750
Less: Identifiable assets acquired net of liabilities assumed measured under ASC Topic 805 (b)	$ 3,000
Goodwill (a-b)	$ 750
Gain on previously held equity interest in DEF:	
Fair value at December 31, 20X2 (c)	$ 1,050
Less basis of ABC's investment:	
Investment at December 31, 20X1	$ 1,000
ABC's equity in DEF's earnings for 20X2, including amortization of fair value adjustments	$ (20)
ABC's share of DEF's other comprehensive income for 20X2 ($100 × 30%)	$ 30

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ABC's basis of the previously held equity interest in DEF before the acquisition of the additional 50% equity interest (d)	$ 1,010
Excess of fair value over ABC's basis in DEF (e) (equal to (c)-(d))	$ 40
Recognize AOCI in earnings (f)	$ 30
Gain on previously held equity interest in DEF recognized in earnings (e + f)	$ 70

ABC records the following to reflect the gain on its previously held equity interest in DEF and its acquisition of DEF as of December 31, 20X2:

	Debit	Credit
Identifiable net assets of DEF	3,000	
Goodwill	750	
AOCI	30	
Cash		2,000
Investment in DEF		1,010
Noncontrolling interest in DEF		700
Gain on previously held equity interest in DEF		70

9.002 Before the business combination, the acquirer may have held an option to purchase a controlling interest (i.e., a call option) in the acquiree. These options are generally not accounted for as a derivative instrument and, since there is no other explicit GAAP, they are generally measured at cost and not remeasured during the option period. An example of this instrument is when an entity has a 20% equity method investment in an investee and a freestanding fixed price call option to acquire the remaining 80%. The accounting for these options before the acquisition is discussed in Question 3.2.35 of KPMG Handbook, Equity method of accounting.

9.002a We understand there are different perspectives in practice about whether the option being exercised should be remeasured at the acquisition date similar to a previously held equity interest. Some view these options similar to any other previously held equity interest and believe they should be remeasured. Others view the option as an executory contract that should not be remeasured. As such, either view may be appropriate depending on the facts and circumstances. However, we believe that remeasuring an option that when exercised results in an asset acquisition is not appropriate.

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BUSINESS COMBINATIONS ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

ASC Paragraph 805-10-25-11

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include any of the following:

a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.

c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

9.003 A business combination occurs when an acquirer obtains control of one or more businesses. When an entity obtains control of a business, even without the transfer of consideration, a business combination has occurred and is within the scope of ASC Topic 805, *Business Combinations.* The acquisition method applies to such transactions, which requires, among other things, recognizing and measuring the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. ASC Topic 805 provides special guidance for these types of transactions.

9.004 The application of the acquisition method in each of the situations identified in ASC paragraph 805-10-25-11 in which an acquiree obtains control of an acquiree without the transfer of consideration is illustrated below.

MEASUREMENT OF GOODWILL IN A BUSINESS COMBINATION ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

ASC Paragraph 805-30-30-3

To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree determined using a valuation technique in place of the acquisition-date fair value of the consideration transferred (see [ASC] paragraph 805-30-30-1(a)(1)). Paragraphs 805-30-55-3 through 55-5 provide additional guidance on applying the acquisition method to combinations of mutual entities, including measuring the acquisition-date fair value of the acquiree's equity interests using a valuation technique.

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ASC Paragraph 805-30-55-2

In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see [ASC] paragraphs 805-30-30-1 through 30-4). [ASC] Subtopic 820-10 provides guidance on using valuation techniques to measure fair value.

9.005 The determination of goodwill in a business combination achieved without the transfer of consideration requires the acquirer to substitute the acquisition-date fair value of its interest in the acquiree for the consideration transferred. The acquisition-date fair value of the acquirer's interest is measured using one or more valuation techniques. The acquisition-date fair value of the acquirer's interest in the acquiree should reflect, in our view, any control premium attributable to the acquirer's controlling financial interest that will exist as a result of the acquirer obtaining control of the acquiree. The acquirer uses the fair value so determined as the consideration transferred to measure goodwill or a gain on a bargain purchase. This also requires the acquirer to:

- Adjust the carrying amount of its interest in the acquiree to fair value;
- Recognize in earnings any gain or loss equal to the difference between the carrying amount of its equity interest in the acquiree before gaining control of the acquiree and the fair value of its controlling interest in the acquiree as a result of the transaction; and
- To otherwise apply the acquisition method in accounting for the business combination.

A BUSINESS COMBINATION RESULTING FROM THE REACQUISITION BY AN ACQUIREE OF ITS OWN SHARES

9.006 If an investee (acquiree) buys back enough of its own shares such that an existing shareholder (acquirer) obtains control of the acquiree, a business combination has occurred and the acquirer would apply the acquisition method to account for the transaction.

Example 9.2: Control Obtained Through the Reacquisition of Shares by an Acquiree

ABC Corp. owns 45% of DEF Corp. DEF repurchases a number of its shares such that ABC's ownership percentage increases to 55%. The repurchase transaction results in ABC obtaining control of DEF and, therefore, is a business combination under ASC Topic 805. ABC is the acquirer of DEF, and accounts for the business combination by the acquisition method. As of the acquisition date (i.e., the date ABC obtains control), ABC:

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(1) Remeasures its previously held interest in DEF (45%) at its acquisition-date fair value, and recognizes in earnings any gain or loss equal to the difference between the carrying amount of its equity interest in DEF before gaining control and the fair value of its controlling interest in DEF as a result of the transaction.

(2) Recognizes and measures the identifiable assets acquired, the liabilities assumed, and the noncontrolling interest in DEF based on the recognition and measurement principles of ASC Topic 805.

(3) Recognizes and measures goodwill or a gain from a bargain purchase, using the fair value of its controlling interest in DEF as a result of the transaction as a substitute for the consideration transferred.

See Section 3 for a discussion of *The Acquisition Method.*

A BUSINESS COMBINATION ACHIEVED THROUGH LAPSE OF MINORITY APPROVAL OR VETO RIGHTS

9.007 An entity (investor) may own a majority interest in another entity (investee), but not consolidate that entity, because the noncontrolling interests in the investee have substantive participating rights that overcome the usual presumption that the investor with a majority voting interest should consolidate the investee. See ASC paragraphs 810-10-25-2 through 25-14 and ASC Section 810-20-25. In such situations, if the substantive participating rights held by the noncontrolling interests expire and the investor holding the majority voting interest gains control of the investee, the investor has acquired the investee in a business combination, and therefore applies the acquisition method to account for the transaction.

Example 9.3: Control Obtained on Lapse of Minority Veto Rights

ABC Corp. owns 55% of DEF Corp. but does not consolidate DEF because of substantive participating rights held by the minority shareholders (see ASC paragraphs 810-10-25-2 through 25-14). On September 30, 20X9, the veto rights expire. The lapse of minority veto rights results in ABC obtaining control of DEF and, therefore, this event meets the definition of a business combination under ASC Topic 805. ABC is the acquirer of DEF, and accounts for the business combination by the acquisition method.

As of the acquisition date (i.e., September 30, 20X9), the carrying amount of ABC's 55% interest in DEF is $42 million. ABC also determines, using one or more valuation techniques, that the acquisition-date fair value of DEF's identifiable assets and liabilities is $90 million (determined in accordance with the recognition and measurement principles of ASC Topic 805), the acquisition-date fair value of ABC's 55% interest in DEF (including a control premium) is $60 million, and the acquisition-date fair value of the 45% noncontrolling interest after the transaction is $45 million.

In applying the acquisition method to this transaction, ABC:

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(1) Remeasures its previously held interest in DEF at its acquisition-date fair value ($60 million), adjusts the carrying amount of its interest in DEF to the fair value so determined, and recognizes in earnings the resulting gain of $18 million ($60 million fair value of its controlling interest as a result of the transaction less the $42 million historical carrying amount of ABC's equity interest in DEF).

(2) Recognizes and measures the identifiable assets acquired and the liabilities assumed in accordance with the recognition and measurement principles of ASC Topic 805 ($90 million), and the noncontrolling interest in DEF at its acquisition-date fair value ($45 million).

(3) Recognizes goodwill of $15 million ($60 fair value of ABC's controlling interest in DEF used as a substitute for the consideration transferred plus the $45 million acquisition-date fair value of the noncontrolling interest in DEF, less the $90 million fair value of DEF's identifiable assets and liabilities).

ABC's entries to record the acquisition of DEF are:

	Debit	Credit
Investment in DEF	18 million	
Gain on previously held investment in DEF		18 million
Identifiable net assets	90 million	
Goodwill	15 million	
Investment in DEF		60 million
Noncontrolling interest in DEF		45 million

See discussion of *The Acquisition Method* in Section 3.

A BUSINESS COMBINATION ACHIEVED BY CONTRACT ALONE

ASC Paragraph 805-10-25-12

In a business combination achieved by contract alone, the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree's net assets recognized in accordance with the requirements of [ASC] Topic [805]. In other words, the equity interests in the acquiree held by parties other than the acquirer are a noncontrolling interest in the acquirer's postcombination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the noncontrolling interest.

9.008 Business combinations achieved by contract alone are within the scope of ASC Topic 805 and are accounted for by the acquisition method. Thus, the acquirer recognizes the assets acquired and liabilities assumed in accordance with the recognition and measurement requirements of ASC Topic 805. This applies to such transactions even if the acquirer did not previously hold or acquire any equity interest in the acquiree. Equity

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interests held by parties other than the acquirer (i.e., the party that obtains control by contract) are noncontrolling interests and are presented as such in the acquirer's post-combination financial statements.

9.009 Business combinations achieved by contract alone often result in the formation of a variable interest entity. In such situations, the primary beneficiary of the variable interest entity is the acquirer regardless of whether the entity has adopted ASU 2025-03, because business combinations achieved by contract alone are not effected primarily by exchanging equity interests. See the discussion below and the discussion of *Variable Interest Entities* in Section 4.

9.010 Paragraph B78 of Statement 141(R) cites as an example of a business combination achieved by contract alone a transaction in which a physician practice management entity executes a management agreement with a physician practice, and notes that the EITF reached a consensus that these transactions should be accounted for as business combinations. ASC paragraphs 810-10-15-19 through 15-22, 25-61 through 25-81, and 55-206 through 55-209

Example 9.4: Physician Practice Management Entity Enters into a Management Agreement with a Physician Practice

Q. Should the acquisition method be applied in a transaction in which a physician practice management entity (PPM) executes a management agreement with a physician practice (assume the physician practice is a business)?

A. Many of the arrangements between a physician practice and a PPM arise when the PPM seeks to acquire the physician practice. Legal or business reasons often preclude the PPM from acquiring the physician practice's outstanding equity interests. As an alternative, the PPM often will acquire some or all of the net assets of the physician practice, assume some or all of its contractual rights and responsibilities, and execute a long-term management agreement to operate the physician practice with its owners (typically the physicians) receiving consideration in exchange. ASC paragraphs 810-10-25-61 through 25-81 provide guidance for determining when a controlling financial interest in a physician practice through a contractual management arrangement with a PPM is established.

If a PPM establishes a controlling financial interest in a physician practice through a contractual management arrangement, and the physician practice is not a variable interest entity, then the PPM should apply the acquisition method in accordance with ASC Topic 805. However, if the physician practice is a variable interest entity, the primary beneficiary is the acquirer and, accordingly, the primary beneficiary (which could be the PPM) would apply the acquisition method. See the discussion of *Variable Interest Entities* in Section 4.

9.011 While ASC paragraphs 810-10-25-61 through 25-81 relate to entities that operate in the health care industry, its guidance for establishing a controlling financial interest applies to similar arrangements in other industries. For example, this guidance might

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apply to research and development arrangements, franchise arrangements, hotel management contracts, and service corporations for real estate investment trusts. These arrangements may involve the transfer of significant rights from the legal owners of an entity to another entity via a management arrangement or similar contract. If an entity establishes a controlling financial interest in another entity (acquiree) that is a business as a result of entering into a management arrangement, the entity should first assess whether the acquiree is a variable interest entity. If the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree is the accounting acquirer and should apply the acquisition method and consolidate the VIE. If the acquiree is not a VIE, the entity that established the controlling financial interest in the acquiree is the accounting acquirer, and should apply the acquisition method and consolidate the entity. See Section 4 for a discussion of *Variable Interest Entities*.

REVERSE ACQUISITIONS

ASC Master Glossary: Reverse Acquisition

An acquisition in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in [ASC] paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.

ASC Paragraph 805-40-05-2 (Emphasis added)

As one example of a reverse acquisition, a private operating entity may want to become a public entity but not want to register its equity shares. To become a public entity, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this situation, the public entity is the *legal acquirer* because it issued its equity interests, and the private entity is the *legal acquiree* because its equity interests were acquired. However, application of the guidance in [ASC] paragraphs 805-10-55-11 through 55-15 results in identifying:

a. The public entity as the *acquiree* for accounting purposes (the accounting acquiree)

b. The private entity as the *acquirer* for accounting purposes (the accounting acquirer).

ASC Paragraph 805-40-25-1

For a business combination transaction to be accounted for as a reverse acquisition, the accounting acquiree must meet the definition of a business. All of the recognition principles in [ASC] Subtopics 805-10, 805-20, and 805-30, including the requirement to recognize goodwill, apply to a reverse acquisition.

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ASC Paragraph 805-40-30-1

All of the measurement principles applicable to business combinations in [ASC] Subtopics 805-10, 805-20, and 805-30 apply to a reverse acquisition.

9.012 The example of a reverse acquisition included in ASC Section 805-40-55 is comprehensive in nature. That example is presented below in its entirety as Example 9.8 in Paragraph 9.019 to illustrate the basic concepts that apply to the accounting for reverse acquisitions.

9.013 See Example 6.3, *Transfer of a Subsidiary to an Acquiree,* in Section 6 for an additional example of a reverse acquisition.

REVERSE ACQUISITIONS INVOLVING A SHELL COMPANY

9.014 The SEC staff has taken the position that a transaction between a private operating company and a nonoperating public *shell company*, in which the shell company is the issuer of securities and the operating company is the acquirer for accounting purposes, should be treated for financial reporting purposes as an issuance of securities by the operating company. These transactions are not business combinations because the shell company is not a business. The operating company would credit equity for the fair value of the net monetary assets of the shell company (i.e., no goodwill or intangible assets would be recognized in this transaction). Costs directly related to this transaction should be charged to equity only to the extent of cash received, while all costs in excess of cash received should be charged to expense.

9.014a Whether a public company meets the SEC's definition of a shell company is a legal determination that should be performed by the company's SEC legal counsel.

9.014b In many instances, a reverse acquisition may involve a public company that no longer has future operating prospects (e.g., a life sciences company whose only drug candidate fails during clinical trials). The public company may find a merger partner in the form of a private company that wants to go public. A reverse acquisition may benefit both parties as it maximizes value for the shareholders of the public company and allows the private company to become public without incurring the cost and time associated with an IPO process. Often, the public company does not meet the SEC's definition of a shell company because it had significant pre-combination assets and/or activities.

9.015 Even if a public company does not meet the SEC's definition of a shell company, the public company may have little to no assets (other than cash or cash equivalents) or activities by the time the reverse acquisition is consummated. If the public company's assets or activities just prior to the reverse acquisition meet the definition of a business, and the private company is the acquirer for accounting purposes, the transaction constitutes a business combination. However, if the assets and activities of the public company are not sufficient to meet the definition of a business, and the private company is the acquirer for accounting purposes, the accounting acquirer would account for this transaction as the acquisition of a group of assets.

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MEASURING THE CONSIDERATION TRANSFERRED

ASC Paragraph 805-40-30-2

In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree. Instead, the accounting acquiree usually issues its equity shares to the owners of the accounting acquirer. Accordingly, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. Example 1, Case A (see [ASC] paragraph 805-40-55-8) illustrates that calculation. The fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred in exchange for the acquiree.

PREPARATION AND PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS

ASC Paragraph 805-40-45-1

Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to retroactively adjust the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree). Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).

ASC Paragraph 805-40-45-2 (Emphasis added)

Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect all of the following:

a. The assets and liabilities of the legal subsidiary (the accounting acquirer) recognized and measured at their precombination carrying amounts.

b. The assets and liabilities of the legal parent (the accounting acquiree) recognized and measured in accordance with [ASC] Topic [805] applicable to business combinations.

c. The retained earnings and other equity balances of the legal subsidiary (accounting acquirer) *before* the business combination.

d. The amount recognized as issued equity interests in the consolidated financial statements determined by adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the

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business combination to the fair value of the legal parent (accounting acquiree) determined in accordance with the guidance in [ASC] Topic [805] applicable to business combinations. However, the equity structure (that is, the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.

e. The noncontrolling interest's proportionate share of the legal subsidiary's (accounting acquirer's) precombination carrying amounts of retained earnings and other equity interests as discussed in [ASC] paragraphs 805-40-25-2 and 805-40-30-3 and illustrated in Example 1, Case B (see [ASC] paragraph 805-40-55-18).

9.016 In a business combination, the acquirer recognizes the assets and liabilities of the acquiree in accordance with the recognition and measurement principles of ASC Topic 805. The acquirer includes the acquiree's results of operations in its post-combination financial statements from the acquisition date. This guidance also applies to reverse acquisitions, in which the acquiree (for accounting purposes) is the surviving entity. The historical financial statements of the acquirer (for accounting purposes) are presented as the historical financial statements of the combined entity, and the assets and liabilities of the acquiree (the legal acquirer) are recognized and measured in accordance with the recognition and measurement principles of ASC Topic 805. Likewise, the results of operations of the acquired entity (the legal acquirer) are included in the financial statements of the combined entity only from the date of acquisition, even if the acquired entity (legal acquirer) is the surviving entity.

9.017 The equity of the acquirer is presented as the equity of the combined entity; however, the capital share account of the acquirer is adjusted to reflect the par value of the outstanding shares of the legal acquirer after considering the number of shares issued in the business combination. The difference between the capital share account of the acquirer and the capital share account of the legal acquirer (presented as the capital share account of the combined entity) is recorded as an adjustment to additional paid-in capital of the combined entity. For periods prior to the business combination, the equity of the combined entity is the historical equity of the acquirer prior to the merger, retroactively restated to reflect the number of shares received in the business combination. Retained earnings of the acquirer are carried forward after the acquisition. Earnings per share for periods prior to the business combination are restated to reflect the number of equivalent shares received by the acquirer.

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Example 9.5: Financial Statement Presentation

ABC Corp. issues common shares to the shareholders of DEF Corp. in exchange for all outstanding common shares of DEF. On consummation of the combination, DEF becomes a wholly owned subsidiary of ABC and the former shareholders of DEF own 60% of the outstanding common shares of ABC.

Because the former shareholders of DEF receive the larger portion of the voting interests in the combined entity, and assuming there is no evidence pointing to a different acquiring entity, DEF is the acquirer for accounting purposes.

For purposes of the consolidated financial statements of the surviving entity (ABC), DEF's historical financial statements should be presented as the historical financial statements of the combined entity. The assets and liabilities of ABC should be recognized and measured in accordance with ASC Topic 805 as of the acquisition date. The results of operations of ABC are included in the financial statements of the combined entity only for periods subsequent to the acquisition.

Although the equity of DEF (the acquirer) is presented as the equity of the combined entity, the capital share account must be adjusted to reflect the outstanding shares of ABC (the surviving entity). That is, the retained earnings of DEF would be presented as the retained earnings of the combined entity; the capital share account of the combined entity would reflect the par value of ABC's shares; and the additional paid-in capital account of DEF would be adjusted for the difference between the capital share account of DEF and the capital share account of ABC, and that adjusted amount would be presented as additional paid-in capital of the combined entity.

Example 9.6: Pre-combination Shareholdings of the Acquirer

Q. How should shares of a legal acquirer that had been held by the accounting acquirer prior to a reverse acquisition be considered in accounting for the business combination?

A. The transaction should be accounted for as a business combination achieved in stages (step acquisition). The accounting acquirer would recognize and measure the legal acquirer's identifiable assets and liabilities, the previously held interest and noncontrolling interest at acquisition-date fair value. The accounting acquirer would recognize a gain or loss for the difference between the carrying amount of the previously held investment in the legal acquirer and the acquisition-date fair value (see Paragraph 9.005).

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Example 9.7: Presentation of Share-Based Payment Information for Periods Prior to the Acquisition for a Reverse Acquisition

Q. Should the accounting acquirer in a transaction accounted for as a reverse acquisition retrospectively adjust its share-based payment disclosures for periods prior to the business combination when the equity of the accounting acquirer has been retrospectively adjusted to reflect the shares received in the business combination?

A. Yes, in our view it would be appropriate to adjust the share-based payment disclosures to reflect the impact of the business combination on a basis that is comparable to the retrospectively adjusted legal capital that is presented in shareholders' equity.

NONCONTROLLING INTEREST IN A REVERSE ACQUISITION

ASC Paragraph 805-40-25-2

In a reverse acquisition, some of the owners of the legal acquiree (the accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (the accounting acquiree). Those owners are treated as a noncontrolling interest in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal acquiree that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal acquiree—not in the results and net assets of the combined entity. Conversely, even though the legal acquirer is the acquiree for accounting purposes, the owners of the legal acquirer have an interest in the results and net assets of the combined entity.

ASC Paragraph 805-40-30-3

The assets and liabilities of the legal acquiree are measured and recognized in the consolidated financial statements at their precombination carrying amounts (see [ASC] paragraph 805-40-45-2(a)). Therefore, in a reverse acquisition the noncontrolling interest reflects the noncontrolling shareholders' proportionate interest in the precombination carrying amounts of the legal acquiree's net assets even though the noncontrolling interests in other acquisitions are measured at their fair values at the acquisition date.

9.018 In a reverse acquisition, the combined entity should reflect a noncontrolling interest when the legal acquirer does not obtain all the ownership interests in the legal acquiree. This noncontrolling interest is measured based on the proportionate share of the pre-combination carrying amounts of the accounting acquirer's (legal acquiree's) net assets. Other financial instruments that are classified as equity in the legal acquiree's financial statements that remain outstanding after a reverse acquisition are also classified as a noncontrolling interest in the post-combination financial statements of the combined entity.

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EARNINGS PER SHARE

ASC Paragraph 805-40-45-3

As noted in [ASC paragraph 805-40-45-2](d), the equity structure in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal acquirer (the accounting acquiree), including the equity interests issued by the legal acquirer to effect the business combination.

ASC Paragraph 805-40-45-4

In calculating the weighted-average number of common shares outstanding (the denominator of the earnings-per-share [EPS] calculation) during the period in which the reverse acquisition occurs:

a. The number of common shares outstanding from the beginning of that period to the acquisition date shall be computed on the basis of the weighted-average number of common shares of the legal acquiree (accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the merger agreement.

b. The number of common shares outstanding from the acquisition date to the end of that period shall be the actual number of common shares of the legal acquirer (the accounting acquiree) outstanding during that period.

ASC Paragraph 805-40-45-5

The basic EPS for each comparative period before the acquisition date presented in the consolidated financial statements following a reverse acquisition shall be calculated by dividing (a) by (b):

a. The income of the legal acquiree attributable to common shareholders in each of those periods

b. The legal acquiree's historical weighted average number of common shares outstanding multiplied by the exchange ratio established in the acquisition agreement.

9.018a For further guidance on the calculation and presentation of EPS in a reverse acquisition, see Section 7.5.20 of KPMG Handbook, Earnings Per Share.

SHARE-BASED PAYMENT AWARDS IN A REVERSE ACQUISITION

9.018b A reverse acquisition may involve the legal acquirer (accounting acquiree) issuing replacement share-based payment awards to employees of the legal acquiree (accounting acquirer). Because the legal acquirer is not the accounting acquirer, the value of the awards would not be attributed between the acquisition price and post-combination expense similar to replacement awards when the legal acquirer and accounting acquirer are the same entity. From an accounting standpoint, this transaction should be evaluated under the modification guidance in ASC Topic 718 and would not affect the acquisition price. For further discussion, see KPMG Handbook, Share-Based Payment.

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9.018c For employees of the legal acquirer (accounting acquiree), there may not be a change in the legal form or terms of outstanding share-based payment awards. However, from an accounting perspective it is as if the accounting acquirer (legal acquiree) was obligated to issue replacement awards and did so. Therefore, the accounting acquirer (legal acquiree) will attribute the value of the share-based payment awards between the acquisition price and post-combination expense consistent with other replacement awards. See discussion of attributing the value of these awards in Paragraphs 11.025 through 11.033.

Comprehensive Example

9.019 The following example is included in ASC paragraphs 805-40-55-3 through 55-23. The example demonstrates the application of the guidance and concepts discussed in ASC paragraphs 805-40-25-2, 30-2 and 30-3, and 45-1 through 45-5.

Example 9.8: Reverse Acquisition

This example illustrates the accounting for a reverse acquisition in which Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity interests and therefore the legal parent, on September 30, 20X6. This example ignores the accounting for any income tax effects.

The statements of financial position of Entity A and Entity B immediately before the business combination are:

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

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This example also uses the following information:

(a) On September 30, 20X6, Entity A issues 2.5 shares in exchange for each common share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 common shares in exchange for all 60 common shares of Entity B.

(b) The fair value of each common share of Entity B at September 30, 20X6, is $40. The quoted market price of Entity A's common shares at that date is $16.

(c) The fair values of Entity A's identifiable assets and liabilities at September 30, 20X6, are the same as their carrying amounts, except that the fair value of Entity A's noncurrent assets at September 30, 20X6, is $1,500.

Calculating the Fair Value of the Consideration Transferred

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

Measuring Goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognized identifiable assets and liabilities, as follows:

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

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The consolidated statement of financial position immediately after the business combination is:

	$
Current assets ($700 + $500)	1,200
Noncurrent assets ($3,000 + $1,500)	4,500
Goodwill	300
Total assets	6,000
Current liabilities ($600 + $300)	900
Noncurrent liabilities ($1,100 + $400)	1,500
Total liabilities	2,400
Shareholders' equity	
Retained earnings	1,400
Issued equity	
250 common shares ($600 + $1,600)	2,200
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

In accordance with ASC paragraphs 805-40-45-2(c) through 45-2(d), the amount recognized as issued equity interests in the consolidated financial statements ($2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination ($600) and the fair value of the consideration effectively transferred, measured in accordance with ASC paragraph 805-40-30-2 ($1,600). However, the equity structure appearing in the consolidated financial statements (that is, the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

Earnings per Share

ASC paragraph 805-40-55-16. Entity B's earnings for the annual period ending December 31, 20X5, was $600, and the consolidated earnings for the annual period ending December 31, 20X6, is $800. There was no change in the number of common shares issued by Entity B during the annual period ending December 31, 20X5, and during the period from January 1, 20X6, to the date of the reverse acquisition on September 30, 20X6. Earnings per share for the annual period ended December 31, 20X6, is calculated as follows:

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Number of shares deemed to be outstanding for the period from January 1, 20X6, to the acquisition date (that is, the number of common shares issued by Entity A (legal parent, accounting acquiree) in the reverse acquisition)	150
Number of shares outstanding from the acquisition date to December 31, 20X6	250
Weighted-average number of common shares outstanding ([150 × 9 ÷ 12] + [250 × 3 ÷ 12])	175
Earnings per share (800 ÷ 175)	4.57

Restated EPS for the annual period ending December 31, 20X5, is $4.00 (calculated as the earnings of Entity B of 600 divided by the 150 common shares Entity A issued in the reverse acquisition).

Noncontrolling Interest

Assume the same facts as above, except that only 56 of Entity B's 60 common shares are exchanged. Because Entity A issues 2.5 shares in exchange for each common share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3 percent of the issued shares of the combined entity (140 of 240 issued shares). The fair value of the consideration transferred for Entity A, the accounting acquiree, is calculated by assuming that the combination had been effected by Entity B's issuing additional common shares to the shareholders of Entity A in exchange for their common shares in Entity A. That is because Entity B is the accounting acquirer, and ASC paragraphs 805-30-30-7 and 30-8 require the acquirer to measure the consideration exchanged for the accounting acquiree. In calculating the number of shares that Entity B would have had to issue, the noncontrolling interest is ignored. The majority shareholders own 56 shares of Entity B. For that to represent a 58.3 percent equity interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 of the 96 issued shares of Entity B and, therefore, 58.3 percent of the combined entity. As a result, the fair value of the consideration transferred for Entity A, the accounting acquiree, is $1,600 (that is, 40 shares each with a fair value of $40). That is the same amount as when all 60 of Entity B's shareholders tender all 60 of its common shares for exchange. The recognized amount of the group's interest in Entity A, the accounting acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.

The noncontrolling interest is represented by the 4 shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the noncontrolling interest is 6.7 percent. The noncontrolling interest reflects the noncontrolling shareholders' proportionate interests in the pre-combination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated statement of financial position is adjusted to show a noncontrolling interest of 6.7 percent of the pre-combination carrying amounts of Entity B's net assets (that is, $134 or 6.7 percent of $2,000).

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The consolidated statement of financial position at September 30, 20X6, reflecting the noncontrolling interest is as follows:

	$
Current assets ($700 + $500)	1,200
Noncurrent assets ($3,000 + $1,500)	4,500
Goodwill	300
Total assets	6,000
Current liabilities ($600 + $300)	900
Noncurrent liabilities ($1,100 + $400)	1,500
Total liabilities	2,400
Shareholders' equity	
Retained earnings ($1,400 × 93.3%)	1,306
Issued equity	
240 common shares ($560 + $1,600)	2,160
Noncontrolling interest	134
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

The noncontrolling interest of $134 has 2 components. The first component is the reclassification of the noncontrolling interest's share of the accounting acquirer's retained earnings immediately before the acquisition ($1,400 × 6.7% or $93.80). The second component represents the reclassification of the noncontrolling interest's share of the accounting acquirer's issued equity ($600 × 6.7% or $40.20).

SPAC MERGERS

9.020 A SPAC typically raises capital in an IPO for the sole purpose of acquiring or merging with one or more target companies, often in a specific industry. If an acquisition is not accomplished during a predetermined timeframe (typically 18 or 24 months), the capital from its IPO is returned to the investors. The capital structure of a SPAC is often complex and requires significant analysis. See KPMG Handbook, Debt and equity financing, for guidance about the appropriate classification of and accounting for financial instruments as debt or equity. This section focuses on the accounting for a merger between a SPAC and target company and not the SPAC's accounting before the merger.

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9.021 The accounting acquirer determination in a SPAC merger is critical because it dictates the accounting basis of the merged entity. Additionally, determining the predecessor is often correlated with this determination, which affects the form and content of financial statements required in SEC filings. While the SPAC is typically the legal acquirer, the accounting does not always follow the legal form. In many cases, the target company (the legal acquiree) will be considered the accounting acquirer in what is referred to as a reverse recapitalization. When the SPAC is both the legal and accounting acquirer the transaction is commonly referred to as a forward merger.

9.022 Similar to a reverse acquisition involving a shell company (see Paragraphs 9.014 through 9.015), a reverse recapitalization is in substance the issuance of shares by the target company for the net monetary assets of the SPAC, accompanied by a recapitalization. This is because, in most cases, the SPAC will not meet the definition of a business and its only assets are cash and cash equivalents (e.g., nonmonetary assets are nominal).

9.023 Conversely, in a forward merger, the transaction is accounted for as a business combination or asset acquisition, depending on whether the target company meets the definition of a business (see Section 2). Because of the significance of the target company's operations relative to those of the SPAC, the target company is usually considered the predecessor entity for SEC reporting purposes. This results in the financial statements being presented on a 'blackline' or predecessor-successor basis (i.e., the target company's financials are presented on a historical basis for the period before the merger but include the effects of acquisition accounting adjustments post-merger). The presentation should include:

- The predecessor periods and successor periods separated by a blackline; and
- Columns clearly labeled with either 'predecessor' or 'successor', or equivalent.

ACCOUNTING ACQUIRER

9.024 As discussed in Paragraph 4.022b, a SPAC generally has significant pre-combination activities associated with executing its investment strategy and is therefore typically considered a substantive entity that could be the accounting acquirer. As such, in a merger between a SPAC and target company, the entities will need to determine whether the SPAC or target company is the acquirer in the merger.

9.025 The accounting acquirer analysis in a SPAC transaction is often complex. The following decision tree and related discussion depicts the key steps in the accounting acquirer analysis for a typical SPAC merger. See Section 4 for a detailed discussion of the accounting acquirer guidance.

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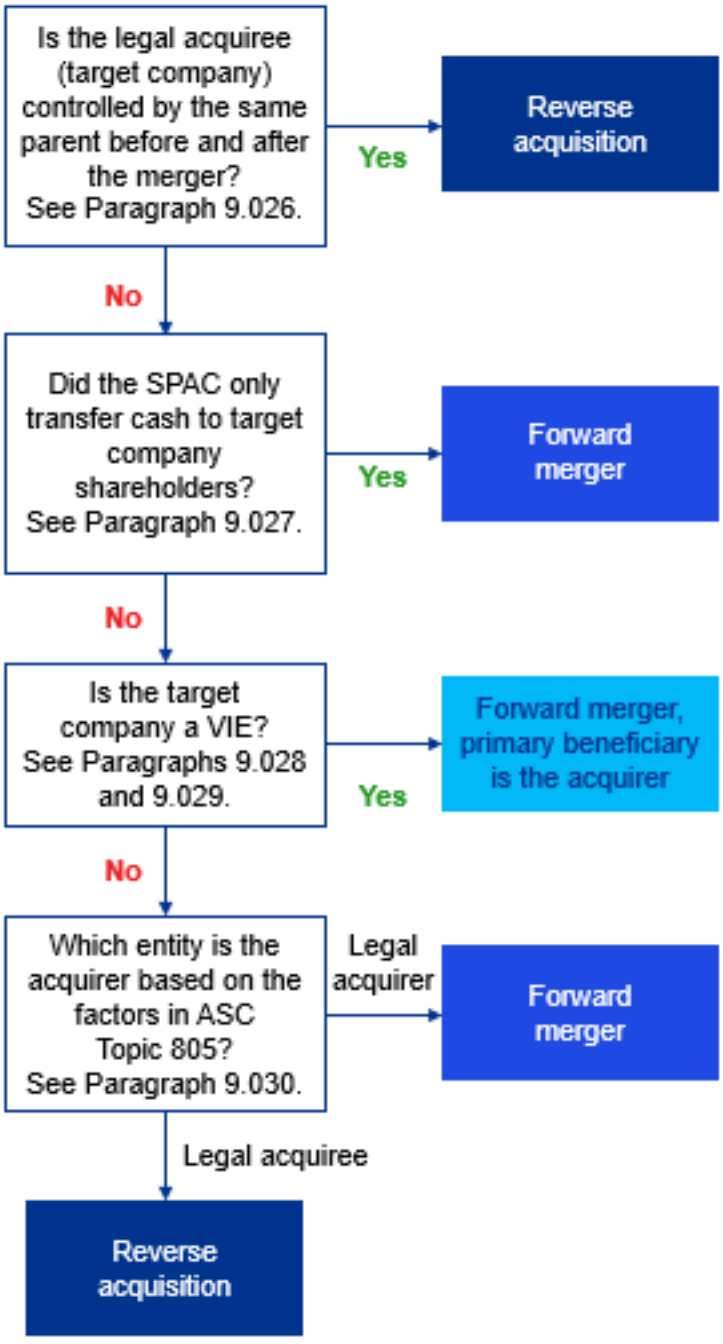
Before adoption of ASU 2025-03[1]



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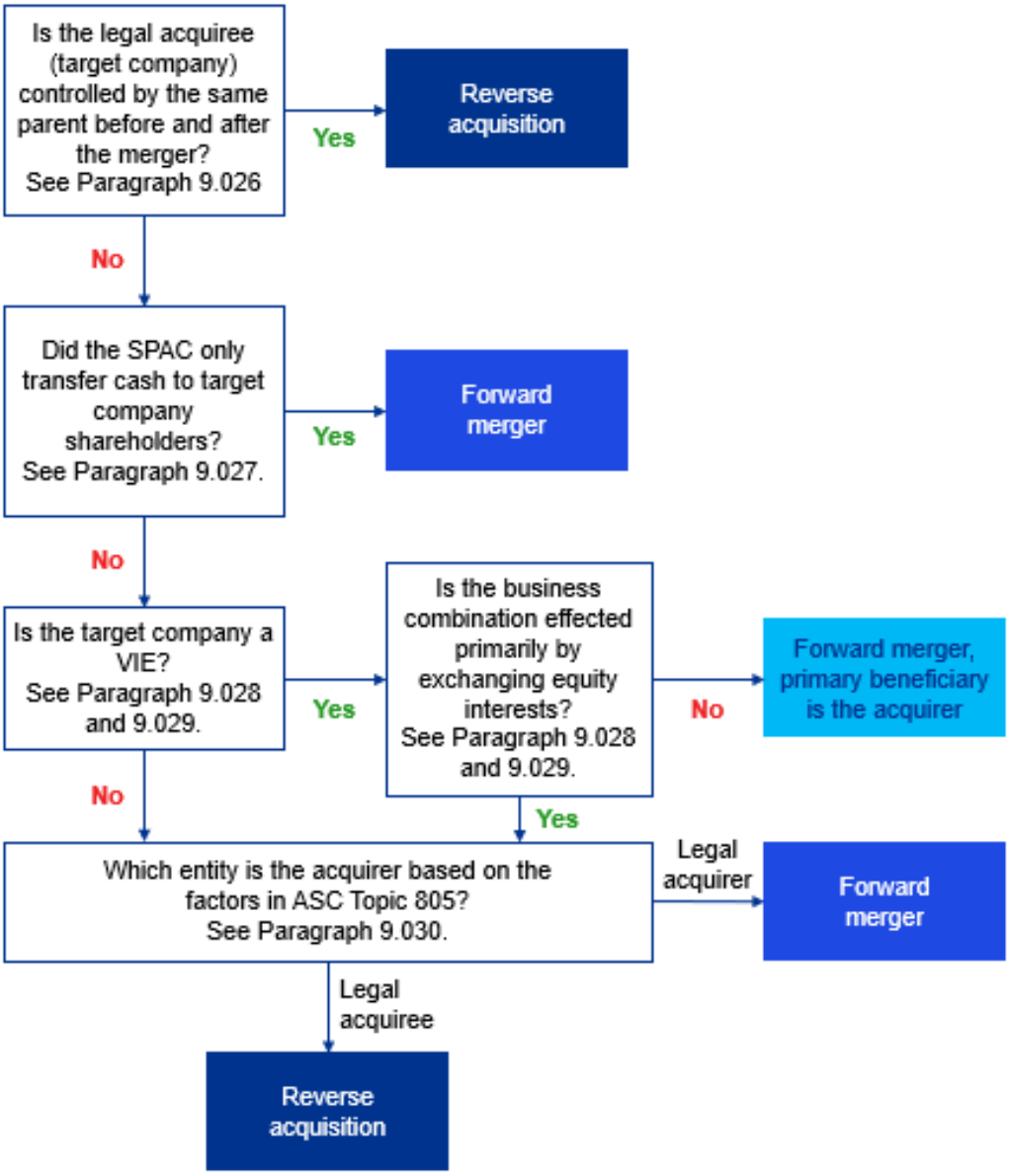
After adoption of ASU 2025-03



Is the legal acquiree (target company) controlled by the same parent before and after the merger?

9.026 For the SPAC to be the accounting acquirer, the target company must undergo a change of control. If the parent entity (or individual) that controls the target company before the transaction controls the SPAC post-transaction (under either the voting or variable interest model), the target company has not undergone a change in control and is the accounting acquirer in a reverse recapitalization transaction. We believe this transaction is similar to a merger of entities under common control because the parent of the target company acquired the SPAC and then merged the target company with the SPAC.

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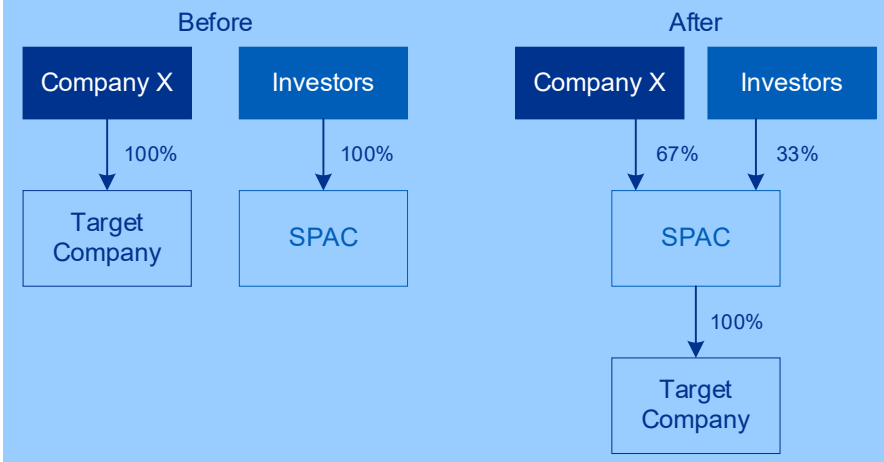
Example 9.9: Target Controlled by Same Parent

Company X has a 100% controlling financial interest in Target Company. SPAC's founder and its public investors collectively own 100% of SPAC. SPAC agrees to merge with Target Company. To effect the merger, SPAC issues shares to Company X in exchange for a 100% interest in Target Company.



After the acquisition, SPAC is owned 67% by Company X and 33% by the group of disparate third-party investors. Voting rights are consistent with ownership percentages. Company X has a controlling financial interest in SPAC post-merger and would consolidate SPAC under ASC Subtopic 810-10.

Assessment

Because Target Company is controlled by Company X before and after the acquisition, Target Company is the accounting acquirer for purposes of the SPAC consolidated financial statements and the transaction would be accounted for similar to a reverse recapitalization.

Does the SPAC only transfer cash to target company shareholders?

9.027 In a transaction primarily effected by transferring cash or incurring liabilities, the entity that transfers the cash or incurs the liabilities is generally the acquirer (see Paragraph 4.005). If the SPAC only transfers cash in exchange for all the outstanding shares of the target company, the SPAC is deemed the accounting acquirer. In transactions where the SPAC issues both cash and equity, further consideration of the remaining steps in the decision tree is necessary.

Is the target company a VIE? Is the business combination effected primarily by exchanging equity interests (after adoption of ASU 2025-03 only)?

9.028 Before the adoption of ASU 2025-03, if the target company is a VIE and the SPAC is the primary beneficiary, the SPAC is the accounting acquirer because a primary beneficiary of a VIE is always the accounting acquirer. ASU 2025-03 amends the framework for identifying the accounting acquirer when the legal acquiree is a VIE. After

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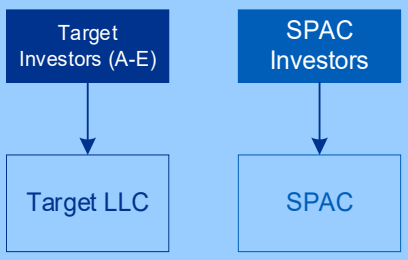
adoption of ASU 2025-03, an entity first considers whether the acquisition was primarily effected by the exchange of equity interests. In a business combination in which a VIE is acquired, the primary beneficiary of the VIE is the accounting acquirer unless the business combination is effected primarily by exchanging equity interests, in which case the general factors in Topic 805 are evaluated. However, as noted above, if the same parent (or individual) controls the target company before and after the merger, this assessment is not relevant even if the target company is a VIE.

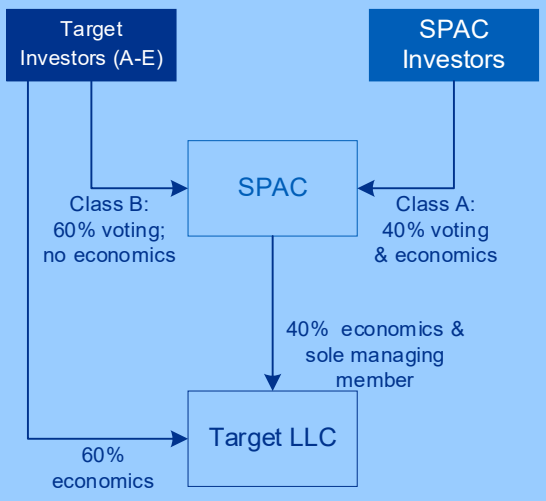
9.029 In our experience, evaluating whether or not the target company is a VIE can be challenging and the question frequently arises when the transaction involves an Up-C structure and the target company is a limited liability corporation, partnership, or similar entity. See KPMG Handbook, Consolidation, for further information on determining when an entity is a VIE and identifying the primary beneficiary.

Example 9.10: SPAC Is Primary Beneficiary of VIE

Target LLC is owned by a group of investors (A-E), none of which have a controlling financial interest in Target LLC. SPAC's founder and its public investors collectively own 100% of SPAC.



Target LLC and SPAC agree to merge using an Up-C structure. To effect the merger, SPAC issues equity interests to Investors A-E. The following illustrates the post-merger structure.



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The pre-merger investors in Target LLC continue to hold limited liability interests in Target LLC that represent a 60% economic interest in Target LLC. They also have corresponding Class B shares in SPAC giving them 60% of the voting rights but no economic interests in SPAC.

SPAC is the sole managing member in Target LLC and has a 40% economic interest. The pre-merger SPAC investors have 40% of SPAC's Class A shares, which contain both voting and economic rights in SPAC.

Target LLC management is the management of the merged entity. SPAC's board of directors consists of 7 members, 6 of whom are appointed by pre-merger Target LLC investors and 1 that is appointed by SPAC's founder. All significant decisions of SPAC's board require a simple majority vote.

Target LLC has governing provisions that are the functional equivalent of a limited partnership and therefore is evaluated similar to a limited partnership under ASC Topic 810. The non-managing members in Target LLC do not have substantive kick-out or participating rights. SPAC makes all of the decisions affecting the economic performance of Target LLC.

Assessment

Target LLC is a VIE because the non-managing members do not have substantive kick-out or participating rights. SPAC is the primary beneficiary as it makes all decisions affecting the economic performance of Target LLC and has a significant variable interest. As a result, before adoption of ASU 2025-03, SPAC consolidates Target LLC under ASC Topic 810 and is the accounting acquirer in accordance with ASC paragraph 805-10-25-5. Because of the specific requirement that the primary beneficiary of a VIE is the accounting acquirer, there would be no analysis considering factors discussed in Paragraph 9.030.

After adoption of ASU 2025-03, because the business combination is effected primarily by exchanging equity interests, an analysis considering factors discussed in Paragraph 9.030 is needed. Target shareholders have the largest portion of voting rights, Target's management dominates the management of the combined entity, Target appoints a majority of the board of directors, and the fact that Target is larger than SPAC (which has no significant operations) indicates that Target has more influence over the combined company. Based on those factors, Target LLC is the acquirer.

Which entity is the acquirer based on the indicators from ASC Topic 805?

9.030 To determine the accounting acquirer in a transaction primarily effected by issuing equity, ASC Topic 805 requires a number of factors to be considered. The table below provides a summary of the key considerations about the factors discussed in Paragraphs 4.008 through 4.017c relevant to a typical SPAC transaction. No individual factor is necessarily determinative, and judgment is required in instances where different factors suggest that either the SPAC or the target company is the accounting acquirer. When the SPAC acquires more than one unrelated target company at the same time, the accounting acquirer determination can become even more complex.

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Table 9.1: Key Factors in Determining Acquirer in a SPAC Transaction

Factors for Consideration	SPAC Merger Considerations
Relative voting rights	
Acquirer usually is the entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity (see Paragraph 4.009 through 4.010).	Relative voting rights refers to equity interests, not limited to common shares, with voting rights (e.g., voting preferred shares, options, warrants, and convertible securities that are in-the-money and that are vested and exercisable or convertible into shares with voting rights at the date of acquisition). Such rights, along with the uncertainty created by SPAC shareholders' ability to redeem their equity interests just prior to the merger, can complicate the evaluation of which party as a group is expected to retain or receive the largest portion of the voting rights subsequent to the merger. Therefore, the analysis may not be able to be finalized until the merger is nearly complete. Voting shares issued to PIPE (private investment in public equity) investors at the time of the merger should also be evaluated to determine if some or all of them should be grouped with one of the other parties for purposes of this analysis (e.g., when PIPE investors are affiliated or aligned with the SPAC sponsor or former owners of the target company).
Existence of a large minority voting interest if no owner or organized group has a significant voting interest	
Acquirer usually is the entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity (see Paragraph 4.011).	The existence of an owner or organized group of owners that has a large minority ownership interest as compared to the rest of the owners may indicate that one of the entities is the acquirer – particularly in instances where no other owner, or organized group of owners, has a significant voting interest in the combined entity. While such ownership may not represent a majority interest, we believe there may be a minority ownership interest significant enough to indicate which pre-combination entity is the accounting acquirer when all other voting interests are widely held. This factor may be of greater significance when the SPAC concurrently acquires more than one unrelated target company.
Composition of the governing body	
Acquirer usually is the entity whose owners can elect, appoint or remove a majority of the members of the	When considering this factor, we believe it is important to consider not only the composition of the board of directors and the number of individuals appointed by each of the pre-combination entities, but also whether control of the board by a shareholder group is temporary. Consideration should be given not only to the board's current composition, but also to the period of time each board

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governing body of the combined entity (see Paragraph 4.012).	member is entitled to hold their position, which may indicate whether the shareholder group has substantive control (see Paragraph 4.012 for details).
Composition of the senior management	
Acquirer usually is the entity whose former management dominates the senior management of the combined entity (see Paragraph 4.013).	While it is common that a majority management comes from the target company, additional management positions could be created as part of the merger and appointed by the SPAC. If the senior management of the combined entity is not dominated by individuals from one of the pre-combination entities, we believe more weight should be given to those executive positions that are most closely aligned with the core business activities of the combined entity.
Relative size of each of the combining entities	
Acquirer usually is the entity whose relative size is significantly larger than the other combining entity (see Paragraphs 4.17 through 4.017c).	Given that the SPAC has minimal operations pre-combination, we believe this consideration almost always indicates that the target company is the accounting acquirer.
Terms of the exchange of equity interests	
Acquirer usually is the entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity (see Paragraph 4.015).	While an important aspect of the evaluation, this factor is often challenging, given that most of the target companies acquired by a SPAC are private and therefore their equity shares do not have a readily determinable market value. The calculation of fair value is subjective and subject to significant estimation uncertainty, which should be carefully evaluated in determining which entity paid a premium.

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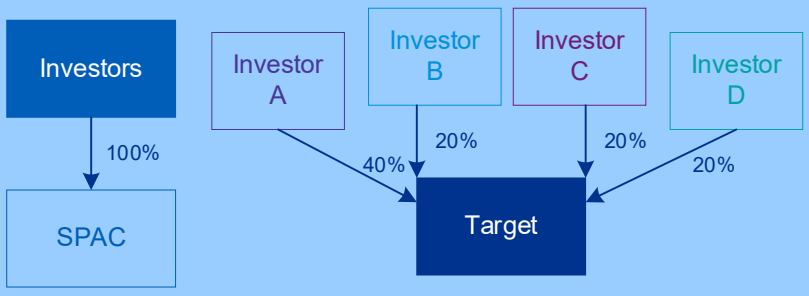
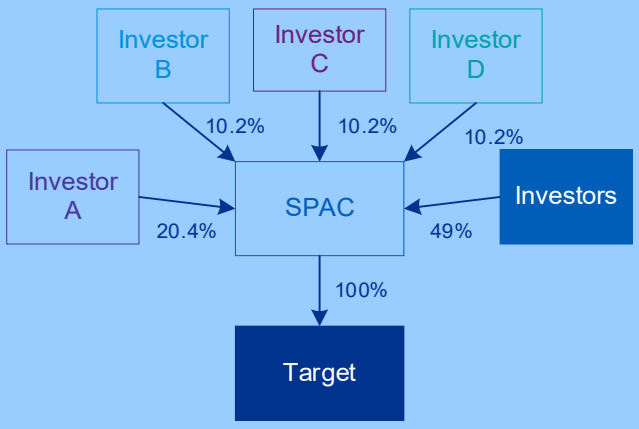
Example 9.11: Determining Accounting Acquirer in a SPAC Transaction

Target Company is owned by four investors (Investor A-D). Investor A has a 40% interest and the other investors (B-D) each have a 20% ownership interest in Target. None of the investors (A-D) have a controlling financial interest in Target. The SPAC's founder and its public investors collectively own 100% of SPAC.



SPAC agrees to merge with Target. To effect the merger, SPAC issues equity to Investors A-D and acquires 100% of the interests of Target. The former SPAC shareholders collectively own 49% of the outstanding voting shares. Investor A has 20.4% of the voting shares in SPAC and Investors B, C and D each have 10.2%. One of the Investors, the SPAC founder, has 20% of the post-merger outstanding voting shares.



The board is comprised of 7 members, 5 of whom are appointed by former Target shareholders and 2 that is appointed by the former SPAC shareholders. All significant board decisions require a simple majority. The directors are elected by the shareholders on an annual basis (i.e., no staggered terms).

The management of Target is the management of the combined entity.

Assessment

Target is the acquirer. Target shareholders have the largest portion of voting rights, Target's management dominates the management of the combined entity, Target appoints a majority of the board of directors, and the size of Target indicates that Target has more influence over the combined company. While the SPAC founder retains a large minority interest, that factor is not enough to overcome the other considerations.

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Therefore, Target is determined to be the accounting acquirer and the transaction should be accounted for as a reverse recapitalization.

REVERSE RECAPITALIZATIONS

9.031 As discussed in Paragraph 9.021, if the target company in a SPAC merger is the accounting acquirer, the accounting is generally similar to a reverse acquisition involving a shell company, or a reverse recapitalization. There is no explicit guidance on the accounting for a reverse recapitalization. Therefore, entities must look at other existing GAAP to account for the various provisions of the merger agreement. The following table describes the key differences between a reverse recapitalization and a forward merger accounted for as a business combination. See KPMG Handbook, Asset acquisitions, for a discussion of forward mergers that are accounted for as asset acquisitions.

Table 9.2: Common Differences between Business Combinations and Reverse Recapitalizations in SPAC Transactions

Topic	Business Combination (SPAC Acquirer)	Reverse Recapitalization
Measurement of Target Company Assets and Liabilities	The SPAC generally recognizes the target company's assets and liabilities at fair value (i.e., goodwill and identifiable intangible assets may be recognized) in accordance with ASC Topic 805. See Section 7.	The target company's net assets are maintained at historical cost. The target company generally credits equity for the fair value of the net assets of the SPAC, and no goodwill or intangible assets are recognized in the transaction. See Paragraph 9.014.
Pre-Merger Period	The target company is typically the predecessor for SEC reporting purposes. Therefore the target's financial statements become those of the registrant and should be included for the required comparative periods before the merger. This involves the presentation of the financial statements on a 'blackline' or predecessor-successor basis, with the target company's pre-merger financial statements in the predecessor period. The successor period financial statements	The financial statements are presented as a continuation of the target company and the pre-merger periods reflect the target's historical results.

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	include the consolidated results of both entities and reflect the acquisition accounting adjustments on the target company's net assets. This presentation includes: • The predecessor and successor periods separated by a black line; and • The columns clearly labeled with either 'predecessor' or 'successor', or equivalent.	
Equity	The predecessor period includes the equity structure of the target before the merger and the equity structure is not recast to reflect the equity structure of the merged entity. The successor period includes the equity structure of the SPAC from the acquisition date forward.	The retained earnings and accumulated other comprehensive income of the target company are carried forward. However, the post-close equity presentation will follow the capital structure of the SPAC (the legal acquirer) and reflect its issuance of additional capital to complete the transaction (including any equity or liability classified instruments issued as part of the merger). The prior periods presented will generally be retroactively adjusted to reflect the same capital structure (i.e., using the exchange ratio included in the merger agreement). Any offsetting adjustments are made to common stock and additional paid-in capital.
Earnings Per Share	EPS in the predecessor periods, if applicable, would be presented based on the predecessor entity's capital structure. EPS for the successor period is presented based on the SPAC's equity structure and post-acquisition earnings.	EPS is usually revised for periods prior to the merger based on the accounting acquirer's weighted average number of shares outstanding during these historical periods presented, similar to a reverse acquisition or a business combination between entities under common control. See Section 7.5 of

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		KPMG Handbook, Earnings per share, for further information.
Transaction Costs	Transaction costs related to the business combination are expensed as incurred, unless the costs are incurred to issue debt or equity securities, in which case they are recognized in accordance with other applicable GAAP for those transactions. If the SPAC incurred transaction costs before the acquisition date, when blackline financial statements are presented because the target company is the predecessor entity, the SPAC's transaction costs may not be recorded in post-merger financial statements. However, the amount of these expenses and the fact that they were not recorded in the predecessor period should be disclosed.	Transaction costs incurred by the target company should be recorded based on the activities to which the costs relate and the structure of the transaction. For example, costs related to: • The issuance of equity are recorded as a reduction of the amount of equity raised, while all costs in excess of cash received should be charged to expense. • The issuance of debt are capitalized as debt issuance costs. • Other advisory services are expensed as incurred • Liability classified financial instruments (e.g., under Subtopic 815-40) are expensed as incurred. Accounting for the costs may involve allocating them to the various activities on a relative fair value basis. We understand there is diversity in practice regarding allocating transaction costs to liability classified financial instruments such as warrants that were outstanding before the merger. Costs incurred by the SPAC to consummate the merger are generally expensed as incurred. If the costs relate to the SPAC issuing debt or equity (e.g., shares acquired by PIPE), the costs are accounted for under applicable GAAP for that transaction.

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Contingent Consideration ('Earnouts')	Contingent consideration is generally a part of the acquisition price unless considered compensatory in which case it is accounted for under other GAAP, such as ASC Topic 718 or 710. See discussion of identifying and accounting for contingent consideration in Sections 6, 11 and 12.	The earnout is accounted for under other GAAP such as ASC Topic 710 or 718 if compensatory or the applicable financial instruments literature (e.g., ASC Topic 815 or 480). See Paragraph 9.032 for further discussion.
Share-Based Payments	Share-based payment awards of the SPAC issued to employees of the target company are allocated between consideration transferred and post-combination period expense. See discussion starting at Paragraph 11.023a.	The substance of any share-based payment awards provided is evaluated to determine if the awards are new awards or replacement awards. Awards that are modified or replaced should be evaluated under the modification guidance in ASC Topic 718. See chapter 5 of KPMG Handbook, Share-Based Payment, for further details.

CONTINGENT CONSIDERATION IN A REVERSE RECAPITALIZATION

9.032 On the occurrence of a future event, the merger agreement may require the SPAC to issue additional consideration to the former shareholders of the target company and/or the pre-merger SPAC shareholders. These arrangements are commonly referred to as 'earnouts' and often involve the contingent issuance of additional shares, warrants or cash. There is no explicit guidance for these arrangements and entities need to consider the applicable GAAP depending on the nature and substance of the transaction.

Compensatory Arrangements

9.033 In some cases, the contingent consideration is compensatory and would be accounted for under the applicable compensation guidance (e.g., ASC Topic 710 or 718). For example, the arrangement is compensatory when employees must remain employed for a period of time to earn the consideration (i.e., there is a required service period). However, even if no future service is required, the facts and circumstances will need to be evaluated to determine whether the contingent consideration is in the scope of the compensation guidance. For example, contingent consideration granted to a holder of vested options may be in the scope of ASC Topic 718.

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Not Compensatory

9.034 When the contingent consideration is not compensatory, the entity considers other relevant GAAP, including the applicable financial instruments guidance in ASC Topic 815 and/or ASC Topic 480. Under that guidance, the classification of the contingent consideration and the subsequent accounting depends on whether it is equity or liability classified. A liability-classified instrument is remeasured to fair value each period with changes recorded in earnings. An equity classified instrument is not remeasured. See KPMG Handbook, Debt and equity financing, for additional information on making this complex determination.

9.035 When the contingent consideration is granted to the investors of the target company on a pro rata basis, the initial fair value is recorded as a dividend. In other cases, it may be appropriate to account for the amount as an adjustment to additional paid-in capital.

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[1] ASU 2025-03, *Determining the Acquirer in the Acquisition of a Variable Interest Entity*, amends the framework for identifying the accounting acquirer when the legal acquiree is a VIE. Under the amended framework, entities consider the general accounting acquirer factors in ASC 805 when the transaction is primarily effected by the exchange of equity interests. The ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2026. Early adoption is permitted.

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Section 10 - Measurement Period

Detailed Contents

Definition and Purpose of the Measurement Period
The Measurement Period
Financial Reporting When the Initial Accounting for a Business Combination Is Incomplete
Reporting of Provisional Amounts
Disclosures
Adjustments to Provisional Amounts During the Measurement Period
Identifying Adjustments to Provisional Amounts
Example 10.1: Use of Hindsight When Measuring the Fair Value of Contingent Consideration
Example 10.2: Information Becomes Available before and Shortly after the Measurement Period Ends
Adjustments to Provisional Amounts Are Reported in the Subsequent Period
Other Examples of Measurement Period Adjustments
Incomplete Valuation Information at the Reporting Date
Example 10.3: Appraisal Received during the Measurement Period Identifies Decrease in Fair Value Occurring after the Acquisition Date
Example 10.4: Pension Plan Valuation Not Completed at the Acquisition Date
Obligation for Defective Products
Example 10.5: New Information on Defective Product Liability Obtained during the Measurement Period
Loans Acquired in an Acquisition
Example 10.6: New Information on the Fair Value of an Acquired Loan Obtained during the Measurement Period
Example 10.7: Decrease in Fair Value of Acquired Loan Resulting from an Event Occurring during the Measurement Period
New Information Obtained on a Contingency Identified Pre-Combination
Example 10.8: Contingency Existed but Additional Information Identified after the Acquisition Date
After the Measurement Period Ends, the Acquisition Accounting Is Adjusted Only to Correct Errors
Example 10.9: Error Discovered after the End of the Measurement Period
Adjustments to Provisional Amounts Related to Deferred Tax Assets and Liabilities During the Measurement Period
Contingent Consideration
Contract Assets and Contract Liabilities (After Adoption of ASU 2021-08)

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DEFINITION AND PURPOSE OF THE MEASUREMENT PERIOD

THE MEASUREMENT PERIOD

ASC Paragraph 805-10-25-13

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, in accordance with [ASC] paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.

ASC Paragraph 805-10-25-14

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

ASC Paragraph 805-10-25-15

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure any of the following as of the acquisition date in accordance with the requirements of [ASC] Topic [805]:

a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree (see [ASC] Subtopic 805-20)

b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill in accordance with [ASC] paragraphs 805-30-30-1 through 30-3)

c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer (see [ASC] paragraph 805-30-30-1(a)(3))

d. The resulting goodwill recognized in accordance with [ASC] paragraph 805-30-30-1 or the gain on a bargain purchase recognized in accordance with [ASC] paragraph 805-30-25-2.

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10.000 The information necessary to enable an acquirer to complete the identification and measurement of these items often will be unavailable by the end of the first reporting period following the acquisition date. For example, appraisals may be required to determine fair value of plant and equipment acquired, a discovery period might be needed to identify and value intangible assets acquired, and an actuarial determination may be required to determine the pension liability (or asset) to be recorded. Additionally, if a business combination is consummated near the end of the acquirer's reporting period or the acquiree's operations are extensive or unusually complex, the acquirer may require additional time to obtain all of the data required to complete the acquisition accounting. The objective of the measurement period is to provide a reasonable period of time for the acquirer to obtain the information necessary to enable it to complete the accounting for a business combination. The acquirer determines whether it has obtained all the information it is seeking on an item-by-item basis, as it may be easier to obtain the information needed to determine the fair value of certain acquired items than others.

10.001 The FASB determined that a *reasonable time* ends when the acquirer receives the information it was seeking about facts and circumstances existing as of the acquisition date, but in any event cannot continue for more than one year from the acquisition date. In limiting the measurement period to a maximum of one year, the FASB concluded that extending the measurement period beyond one year would not be particularly helpful, because obtaining reliable information about circumstances and conditions that existed as of an acquisition date more than a year earlier is likely to become more difficult as time passes. The FASB also noted that, while the outcome of some contingencies and similar items may not be known within a year, the purpose of the measurement period is to provide time to obtain the information necessary to measure the items as of the acquisition date, and that determining the ultimate settlement amount of a contingency is not part of the acquisition accounting. Statement 141(R), par. B392

FINANCIAL REPORTING WHEN THE INITIAL ACCOUNTING FOR A BUSINESS COMBINATION IS INCOMPLETE

REPORTING OF PROVISIONAL AMOUNTS

10.002 If the initial accounting for a business combination is not complete at the end of the financial reporting period following the acquisition date, the acquirer reports provisional amounts for the assets, liabilities, equity interests, or items of consideration for which the accounting is incomplete. Because the acquirer evaluates whether it has the information it seeks on an item-by-item basis, the amounts reported may be final for certain items and provisional for others. ASC Topic 805, *Business Combinations,* does not provide specific guidance on determining provisional amounts. We believe that those amounts should be determined based on the available information at the acquisition date, consistent with the recognition and measurement requirements of ASC Topic 805. We do not believe it is appropriate to assign only nominal amounts, or no amounts, simply because the acquirer anticipates receiving additional information about facts and circumstances that existed as of the acquisition date.

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DISCLOSURES

10.003 Until the accounting for a business combination is complete, the acquirer is required to include additional disclosures in its financial statements. ASC paragraph 805-20-50-4A specifies these disclosure requirements, which include, for particular assets, liabilities, noncontrolling interests, or items of consideration for which the initial accounting is incomplete and for which the amounts recognized in the financial statements have been determined only provisionally:

(1) The reasons why the initial accounting is incomplete;

(2) The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete; and

(3) The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with ASC paragraph 805-10-25-17.

10.004 The disclosures in an acquirer's post-combination financial statements, when the initial accounting for an acquisition is incomplete, should clearly identify the status of the acquisition accounting, consistent with the level of detail required by ASC Topic 805. Disclosures should include more than a general statement that the business combination accounting is incomplete or that the measurement period still is open to meet those disclosure requirements. The disclosures in the acquirer's initial post-combination financial statements following an acquisition should describe why the initial accounting is incomplete, and the items in its financial statements for which the initial accounting is incomplete. Post-combination financial statements issued during the measurement period should describe the adjustments to the acquisition accounting during the most recent reporting period, and update the other disclosures with respect to the status of the acquisition accounting, including the items for which the initial accounting remains incomplete. In making these disclosures, the acquirer should give consideration to the following:

- The measurement period does not provide an *open* one-year period following the acquisition date to complete the acquisition accounting. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date, or learns that more information is not available. "However, in no circumstances may the measurement period exceed one year from the acquisition date." Statement 141(R), par. B392; ASC paragraph 805-10-25-14
- The required disclosures under ASC paragraph 805-20-50-4A should be sufficiently detailed to identify the nature of the items for which the acquisition accounting has not been completed. Thus, it would generally be expected that subsequent adjustments to the acquisition accounting during the measurement period would have been included in the ASC paragraph 805-20-50-4A disclosures as an area of potential adjustment to the acquisition accounting in any post-combination financial statements of the acquirer.

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Additional assets acquired or liabilities assumed in an acquisition that were not recognized at the acquisition date might be identified during the measurement period. For example, new information obtained about facts and circumstances that existed at the acquisition date might indicate that an income tax uncertainty that was not recognized by the acquirer in the initial accounting for an acquisition because it did not meet the more-likely-than-not criterion for recognition at the acquisition date did, in fact, meet that criterion at the acquisition date. Similarly, new information might be obtained about facts and circumstances that existed at the acquisition date, but that were unknown at that date, that indicate additional assets or liabilities (including those arising from contingencies) not recognized in the initial accounting for an acquisition should be recognized as part of the accounting for the acquisition. ASC paragraphs 805-10-25-13 and 25-14 require an acquirer to recognize additional assets or liabilities during the measurement period if it obtains new information about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities at that date. Thus, an acquirer should assess the potential for identifying additional assets or liabilities not recognized at the acquisition date in making the disclosures required by ASC paragraph 805-20-50-4A about provisional amounts. For example, unless an acquirer has a high level of confidence that it has identified all liabilities assumed due to legal and regulatory matters, including but not limited to those related to environmental regulation and taxation arising from an acquisition, it should disclose the status of its review and disclose the potential for adjustments to the provisional amounts initially recognized. Such disclosure might be along the following lines:

> "[Acquiree] is subject to the legal and regulatory requirements, including but not limited to those related to environmental matters and taxation, in each of the jurisdictions in the 12 countries in which it operates. [Acquirer] has conducted a preliminary assessment of liabilities arising from these matters in each of these jurisdictions, and has recognized provisional amounts in its initial accounting for the acquisition of [Acquiree] for all identified liabilities in accordance with the requirements of ASC Topic 805. However, [Acquirer] is continuing its review of these matters during the measurement period, and if new information obtained about facts and circumstances that existed at the acquisition date identifies adjustments to the liabilities initially recognized, as well as any additional liabilities that existed at the acquisition date, the acquisition accounting will be revised to reflect the resulting adjustments to the provisional amounts initially recognized."

- Adjustments to provisional amounts, or recognition of additional assets acquired or liabilities assumed, identified during the measurement period, should be recognized as they are identified, even if the acquirer expects that further adjustments might be needed during the measurement period. Thus, for

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example, if an acquirer issues quarterly financial statements during the period following an acquisition, those financial statements should reflect, on a cumulative basis, any measurement period adjustments identified since the issuance of financial statements for the previous reporting period(s). Additionally, the disclosures required by ASC Topic 805, including those required by ASC paragraph 805-20-50-4A for business combinations for which the initial accounting is incomplete, are required to be included in interim financial statements.

The SEC staff has challenged measurement period adjustments when there were no prior disclosures by the acquirer about the reported amounts being provisional and why the initial accounting was incomplete. Absent sufficient prior disclosures about the reported amounts being provisional, the SEC staff ordinarily expects the accounting for those items to be final. See the discussion of *Disclosures* in Section 13.

ADJUSTMENTS TO PROVISIONAL AMOUNTS DURING THE MEASUREMENT PERIOD

IDENTIFYING ADJUSTMENTS TO PROVISIONAL AMOUNTS

ASC Paragraph 805-10-30-2

The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the time at which additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts.

ASC Paragraph 805-10-30-3

Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

10.005 In many instances, it will be clear whether information obtained after the acquisition date (but within the measurement period) relates to facts and circumstances that existed at the acquisition date and should, therefore, result in an adjustment to the provisional amounts recognized, or whether the additional information relates to events that occurred after the acquisition date and should, therefore, be accounted for as events of the post-combination period. However, in other instances, whether an event should be recognized as an adjustment to a provisional amount or as a post-combination event will be less clear, and will require analysis and judgment. See the discussion in Paragraph

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10.007 about the analogy of measurement period adjustments to *recognized subsequent events* under ASC Subtopic 855-10, *Subsequent Events - Overall.*

10.006 Even if additional information related to circumstances and conditions that existed as of the acquisition date comes to light during the measurement period, such information results in adjustments to the provisional amounts recognized at the acquisition date only if:

- The additional information affects the measurement of items that were initially recognized at the acquisition date;
- The additional information establishes that an additional asset was acquired or a liability was assumed that was not recognized in the initial accounting for the acquisition; or
- An asset or a liability was recognized at the acquisition date, and the subsequent information establishes that such asset or liability did not meet the recognition requirements of ASC Topic 805 at that date.

10.007 In considering the nature of post-combination adjustments, the FASB concluded that adjustments to provisional amounts during the measurement period are analogous to *recognized subsequent events* in ASC Subtopic 855-10. Recognized subsequent events are events that occur after the balance sheet date but before financial statements are issued or are available to be issued, that provide additional evidence about conditions that existed at the financial statements balance sheet date (including the estimates inherent in the process of preparing financial statements) and, thus, are reflected in the financial statements as if they had been initially recognized at that date. Similarly, the effects of information that first becomes available during the measurement period and provides evidence of conditions or circumstances that existed at the acquisition date should be reflected in the accounting as of the acquisition date. Statement 141(R), par. B399 (revised to reflect changes in accounting guidance and terminology in ASC Subtopic 855-10); ASC paragraphs 805-10-30-2 and 30-3

Example 10.1: Use of Hindsight When Measuring the Fair Value of Contingent Consideration

ABC Corp. acquires DEF Corp. on February 28, 20X4. The acquisition agreement calls for ABC to pay the former shareholders of DEF additional consideration based on the performance of DEF's business for the two years after the acquisition date. Based on the due diligence performed at the acquisition date, the fair value of the contingent consideration is estimated to be $20 million.

DEF's performance in the 10 months after the acquisition date has been significantly better than anticipated, in part because of better synergies in integrating DEF's operations into ABC's existing distribution channels. As a consequence, at December 31, 20X4 (which is within the measurement period), the fair value of the contingent consideration is estimated to be $50 million.

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The adjustment to the contingent consideration would not constitute a measurement period adjustment because it reflects new conditions (i.e., improved performance of DEF) rather than more information about conditions that existed at the acquisition date. Therefore, the $30 million adjustment to the fair value of the contingent consideration is included in income for the year ended December 31, 20X4.

Example 10.2: Information Becomes Available before and Shortly after the Measurement Period Ends

ABC Corp. acquires DEF Corp. on April 30, 20X8. Provisional amounts are recognized for certain of the assets acquired and liabilities assumed, including a liability related to a contractual dispute between DEF and one of its customers. DEF completed the contract before the acquisition date, but its customer claimed, shortly before the acquisition date, that certain amounts were due to the customer from DEF under penalty clauses for completion delays included in the contract. ABC evaluated the dispute based on the information available at the acquisition date, and concluded that DEF was responsible for at least some of the delays in completing the contract. ABC recognized a provisional amount for this liability in its acquisition accounting of $1 million, which was its best estimate of the fair value of the liability to the customer based on the information available at the acquisition date.

ABC obtained no new information about the possible outcome of the dispute until September 20X8 and it continued to reflect the liability at the provisional amount of $1 million. However, in September 20X8, based on its evaluation of additional information presented by the customer in support of its claim, ABC concluded that the fair value of the liability for the customer's claim at the acquisition date was $2 million.

ABC continued to receive and evaluate information related to the claim after September 20X8, but its evaluation did not change until May 15, 20X9, when it concluded, based on additional information and responses received from the customer to inquiries made by ABC, that the liability for the claim at the acquisition date was $1.9 million. ABC determined that the amount that would otherwise be recognized with respect to the claim under ASC Topic 450, *Contingencies* (i.e., if the claim had not arisen from a contingency existing at the acquisition date) as of May 15, 20X9, would be $2.2 million.

ABC's accounting for changes to the liability provisionally recognized for this dispute at the acquisition date is:

- ABC increases the provisional amount of $1 million recognized as a liability at the acquisition date to $2 million in September 20X8, because this adjustment results from new information about facts and circumstances that existed at the acquisition date and falls within the measurement period.

The decrease in the estimated fair value of the liability for the claim (from $2 million to $1.9 million) in May 20X9 occurred after the measurement period (i.e., more than one

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year after the acquisition date), and would therefore not be recognized as an adjustment to the acquisition accounting. However, because the amount determined in accordance with ASC Topic 450 ($2.2 million) now exceeds the fair value of the liability recognized under ASC Topic 450 ($2 million), and because the information resulting in this change was obtained after the end of the measurement period, ABC would recognize an increase in the liability of $.2 million, and an offsetting charge to earnings. See discussion of the subsequent measurement and accounting for *Assets and Liabilities Arising from Contingencies,* in Section 12.

ADJUSTMENTS TO PROVISIONAL AMOUNTS ARE REPORTED IN THE SUBSEQUENT PERIOD

ASC Paragraph 805-10-25-16

The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, part or all of which are covered by the acquiree's liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

ASC Paragraph 805-10-25-17

During the measurement period, the acquirer shall recognize adjustments to the provisional amounts with a corresponding adjustment to goodwill in the reporting period in which the adjustments to the provision amounts are determined. Thus, the acquirer shall adjust its financial statements as needed, including recognizing in its current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, if any, as a result of the change to the provisional amounts calculated as if the accounting had been completed at the acquisition date. Paragraph 805-10-55-16 and Example 1 (see paragraph 805-10-55-27) provide additional guidance.

10.008 An acquirer is required to recognize adjustments to provisional amounts identified during the measurement period in the period they are identified, and to recognize such adjustments in the current period as if the accounting for the business combination had been completed at the acquisition date (i.e., on a cumulative basis in the period of the adjustment). These adjustments may relate to the measurement of initially recognized assets acquired or liabilities assumed, identification of additional assets acquired or liabilities assumed, and previously recognized assets or liabilities that do not meet the recognition criteria of ASC Topic 805, based on new information about the facts and

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circumstances that existed at the acquisition date. The current financial statements would reflect the cumulative adjustments to provisional amounts identified during the measurement period, including any adjustments to the assets acquired (including indemnification assets), the liabilities assumed, related deferred taxes, goodwill, and any change in depreciation, amortization, or other income effects as a result of the adjustments.

OTHER EXAMPLES OF MEASUREMENT PERIOD ADJUSTMENTS

10.009 Examples 10.3 through 10.9 illustrate the accounting for adjustments to assets acquired and liabilities assumed in an acquisition that are identified during the measurement period. All adjustments in the examples are deemed to be material for purposes of illustration. Income tax considerations are not addressed in the examples. It is assumed for purposes of each of these examples that, when amounts recognized in the financial statements for the first reporting period following the acquisition are based on provisionally determined amounts, the disclosures required by ASC paragraph 805-20-50-4A were included in those financial statements.

INCOMPLETE VALUATION INFORMATION AT THE REPORTING DATE

10.010 An acquirer may not have obtained the valuation information required to finalize the accounting for certain assets acquired and liabilities assumed in an acquisition by the time it issues its financial statements for the first reporting period following an acquisition. In such instances, the acquiree assigns provisional amounts to the acquired asset or liability assumed, based on an evaluation of the information available at that time.

> **ASC Paragraph 805-10-55-27**
>
> This Example illustrates the measurement period guidance in paragraph 805-10-55-16. Acquirer acquires Target on September 30, 20X7. Acquirer seeks an independent appraisal for an item of property, plant, and equipment acquired in the combination, and the appraisal was not complete by the time Acquirer issued its financial statements for the year ending December 31, 20X7. In its 20X7 annual financial statements, Acquirer recognized a provisional fair value for the asset of $30,000. At the acquisition date, the item of property, plant, and equipment had a remaining useful life of five years. Six months after the acquisition date, Acquirer received the independent appraisal, which estimated the asset's acquisition-date fair value as $40,000.
>
> **ASC Paragraph 805-10-55-28**
>
> In its interim financial statements for the quarter ending March 31, 20X8, Acquirer adjusts the provisional amounts recorded and the related effects on that period's earnings as follows:

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a. The carrying amount of property, plant, and equipment as of March 31, 20X8, is increased by $9,000. That adjustment is measured as the fair value adjustment at the acquisition date of $10,000 less the additional depreciation that would have been recognized had the asset's fair value at the acquisition date been recognized from that date ($1,000 for 6 months' depreciation).

b. The carrying amount of goodwill as of March 31, 20X8, is decreased by $10,000.

c. Depreciation expense for the quarter ended March 31, 20X8 is increased by $1,000 to reflect the effect on earnings as a result of the change to the provisional amount recognized.

ASC Paragraph 805-10-55-29

In accordance with ASC paragraph 805-20-50-4A, Acquirer discloses both of the following:

a. In its 20X7 financial statements, that the initial accounting for the business combination has not been completed because the appraisal of property, plant, and equipment has not yet been received

b. In its March 31, 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, Acquirer discloses that the increase to the fair value of the item of property, plant, and equipment was $10,000 with a corresponding decrease to goodwill. Additionally, the change to the provisional amount resulted in an increase in depreciation expense and accumulated depreciation of $1,000, of which $500 relates to the previous quarter.

Example 10.3: Appraisal Received during the Measurement Period Identifies Decrease in Fair Value Occurring after the Acquisition Date

ABC Corp. acquires DEF Corp. in December 20X8. The fair value of DEF's headquarters and surrounding property was estimated to be $10 million. In May 20X9, ABC obtained an appraisal for the property that indicated a current fair value of $8 million. The appraisal also confirmed the property's acquisition-date fair value of $10 million, and indicated that the subsequent decline in fair value was due to an unexpected change in zoning and land-use laws proposed three months after the acquisition date. Comparable real estate in the same market area also declined significantly as a result of the proposed changes in zoning and land-use laws. ABC concluded that there were no other factors that may have affected the acquisition-date fair value of the property.

In this case, the decline in fair value of the property would not be a measurement period adjustment, because an event after the acquisition (the proposed change in zoning and land-use laws) caused the property value decline. Accordingly, ABC would not adjust the provisionally determined amount recognized in the initial accounting for

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the acquisition. ABC would perform an impairment test under ASC paragraphs 360-10-35-15 through 35-42, to determine if recognition of an impairment loss is required.

Example 10.4: Pension Plan Valuation Not Completed at the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination in August 20X7. At the acquisition date, ABC provisionally recognized a liability of $200 related to DEF's pension plan, based on an actuarial valuation report as of December 20X6 with a rollforward adjustment for the period from the measurement date of the valuation report to the acquisition date, because the calculation of the projected benefit obligation and the information concerning the fair value of the plan assets as of the acquisition date was not available. The remeasurement of the projected benefit obligation and the fair value of plan assets related to DEF's pension plan as of the acquisition date was not completed until November 20X7. This remeasurement reflected an excess of the projected benefit obligation over plan assets of $300 as of the acquisition date. ABC evaluated the reasons for the difference between the provisionally recognized and the finally determined projected benefit obligation, and determined that the differences did not result from an error in the calculation of the provisionally recognized amount, but rather resulted from using the updated information that was not available until November 20X7.

ABC should recognize the additional $100 excess of the projected benefit obligation over plan assets as a $100 increase in the provisional liability recognized at the acquisition date, with an offsetting adjustment recognized as an increase in goodwill or a reduction in the gain on a bargain purchase, as applicable. These adjustments would be included in the quarter that includes November 20X7. The impact on net pension cost for the period August 20X7 - November 20X7 would be included in the net pension cost recognized for the quarter that included November 20X7. Net pension cost for periods subsequent November 20X7 would be determined based on the unfunded projected benefit obligation of $300, which includes the effect of the measurement period adjustment identified subsequent to the acquisition.

OBLIGATION FOR DEFECTIVE PRODUCTS

Example 10.5: New Information on Defective Product Liability Obtained during the Measurement Period

ABC Corp. acquired DEF Corp. in a business combination in December 20X8. As of the acquisition date, DEF had established a liability for its warranty obligation for product defects on products sold to 25 customers. DEF had reviewed the customers' claims and concluded, pending actual product testing, that it was obliged under its product warranty to either make repairs or replace certain product components. ABC agreed with DEF's assessment and recognized a liability in the provisional amount of

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$1,000 (25 × $40), the estimated fair value of the liability, as part of its accounting for the acquisition of DEF. In April 20X9, on completion of product testing, ABC concluded that it would be required to replace the defective products in their entirety, and estimated the fair value of the liability for total product replacement as of the acquisition date to be $5,000 (25 × $200).

DEF's liability for defective products existed as of the acquisition date. The new information received in April 20X9 related to facts and circumstances that existed at the acquisition date. Accordingly, ABC would therefore recognize an increase of $4,000 (25 × ($200 - $40)) in the provisional amount of the liability recognized at the acquisition date, and a corresponding increase in goodwill (or as an adjustment to the gain from a bargain purchase, if applicable) in the quarter that includes April 20X9.

LOANS ACQUIRED IN AN ACQUISITION

Example 10.6: New Information on the Fair Value of an Acquired Loan Obtained during the Measurement Period

Bank X acquired Bank Y in a business combination. In measuring the fair value of Bank Y's loan portfolio, Bank X recognizes a loan to one of the Bank's customers, Borrower Z, at its provisionally determined fair value. Subsequent to the acquisition date, Bank Y received financial statements from Borrower Z as of Borrower Z's most recent year-end (which preceded the acquisition date), which indicated that the income from operations of Borrower Z had declined significantly during the past year. Based on this new information, Bank X concluded that the fair value of Borrower Z's loan at the acquisition date was less than the provisional amount recognized at that date.

The new information obtained by Bank X subsequent to the acquisition related to facts and circumstances that existed at the acquisition date. Accordingly, Bank X should recognize a decrease in the provisional amount recognized for Borrower Z's loan to the fair value of the loan determined based on the new information, and a corresponding increase in goodwill (or a decrease in the gain from a bargain purchase, if applicable) in the quarter in which the updated information is obtained.

Example 10.7: Decrease in Fair Value of Acquired Loan Resulting from an Event Occurring during the Measurement Period

Bank X acquired Bank Y in a business combination. In measuring the fair value of Bank Y's loan portfolio, Bank X recognizes a loan to one of Bank Y's customers, Borrower Z, at its provisionally determined fair value. Subsequent to the acquisition date, Bank X learned that Borrower Z had lost its major customer (the loss of its major customer occurred after the acquisition date), which is expected to have a significant negative effect on the operations of Borrower Z. Based on this new information, Bank

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X determined that the fair value of the loan to Borrower Z was significantly less than the amount that had been provisionally determined at the acquisition date.

The new information resulting in the change in the estimated fair value of the loan was not due to facts and circumstances that existed at the acquisition date, but rather was due to an event (the loss of a major customer by Borrower Z) that occurred subsequent to the acquisition date. Therefore, based on the new information, Bank X would determine the amount of any allowance for loss on the loan in accordance with the applicable GAAP, and the offsetting adjustment would be charged to earnings in Bank X's post-combination financial statements.

NEW INFORMATION OBTAINED ON A CONTINGENCY IDENTIFIED PRE-COMBINATION

Example 10.8: Contingency Existed but Additional Information Identified after the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination in April 20X8. ABC identified a contingency during due diligence related to the trade practices of a subsidiary of DEF. ABC was still in the process of obtaining information related to the contingency at the acquisition date and disclosed this as an item subject to potential adjustment during the measurement period. As sufficient information was not available, ABC did not record a liability at the acquisition date. The acquisition agreement included a $20 million indemnification of potentially identified contingencies. ABC caused DEF to discontinue such trading practices immediately following the acquisition.

In February 20X9, before ABC obtained all relevant information about the facts related to the contingency that existed at the acquisition date, the Department of Justice publicly announced the start of a formal investigation into the trade practices of a subsidiary of DEF related to activities that occurred during a three-year period that ended prior to the acquisition date. Based on the subsequent announcement of the investigation into the trade practices of DEF and on the records available related to the period under investigation, ABC concludes that, while the acquisition-date fair value of the liability is not determinable, it is probable that DEF's trade practices during the period under investigation violated the applicable laws and estimates the amount of the unasserted claim at the acquisition date to be $30 million. In addition, after seeking advice from legal counsel, ABC concludes that it has recourse against the previous shareholders of DEF up to the $20 million from the indemnification clause in the acquisition agreement, and has responsibility for any remaining loss arising from claims related to the investigation.

The contingency existed as of the acquisition date; however, ABC did not obtain the additional information until after the acquisition date but before the end of the measurement period. If ABC had been aware of this information at the acquisition date, it would have recognized a liability as of that date. Therefore, ABC should record a

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measurement period adjustment to reflect the $30 million estimated amount of the liability related to the contingency, consistent with ASC paragraph 805-10-25-16, offset by the indemnification asset of $20 million, as well as a corresponding increase in goodwill.

AFTER THE MEASUREMENT PERIOD ENDS, THE ACQUISITION ACCOUNTING IS ADJUSTED ONLY TO CORRECT ERRORS

> **ASC Paragraph 805-10-25-19**
>
> After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with [ASC] Topic 250.

10.011 Because the measurement period extends for a maximum period of one year following the acquisition date, no further adjustments are made to the acquisition accounting thereafter except to correct an error. If errors in the acquisition accounting are discovered during the measurement period, but after post-combination financial statements have been issued, adjustments to the post-combination financial statements to correct the error should also be accounted for as the correction of an error under ASC Topic 250, *Accounting Changes and Error Corrections.*

10.012 – 10.015 Paragraphs not used.

Example 10.9: Error Discovered after the End of the Measurement Period

Case 1: New Information Obtained after the End of the Measurement Period

ABC Corp., a calendar-year-end nonpublic entity, acquired DEF Corp. in a business combination in November 20X8. The measurement period ended in November 20X9. In January 20Y0, before issuance of its 20X9 financial statements, ABC obtained new information about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of an additional liability at that date.

In this case, because the measurement period has ended and the adjustment resulting from the new information is not the result of an error, ABC would not adjust the acquisition accounting. Instead, it would treat the new information as a recognized subsequent event with respect to its 20X9 financial statements and, accordingly, would reflect the effect of the adjustment resulting from the new information in its 20X9 financial statements by recognizing the additional liability through a charge to earnings.

Case 2: Error Discovered after the End of Measurement Period

Assume the same facts as in Case 1, except that ABC concluded that the new information it obtained in January 20Y0 indicated that it had made an error in the acquisition accounting due to the misuse of facts that existed at the acquisition date.

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In this case, if the effects were material, ABC would restate its financial statements as of the date the information was deemed to be initially available (which could be the period that includes the acquisition date or any of the subsequent interim periods until the end of the measurement period (and any subsequent interim period financial statements after that date) to correct the error in the acquisition accounting by recognizing the liability as of the acquisition date and adjusting goodwill (or the gain on a bargain purchase) by the corresponding amount, and making any cumulative adjustments needed to its results of operations resulting from the error. ABC also would determine whether any other actions were necessary as a result of the restatement of such financial statements.

ADJUSTMENTS TO PROVISIONAL AMOUNTS RELATED TO DEFERRED TAX ASSETS AND LIABILITIES DURING THE MEASUREMENT PERIOD

ASC Paragraph 805-740-25-2

An acquirer shall recognize a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination and shall account for the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, in accordance with the guidance in [ASC] Subtopic 740-10 [*Income Taxes - Overall]* together with the incremental guidance provided in [ASC] Subtopic [805-740].

10.016 Prior to the issuance of ASC Topic 805 and the related amendments to ASC Subtopic 740-10, *Income Taxes - Overall,* ASC Subtopic 740-10 required that the tax benefits arising subsequent to an acquisition (as a result of the initial elimination of a valuation allowance recognized at the acquisition date for an acquiree's deductible temporary differences or operating loss or tax credit carryforwards) be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

10.017 In deliberating ASC Topic 805, the FASB concluded that an acquirer should recognize changes in amounts recognized for acquired deferred tax benefits of an acquiree (both increases and decreases) in the same manner as revisions to other amounts recognized at the acquisition date.

ASC Paragraph 805-740-45-2

The effect of a change in a valuation allowance for an acquired entity's deferred tax asset shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, an acquirer shall recognize any additional

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decrease in the valuation allowance as a bargain purchase in accordance with [ASC] paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a business combination.

b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by [ASC] paragraphs 740-10-45-20 through 45-21).

10.018 The FASB also revised ASC Subtopic 740-10 to provide similar guidance for the subsequent accounting for adjustments to amounts recognized for acquired income tax uncertainties. Therefore, the same approach is used in accounting for such adjustments as is required for subsequent adjustments to acquired deferred tax benefits:

ASC Paragraph 805-740-45-4

The effect of a change to an acquired tax position, or those that arise as a result of the acquisition, shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed as of the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, the remaining portion of that adjustment shall be recognized as a gain on a bargain purchase in accordance with [ASC] paragraphs 805-30-25-2 through 25-4.

b. All other changes in acquired income tax positions shall be accounted for in accordance with the accounting requirements for tax positions established in [ASC] Subtopic 740-10.

10.019 As a result of these requirements, the accounting for subsequent adjustments to amounts recognized at the acquisition date for acquired deferred tax benefits and acquired income tax uncertainties is the same. That is, retrospective adjustments to amounts recognized at the acquisition date are limited to adjustments that result from new information obtained during the measurement period about facts and circumstances that existed as of the acquisition date. All other changes in amounts recognized at the acquisition date are recognized and measured in accordance with ASC Subtopic 740-10. Additionally, because of ASC Topic 805's transition provisions related to income taxes, this accounting applies to all adjustments to acquired deferred tax benefits and acquired income tax uncertainties, including adjustments related to amounts recognized in business combinations consummated before the effective date of ASC Topic 805. See the discussion of the subsequent accounting for income taxes following a business combination in KPMG Handbook, Accounting for Income Taxes, Section 6.

CONTINGENT CONSIDERATION

10.020 The consideration issued by the acquirer in exchange for the acquiree includes a liability (or an asset) arising from a contingent consideration arrangement, measured and recognized at its acquisition-date fair value. Provisional amounts for contingent

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consideration recognized at the acquisition date are adjusted only for adjustments identified during the measurement period that result from new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized at the acquisition date. All other changes in fair value after the acquisition date, including those occurring within the measurement period, do not affect the acquisition date accounting. See the discussions of the initial recognition and measurement of contingent consideration, and the subsequent accounting for contingent consideration under *Contingent Consideration,* in Sections 6 and 12, respectively.

CONTRACT ASSETS AND CONTRACT LIABILITIES (AFTER ADOPTION OF ASU 2021-08)

10.021 Contract assets and contract liabilities acquired in a business combination and measured in accordance with ASC Topic 606 may be recognized at provisional amounts similar to any other asset or liability until the measurement period is closed. Significant judgment may be required to evaluate whether changes in estimates that affect a contract asset or liability result from new information related to conditions that existed at the acquisition date versus conditions that arose after the acquisition date. For example, a change in costs expected to be incurred for purposes of measuring progress toward completion for a performance obligation is an estimate that would need to be made at the acquisition date and continue to be made until the contract is complete. Therefore, it is important to distinguish between information the acquirer obtained to perform the ongoing accounting assessment and information it was waiting to obtain to complete its acquisition date assessment.

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Section 11 - Determining What Is Part of the Business Combination Transaction

Detailed Contents

Example 11.0: Costs of Introducing New Processes to an Acquiree before a Business Combination

Preexisting Relationships

Settlement of Preexisting Relationships

Preexisting Noncontractual Relationships

Example 11.1: Preexisting Noncontractual Relationship

Preexisting Contractual Relationships

Example 11.2: Effective Settlement of a Supply Contract as a Result of a Business Combination

Example 11.3: Effective Settlement of a Contract between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability before the Business Combination

Example 11.4: Effective Settlement of a License Contract between the Acquirer and Acquiree

Example 11.4a: Effective Settlement of Accounts Receivable

Example 11.5: Reacquired Rights with Off-Market Terms

Transactions That Compensate Employees or Former Owners of the Acquiree for Services

Example 11.6: Arrangement for Contingent Payment to an Employee

Example 11.7: Arrangement for Contingent Payment to an Employee at the Suggestion of the Acquirer

Example 11.7a: Arrangement for Bonuses to Be Paid by the Acquirer to Employees

Example 11.7b: Rollover Equity not Compensatory

Additional Indicators for Evaluating Arrangements for Contingent Payments to Employees or Selling Shareholders

Arrangements for Contingent Payments to Employees or Selling Shareholders That Are Forfeited if Employment Terminates

Example 11.8: Stay Bonuses - Scenario 1

Example 11.9: Stay Bonuses - Scenario 2

Example 11.10: Shareholders/Executive Officers - Scenario 1

Example 11.11: Shareholders/Executive Officers - Scenario 2

Example 11.11a: Shareholders/Executive Officers - Scenario 3

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Example 11.12: Executive Officers - Double Trigger Awards

Example 11.12a: Contingent Employee Compensation Paid to Selling Shareholder if Forfeited by Employee

Example 11.12b: Separate Seller Agreement Requiring Continued Employment

Transition Service Agreements (TSAs)

Forgiveness of Full-Recourse Loans

Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree

Attribution of Replacement Awards to Consideration Transferred and Post-combination Vesting

Measurement

Attribution - Employee Awards

Example 11.13: Acquirer Replacement Awards That Require No Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Required Services as of the Acquisition Date

Example 11.14: Recording Replacement Awards that Provide Additional Fair Value if Post-combination Vesting Is Rendered

Example 11.15: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Requisite Service as of the Acquisition Date

Example 11.16: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

Example 11.17: Acquirer Replacement Awards for Which No Post-combination Vesting Is Required Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

Attribution - Nonemployees

Example 11.17b: Acquirer Replacement Awards That Require Post-Combination Vesting Exchanged for Acquiree Awards for Which Nonemployees Have Not Delivered all of the Goods or Services as of the Acquisition Date

Accounting for Forfeitures of Replacement Awards in a Business Combination

Example 11.17c: Effect of Acquirer’s Forfeiture Accounting Policy on Post-Acquisition Accounting for Replacement Share-Based Payment Awards

Awards with Graded Vesting - Employee Awards

Example 11.18: Graded Vesting Replacement Awards

Example 11.18a: Graded Vesting Replacement Awards – Part II

Settlement of Share-Based Awards

Example 11.19: Acquirer Cash Settles an Acquiree's Award

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Change-in-Control Provisions

Example 11.19a: Accelerated Vesting of Awards When a Change-in-Control Provision Is Triggered as Part of the Award's Original Terms

Example 11.20a: Accelerated Vesting of Awards When a Change-in-Control Provision Is Added

Example 11.21a: Acceleration of Awards With a Change in Control and a Secondary Event (Double Trigger)

Awards with Performance Conditions

Awards with Market Conditions

Post-Acquisition Changes in Estimates

Last-Man-Standing Plans

Example 11.23: Last-Man-Standing Plans

Acquisition of Noncontrolling Interest

Example 11.23a: Treatment of the Exchange of Awards in the Acquisition of Noncontrolling Interest

Example 11.23b: Accounting for the Exchange of Partially Vested Awards at the Acquisition Date of the Subsidiary

Example 11.23c: Accounting for the Exchange of Fully Vested Awards Issued after the Acquisition Date of the Subsidiary

Acquirer's Accounting for Unreplaced Awards

Acquirer's Subsequent Grant of Awards When Acquirer Did Not Exchange Acquiree's Awards in the Business Combination Transaction

Example 11.24: Employee Share Options of Acquiree That Are Not Assumed by the Acquirer

Payroll Taxes on Share-Based Awards

Accounting for the Income Tax Effects of Replacement Awards Classified as Equity Issued in a Business Combination

Acquisition-Related Costs

Acquisition-Related Costs Incurred by the Acquirer

Example 11.26: Acquisition-Related Costs

Q&A 11.1: Costs Related to Directors and Officers Liability Insurance

Q&A 11.2: Costs Related to Representations and Warranties Insurance

Costs Related to the Issuance of Equity Securities

Costs Related to the Issuance of Debt

Allocation of Financing and Acquisition Costs

Cost Related to Excise Tax on Net Share Repurchases

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Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred

Example 11.27: Acquisition-Related Payments Made by an Acquiree

Other Transactions

Changes in Interest Rate on Acquirer's Debt Resulting from a Change in Control

Restructuring or Exit Activities

Hedging a Forecasted Transaction Contingent on Consummation of a Business Combination

Example 11.28: Derivative Transaction That Will Lock In the Interest Rate Today on the Forecasted Issuance of Debt Expected to Occur in Six Months

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ASC Paragraph 805-10-25-20

The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).

ASC Paragraph 805-10-25-21

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

a. A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see [ASC] paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree for future services (see [ASC] paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see [ASC] paragraph 805-10-25-23).

11.000 An acquirer is required to identify amounts that are not part of the exchange for the acquiree. Such amounts are not included in the accounting for the business combination, but rather are accounted for as separate transactions in accordance with other relevant GAAP. If a method of allocating consideration is not specifically addressed by other relevant GAAP, we believe allocating amounts based on relative fair value is a reasonable approach.

11.001 Determining what is part of the business combination involves an analysis of the relevant factors of the arrangement. The FASB observed that parties directly involved in the negotiations of a business combination may take on the characteristics of related parties, and thus may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity (for example, to achieve more favorable financial reporting outcomes after the business combination). ASC paragraph 805-10-25-21 provides three examples of transactions that are not part of a business combination and which should therefore be accounted for separately in accordance with other relevant GAAP. The determination as to whether an asset or liability is part of a business combination transaction rather than an asset or a liability resulting from a separate

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transaction requires an acquirer to identify the components of a transaction in which it obtains control over an acquiree. The objective of making the distinction is to ensure that each component is accounted for in accordance with its economic substance. ASC paragraphs 805-10-25-20 through 25-22 and 55-18.

11.002 The implementation guidance in ASC paragraph 805-10-55-18 provides factors (which are not mutually exclusive or individually conclusive) to be considered in assessing whether a transaction is part of a business combination or is a separate transaction and should be accounted for separately in accordance with other relevant GAAP.

(a) *The reasons for the transaction*-Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

(b) *Who initiated the transaction*-Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

(c) *The timing of the transaction*-The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

11.003 In many instances, it will be readily apparent, giving consideration to the specific circumstances including the above factors, whether a transaction or arrangement is part of the business combination or relates to events or transactions that are not a part of the business combination and should therefore be accounted for in accordance with other relevant GAAP. For example, the settlement of matters that arose prior to the

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consideration of a business combination between the acquirer and the acquiree, such as a preexisting lawsuit between the acquirer and the acquiree, or a long-term supply contract or an operating lease agreement between the acquirer and the acquiree with terms that are favorable or unfavorable relative to market terms at the acquisition date, would not be part of the business combination, and would therefore be accounted for in accordance with other relevant GAAP.

11.004 In other instances, it may be less clear whether an amount relates to a transaction or arrangement that is or is not part of the business combination, and a more detailed analysis based on the above factors and other relevant information may be required in making this determination.

11.005 ASC paragraphs 805-10-25-20 through 25-23 provide additional guidance in assessing transactions entered into with an acquiree or by an acquiree on behalf of an acquirer. See *Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred* beginning at Paragraph 11.066.

Example 11.0: Costs of Introducing New Processes to an Acquiree before a Business Combination

Background

An entity (Acquirer) entered into an agreement to purchase a manufacturing operation (Target) from a third party (Seller). Target meets the definition of a business under ASC paragraph 805-10-55-3A. Seller agreed to incur costs to introduce certain new processes into the facility to allow Acquirer to manufacture product not currently manufactured by Target. If the new processes do not meet the specifications agreed by the two parties, Acquirer can withdraw from the acquisition but must pay a penalty, calculated by reference to the costs that Seller will incur to introduce the new processes. The costs are business process reengineering expenses in the scope of ASC Subtopic 720-45.

Acquirer considers the guidance in ASC paragraph 805-10-55-18 to determine whether it should account for the new processes as part of the business combination.

(a) The reasons for the transaction – The introduction of the new processes into the facility, although they could benefit both Target and Acquirer, are primarily for the benefit of Acquirer and the combined entity to allow the facility to manufacture a product not currently manufactured by Target.

(b) Who initiated the transaction – Acquirer initiated the transaction as part of the negotiations of the business combination.

(c) The timing of the transaction – The parties agreed to introduce the new processes during the negotiations for and in contemplation of the business combination to provide future economic benefits to Acquirer and the combined entity.

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Based on the analysis above, Acquirer concludes that introducing new processes just before the business combination is primarily for its own benefit, and therefore not part of consideration transferred in a business combination. As Target is incurring the reengineering costs, Acquirer should record the expense and a payable (that will be paid to either Seller or Target, depending on whether the transaction closes).

At closing, Acquirer applies the portion of the consideration paid to Seller representing the reimbursement of business process reengineering expense as a reduction to the payable it previously recorded. If the acquisition does not proceed, Acquirer will pay the Target or Seller the penalty and reduce the payable.

PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-55-20

The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a *preexisting relationship.* A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or noncontractual (for example, plaintiff and defendant).

11.006 Preexisting relationships between the acquirer and the acquiree, including contractual and noncontractual relationships, should be identified and assessed to determine whether they have been effectively settled as a result of the business combination transaction and should therefore be accounted for separately from the business combination in accordance with other relevant GAAP. Because the acquirer usually consolidates the acquiree following a business combination, preexisting relationships are generally effectively settled as a result of the combination (i.e., following the business combination, such transactions are eliminated in the post-combination consolidated financial statements). Prior to the issuance of ASC Topic 805, EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination" provided guidance for the effective settlement of preexisting relationships between the parties to a business combination. EITF 04-1 was nullified by ASC Topic 805. However, the guidance in EITF 04-1 was generally incorporated into ASC Topic 805.

SETTLEMENT OF PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-55-21

If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

a. For a preexisting noncontractual relationship, such as a lawsuit, fair value

b. For a preexisting contractual relationship, the lesser of the following:

1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market

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transactions for the same or similar items. An *unfavorable contract* is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

11.007 The measurement of the gain or loss arising from a preexisting relationship that is effectively settled as the result of a business combination depends on whether that preexisting relationship was contractual or noncontractual in nature. The difference between the amount of the gain or loss measured in accordance with ASC paragraph 805-10-55-21 and the amount previously recognized by the acquirer, if any, is recognized in earnings at the acquisition date. See KPMG Handbook, *Accounting for Income Taxes*, Section 6 The Tax Effects of Business Combinations for discussion of *Recognizing the Tax Effects of the Effective Settlement of a Preexisting Relationship in a Business Combination*.

Preexisting Noncontractual Relationships

11.008 An example of a preexisting noncontractual relationship between the acquirer and acquiree would be a lawsuit relating to a noncontractual matter in which the two parties had a relationship as plaintiff and defendant. If the lawsuit is effectively settled as a result of a business combination, it would be measured at fair value, and the difference between the amount measured and amounts previously recognized by the acquirer (in accordance with applicable GAAP) would be recognized as a gain or loss at the acquisition date.

Example 11.1: Preexisting Noncontractual Relationship

ABC Corp. is the defendant in a lawsuit in which DEF Corp. is the plaintiff. ABC has recognized a liability in the amount of $8 million related to this lawsuit in accordance with ASC Topic 450, *Contingencies.* On January 1, 20Y0, ABC acquires DEF in a business combination, and pays cash consideration of $100 million to DEF's shareholders. ABC's acquisition of DEF effectively settles the lawsuit. ABC concludes that the lawsuit should be evaluated as a preexisting noncontractual relationship. The fair value of the lawsuit at January 1, 20Y0 is determined to be $5 million. ABC recognizes a $3 million gain on the effective settlement of the lawsuit in earnings at the acquisition date (the $8 million liability previously recognized under ASC Topic 450 less the $5 million fair value of the lawsuit at the acquisition date).

ABC records the following entry to recognize the acquisition of DEF and the effective settlement of the lawsuit with DEF on the acquisition date:

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	Debit	Credit
Net assets of DEF (including goodwill)	$95 million	
Litigation liability	$8 million	
Gain on settlement of litigation		$3 million
Cash		$100 million

In accounting for the acquisition, the consideration transferred to acquire DEF is $95 million (the $100 million paid to the shareholders of DEF less the $5 million recognized in connection with the effective settlement of the lawsuit).

Preexisting Contractual Relationships

11.009 Examples of preexisting contractual relationships between the acquirer and acquiree include a vendor and customer relationship, a lessor and lessee relationship, a licensor and licensee relationship, or a lender and a borrower relationship. A preexisting contractual relationship that is effectively settled as a result of a business combination is measured at the lesser of:

(a) the amount by which the contract is favorable or unfavorable from the perspective of the acquirer, or

(b) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable.

If the contract is noncancelable but does not have a stated settlement provision, a settlement gain or loss is recognized on the basis of the amount by which the contract is favorable or unfavorable from the perspective of the acquirer. The difference between the amount so measured and any amounts previously recognized by the acquirer (in accordance with applicable GAAP) is recognized as a gain or loss at the acquisition date. If the contract is cancelable without a penalty, no gain or loss is recognized because the settlement provision of that contract is zero.

11.010 The following example, which is taken from ASC paragraphs 805-10-55-30 through 55-32, illustrates the accounting for the effective settlement of a supply contract as a result of a business combination.

Example 11.2: Effective Settlement of a Supply Contract as a Result of a Business Combination

AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates in the contract are higher than rates at which AC could purchase similar electronic components from other suppliers. The supply contract allows AC to terminate the contract before the end of the initial 5-year term by paying a $6 million penalty. With 3 years remaining under the supply contract, AC pays $50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.

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Included in the total fair value of TC is $8 million related to the fair value of the supply contract with AC. The $8 million represents a $3 million component that is "at-market" because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a $5 million component for pricing that is unfavorable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognized any assets or liabilities related to the supply contract before the business combination.

In this example, AC recognizes a loss of $5 million (the lesser of the $6 million settlement provision stated in the contract and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The $3 million at-market component of the contract is subsumed into goodwill in the acquisition accounting. The consideration transferred by AC to acquire TC is $45 million (the $50 million paid less the $5 million attributable to the effective settlement of the unfavorable supply contract). ASC paragraphs 805-10-55-30 through 55-32

11.011 The following example, which is taken from ASC paragraph 805-10-55-33, illustrates the accounting for the effective settlement of a supply contract when the acquirer had previously recognized a liability prior to the business combination.

Example 11.3: Effective Settlement of a Contract between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability before the Business Combination

Whether AC had previously recognized an amount in its financial statements related to a preexisting relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. In Example 11.2, GAAP might have required AC to recognize a $6 million liability for the supply contract before the business combination. In that situation, AC recognizes a $1 million settlement gain on the contract in earnings at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, AC has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million. ASC paragraph 805-10-55-33

11.012 The following example illustrates the accounting for the settlement of a license agreement as a result of a business combination.

Example 11.4: Effective Settlement of a License Contract between the Acquirer and Acquiree

ABC Corp. licensed spectrum capacity to DEF Corp. After the original agreement, the market price of spectrum capacity changed substantially such that the contract is now favorable to DEF. ABC acquired DEF while the spectrum license was favorable to DEF

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and unfavorable to ABC. The fair value of DEF, including the favorable contract is $102, whereas the fair value of DEF if the contract were instead at market value is $100.

ABC pays the same amount as a market participant to acquire DEF ($102), but as the acquisition effectively settles the preexisting relationship, ABC would recognize a loss on settlement of the preexisting relationship separate from the acquisition accounting. Assuming ABC did not have a provision previously recognized for the unfavorable contract, it would record the following:

	Debit	Credit
Net assets of DEF Corp.	100	
Loss on settlement of contract	2	
Cash		102

In contrast, if a market participant acquired DEF, the market participant would record an asset of $2 related to the favorable contract (from DEF's perspective).

11.012a The following example illustrates the accounting for the settlement of accounts receivable as a result of a business combination.

Example 11.4a: Effective Settlement of Accounts Receivable

Company A purchased all outstanding stock of Company B for $150. Company B was a customer of Company A. At the acquisition date, Company A had a $10 accounts receivable balance recorded from Company B and Company B had a corresponding payable.

The accounts receivable and accounts payable balance between Company A and B was effectively settled in the acquisition as the amount will eliminate in consolidation after the acquisition. Therefore, Company A increased the consideration transferred by the amount of the settled receivable to $160 ($150 cash + $10 receivable). There was no gain or loss because there was no difference between the effective settlement amount and the carrying amount of the receivable.

Effective Extinguishment of Debt between the Acquirer and the Acquiree

11.013 A business combination may result in the effective extinguishment of debt issued by the acquirer. When a business combination results in the extinguishment of debt issued by the acquirer to the acquiree, the acquirer should apply ASC Subtopic 470-50, *Debt - Modifications and Extinguishments,* to account for the debt extinguishment. Any settlement gain or loss that the acquirer recognizes in connection with the debt extinguishment is recognized outside of the accounting for the acquisition.

11.014 If the preexisting relationship that is settled is debt issued by the acquiree to the acquirer, then the acquirer applies the guidance in ASC paragraph 805-10-55-21(b) related to the settlement of preexisting relationships in a business combination.

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Reacquired Rights

11.015 An acquirer may have a preexisting relationship with an acquiree in the form of a previously granted right such as a right to use intellectual property such as a brand or trademark. As a result of a business combination, the acquirer essentially reacquires that previously granted right. For example, an acquirer may have previously granted the acquiree the right to use the acquirer's trade name under a franchise agreement. ASC Topic 805 specifies that rights reacquired by an acquirer in a business combination are identifiable intangible assets that the acquirer recognizes separately from goodwill. See Section 7 for guidance on the measurement of rights that are reacquired in a business combination.

11.016 Additionally, if the terms of the reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer recognizes a settlement gain or loss separate from the business combination, measured using the guidance for settling preexisting relationships provided in ASC paragraphs 805-20-25-14 through 25-15 and 805-10-55-21.

Example 11.5: Reacquired Rights with Off-Market Terms

Franchisor ABC Corp. acquires the business of operating Franchisee DEF Corp. In connection with the acquisition, Franchisor ABC reacquires previously granted franchise rights. Franchisor ABC pays $30 million to acquire Franchisee DEF. The reacquired franchise right is valued at $3 million in accordance with the measurement guidance in ASC Topic 805. The terms of the contract covering the rights are unfavorable (from the perspective of the ABC, the acquirer) by $4 million relative to the terms of current market transactions for the same or similar items, and the contract does not include any cancellation or settlement provisions. The amount of the identifiable net assets of Franchisee DEF, measured in accordance with ASC Topic 805, is $17 million (excluding the franchise right). Franchisor ABC records the reacquisition of the franchise right and the acquisition of Franchisee DEF as follows:

	Debit	Credit
Loss on reacquired franchisee right	$4 million	
Reacquired franchise right (intangible asset)	$3 million	
Identifiable net assets of Franchisee DEF (excluding the reacquired franchise right)	$17 million	
Goodwill	$6 million	
Cash		$30 million

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TRANSACTIONS THAT COMPENSATE EMPLOYEES OR FORMER OWNERS OF THE ACQUIREE FOR SERVICES

11.017 Arrangements for Contingent Payments to Employees or Selling Shareholders (Application of ASC paragraph 805-10-25-21(b)).

> **ASC Paragraph 805-10-55-24**
>
> Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

11.018 In a business combination an acquirer may enter into an arrangement for contingent payments to employees or selling shareholders of the acquiree. The accounting for such arrangements depends on whether they represent contingent consideration issued in the business combination and are included in the accounting for the acquisition, or are separate transactions and are accounted for in accordance with other relevant GAAP.

- Contingent consideration issued in a business combination is usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met; however, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met or fail to be met. (ASC Section 805-10-20) See the discussion of *Contingent Consideration* in Section 6.
- Arrangements for contingent payments to employees or selling shareholders that do not meet the definition of contingent consideration are not part of the accounting for the business combination, and are therefore accounted for separately in accordance with other relevant GAAP.

11.019 An understanding of the factors in ASC paragraph 805-10-55-18 (i.e., the reasons why the acquisition agreement includes a provision for such payments, who initiated the arrangement, and the timing of when the parties entered into the arrangement), as well as the conditions that trigger payment of the consideration, may be helpful in assessing whether the arrangement represents contingent consideration issued in the business combination or is a transaction to be accounted for separately from the business combination.

11.020 The following two examples, which are included as ASC paragraphs 805-10-55-34 through 55-36, illustrate the consideration of ASC paragraph 805-10-55-18 factors on the determination of whether an arrangement for contingent payments represents contingent consideration issued in a business combination or is a transaction to be accounted for separately from the business combination.

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Example 11.6: Arrangement for Contingent Payment to an Employee

TC hired a candidate as its new CEO under a 10-year contract. The contract required TC to pay the candidate $5 million if TC is acquired before the contract expires. AC acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay $5 million is included in the application of the acquisition method. ASC paragraphs 805-10-55-34 through 55-35

Example 11.7: Arrangement for Contingent Payment to an Employee at the Suggestion of the Acquirer

In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method. ASC paragraph 805-10-55-36

11.020a Contingent payments to employees may also be similar to sign on bonuses if they are paid by the acquirer on the acquisition date without any requirement to perform post-acquisition services. The following example illustrates the consideration of ASC paragraph 805-10-55-18 in those arrangements.

Example 11.7a: Arrangement for Bonuses to Be Paid by the Acquirer to Employees

Similar to Example 11.7, during the negotiations for the business combination, TC enters into an agreement whereby employees that will become employed by AC will receive cash bonuses as of the acquisition date if they continue to be employed on that date. If the agreement was entered into in contemplation of the business combination, it may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay the employees in its post-combination financial statements as an expense separately from application of the acquisition method.

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Example 11.7b: Rollover Equity not Compensatory

ABC LLC, 100% owned by ABC Parent LLC, acquires DEF LLC in a business combination primarily by paying the shareholders of DEF cash consideration in exchange for their ownership interests in DEF. As part of the overall transaction, ABC Parent enters into a rollover agreement with the CEO of DEF to receive limited liability company interests in ABC Parent for a portion of the CEO's purchase consideration based on her 5% ownership in DEF. That is, instead of receiving only cash consideration for her ownership in DEF, the CEO received a combination of cash and LLC interests in ABC Parent that were commensurate with the fair value of the cash consideration that other shareholders of DEF received for their ownership interest.

The CEO will become an employee of the combined entity. However, the rollover agreement does not require any continuing involvement with the ongoing operations of the company or vesting provisions tied to continuing employment.

The rollover equity is not considered compensatory due to the fact there is no required continuing employment and considering the indicators in ASC paragraph 805-10-55-25. The substance of the transaction is exchanging cash and equity for the CEO's previous ownership interest in DEF. Therefore, ABC should include the fair value of the rollover equity issued by its parent company as part of the consideration transferred.

ADDITIONAL INDICATORS FOR EVALUATING ARRANGEMENTS FOR CONTINGENT PAYMENTS TO EMPLOYEES OR SELLING SHAREHOLDERS

ASC Paragraph 805-10-55-25

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. *Continuing employment.* The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.

b. *Duration of continuing employment.* If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.

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c. *Level of compensation.* Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.

d. *Incremental payments to employees.* If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

e. *Number of shares owned.* The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

f. *Linkage to the valuation.* If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. *Formula for determining consideration.* The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. *Other agreements and issues.* The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement

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with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

ARRANGEMENTS FOR CONTINGENT PAYMENTS TO EMPLOYEES OR SELLING SHAREHOLDERS THAT ARE FORFEITED IF EMPLOYMENT TERMINATES

11.021 ASC paragraph 805-10-55-25 states that a contingent consideration arrangement in which the contingent payments are forfeited if employment terminates is compensation for post-combination services. Before the effective date of ASC Topic 805, EITF Issue No. 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination," which was nullified by ASC Topic 805, indicated that a contingent consideration arrangement in which payments are automatically forfeited if employment terminates is a *strong indicator* that the arrangement is compensation for post-combination service. Discussion with the FASB staff indicated that the removal of the words *strong indicator* from the guidance in ASC paragraph 805-10-55-25 was intentional and intended to require contingent consideration arrangements in which payments are forfeited if employment terminates to be accounted for as compensation for post-combination services. We believe that an arrangement in which contingent payments to employees or selling shareholders are payable only if the recipients remain in the employment of the combined entity following an acquisition, represents compensation for post-combination service, even if evaluation of some (or even all) of the other indicators in ASC paragraph 805-10-55-25 indicate that the payments would otherwise be considered to be additional consideration transferred in exchange for the acquiree. If a contingent consideration arrangement is not affected by employment termination, the other indicators in ASC paragraph 805-10-55-25 should be considered in determining whether the arrangement is part of the exchange for the acquiree or a separate transaction. Before determining whether the arrangement is contingent on the recipient's continued employment, the facts and circumstances of the arrangement should be considered to determine whether one or multiple arrangements exist. Examples 11.9 and 11.11 illustrate circumstances in which multiple arrangements may exist.

11.021a In evaluating whether an arrangement should be recorded as compensation for post-combination service, an acquirer should carefully consider any arrangements in which a related party or a holder of an economic interest in the entity transfers, or promises to transfer, cash or other assets to employees that remain in the employment of the combined entity following the acquisition. Unless there is evidence that the transfer was clearly for a purpose other than compensation for services to the combined entity (or to incentivize their continued employment), those payments are recorded as

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compensation. When the payments to employees are contingent on continued employment, or the other indicators in ASC paragraph 805-10-55-25 indicate the payments are compensatory, the acquirer would record post-combination compensation expense.

11.021b As the concept of an economic interest is broadly applied, there may be arrangements with continuing employees to which the acquirer is not a party that are considered compensatory because it is not clear that the transfer was for a purpose other than compensation. For example, a selling shareholder may enter into an arrangement with its former employees that become employees of the combined entity to share a portion of an earnout (contingent consideration) received from the acquirer. While the selling shareholder may enter into the arrangement to increase the likelihood that it will receive the earnout, the promise to pay a portion of the earnout to employees who are providing service to the combined entity indicates that the arrangement will benefit the combined entity and therefore would be compensatory. As the transfer is not for a purpose other than compensation, the acquirer recognizes the arrangement as compensation for post-combination services.

Example 11.8: Stay Bonuses - Scenario 1

ABC Corp. acquires all of the outstanding equity shares of DEF Corp. in a business combination. In connection with the acquisition, ABC offers bonuses (to be paid in cash) to certain senior-level employees of DEF (the *offerees).* All of the offerees are shareholders of DEF and, collectively, owned all of the outstanding shares of DEF before its acquisition by ABC. The payment of bonuses to an individual offeree is contingent on the offeree remaining employed by the combined entity for a two-year period after the acquisition (i.e., an offeree's right to receive a bonus is forfeited in the event the offeree does not remain with ABC during the two-year period). The amount of the bonuses to be paid to each offeree will be determined based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition.

The bonuses represent compensation for post-combination services, as the right to a bonus is forfeited if an offeree does not remain with the combined entity for the two-year period following the acquisition. Evaluation of the other factors related to the arrangement would not overcome this conclusion. Thus, the combined entity should recognize compensation cost in a systematic and rational manner during the two-year period the offerees' bonuses are earned.

Example 11.9: Stay Bonuses - Scenario 2

Assume the same facts as in Example 11.8, except that the arrangement provides for contingent payments to each of the offerees (i.e., the former shareholders of DEF) as follows:

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(1) Regardless of whether an offeree remains employed by the combined entity, the offeree is entitled to a contingent payment based on a multiple of earnings during the two-year period following the acquisition and the number of shares of DEF held by the offeree and acquired by ABC in the acquisition.

(2) If an offeree remains employed by the combined entity for the two-year period following the acquisition, the offeree is entitled to a contingent payment equal to the higher of the amount determined under (1), or an amount determined based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition.

In this example, each of the offerees are entitled to a contingent payment based on a multiple of earnings and the number of DEF shares they held at the acquisition date (i.e., as determined under (1) above), regardless of whether they remain with the combined entity during the two-year post-combination period. Thus, because all shareholders are participating in the arrangement in proportion to their ownership interest in DEF before ABC acquires it, and because the contingent payment is not tied to employment following the acquisition date, this portion is considered a separate contingent consideration arrangement and constitutes part of the consideration transferred by ABC in exchange for control of DEF. The contingent consideration obligation is measured at its fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings (even if the arrangement was a derivative, it is not subject to the requirements of *ASC Topic 815, Derivatives and Hedging,* as it falls under the scope exclusion of ASC paragraphs 815-10-15-59 through 15-61, and therefore could not be designated as a hedging instrument).

See the discussion of *Contingent Consideration* in Section 6, *Recognizing and Measuring the Consideration Transferred.*

If an offeree remains with the combined entity during the two-year post-combination period, the offeree will be entitled to an additional payment if the amount determined under (2) above (i.e., based on a multiple of earnings and the offeree's average annual salary during the two-year period following the acquisition) exceeds the amount determined under (1) above. Because any such additional payment is contingent on the offeree's continuing employment with the combined entity, the additional payment for this contingent consideration arrangement is compensation, is recognized by ABC for post-combination services, and is therefore recognized by the combined entity as compensation cost in a systematic and rational manner during the two-year period the offeree's bonuses are earned.

Example 11.10: Shareholders/Executive Officers - Scenario 1

ABC Corp. purchases DEF, a small brokerage firm in which all of the shareholders are executive officers of the firm. The terms of the purchase transaction provide for future payments to the DEF shareholders based on future operating results and the continued

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employment of the executive officers/shareholders for three years following the acquisition. The potential additional payments to each of the shareholders based on future operating results would be ratable based on their pre-combination shareholdings, would exceed by a significant amount the consideration transferred to them at the acquisition date and, if earned, will exceed by a significant amount what would generally be considered to be *reasonable compensation.* However, if an executive officer/shareholder does not remain with the entity for the full three-year period, that individual's rights to future payments are forfeited.

Because the future payments are contingent on the officers'/shareholders' continuing employment with the combined entity following the acquisition, ABC should recognize the future payments as compensation cost over the post-combination service period.

Example 11.11: Shareholders/Executive Officers - Scenario 2

ABC Corp. purchases Target from its four shareholders, consisting of Target's CEO and spouse, and two unrelated parties. The Target CEO is the only shareholder who will be employed by ABC. ABC offers each of the four shareholders additional cash consideration contingent on the Target CEO's continuing employment for two years subsequent to the business combination.

ABC should recognize the additional consideration payable to the Target CEO as compensation cost during the two-year post-combination period, because the CEO's right to the additional payment is conditioned on the CEO's continued employment during that period. In addition, due to the nature of a spousal relationship unless it is clear that the shares held by the spouse are unrelated to the spousal relationship, the portion of the contingent consideration paid to the spouse is part of the CEO's contingent consideration arrangement and is also compensation cost over the two-year post-combination period.

The two unrelated shareholders do not have any future employment requirements and therefore represent a separate arrangement. Accordingly, the fair value of the portion of the additional consideration payable to the two unrelated shareholders is contingent on the CEO remaining in the employment of ABC for the two-year post-combination, and thus constitutes part of the consideration transferred by ABC in exchange for control of Target. Thus, the contingent consideration is measured at fair value at the acquisition date, and is included in the acquisition accounting. Additionally, because the contingent consideration is payable in cash, it is classified as a liability and remeasured to fair value each reporting period until the contingency is resolved. Changes in fair value are recognized in earnings (unless the arrangement qualifies as a hedging instrument for which ASC Topic 815 requires the changes to be initially recognized in other comprehensive income, which seems to be an unlikely scenario in this example).

See discussion of *Contingent Consideration* in Section 6, *Recognizing and Measuring the Consideration Transferred.*

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We are aware of an alternative view whereby the payments to the unrelated shareholders are also accounted for as compensation cost even though they have no employment requirements. Under this view, if the payment is contingent on continued employment of any employee, regardless of whether the employee is the recipient of the payment, the contingent consideration is compensation cost.

Example 11.11a: Shareholders/Executive Officers - Scenario 3

ABC Corp. purchases Target Corp. from its shareholders, ten of whom are employees of Target. Those employees include the CEO and others in executive positions at Target.

ABC offers each of the shareholders additional cash consideration contingent on the continuing employment of at least seven of the ten employees for two years subsequent to the business combination. If any four employees leave in the two-year period, none of the shareholders receive the additional payment. As such, the additional consideration is based on the total number of employees who stay and is not linked to specific individuals.

ABC should recognize the additional consideration payable to the shareholders as compensation cost during the two-year post-combination period. Unlike Scenario 2, because the contingent arrangement is based on the group of employees as a whole, we believe there is no basis to identify the payment to each shareholder as a separate unit of account for purposes of the analysis.

Example 11.12: Executive Officers - Double Trigger Awards

Scenario 1

ABC Corp. purchases Target. Target's COO has an employment agreement that requires her to receive a $5 million cash severance payment upon a change in control of the company and severance by the combined company. In this situation, if Target's COO is terminated after the acquisition is consummated, the $5 million severance payment would be treated as a post-combination expense, because the ultimate *trigger* for the payment is the decision to terminate the former COO, which is made by the acquirer after the acquisition date. This would be the case even if ABC plans, as part of its acquisition decisions, to terminate Target's COO after the acquisition is consummated.

Scenario 2

Contrary to Scenario 1, the double trigger in the COO's employment contract states that she is entitled to the payment upon change in control and a *Good Reason.* Specifically, the Good Reason clause states that she is entitled to the payment if after the combination, her responsibilities in the combined company are significantly reduced from her responsibilities before the acquisition. ABC plans to offer Target COO a

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position as marketing director of the combined company in which she will report to ABC's COO.

In our experience, entities normally view Scenario 2 as similar to Scenario 1 because ABC has the ability to decide what the role and responsibilities of Target's former COO will be after the acquisition and can, in effect, determine whether the second trigger is invoked.

We are aware, however, that some Good Reason clauses may provide the acquirer with no reasonable alternative and therefore would be the equivalent of a single trigger provision (see Example 11.6). This alternative view would depend on the specific facts and circumstances of the Good Reason clause and an SEC registrant may want to consider consultation with the SEC staff before applying this approach.

Example 11.12a: Contingent Employee Compensation Paid to Selling Shareholder if Forfeited by Employee

ABC Corp. acquires DEF Corp. on January 1, 20X8. As part of the acquisition, ABC agrees to make cash payments to DEF employees over the next two years provided they remain employed by the combined company. The payments are based on certain EBITDA targets of the combined company and payable only if the employees are still employed at the end of each year. Any amounts forfeited because an individual is no longer employed at the end of the year will instead be paid to the former shareholders of DEF.

Although ABC will make the payments irrespective of whether the employees complete the requisite service, ABC should account for the payments as compensation expense in its post-combination financial statements. The nature of this arrangement is to retain the employees and the payments should not be reflected as consideration transferred to the seller.

Example 11.12b: Separate Seller Agreement Requiring Continued Employment

ABC Holdco owns 100% of DEF Opco. The shareholders of ABC are key employees of DEF.

XYZ Inc. acquires DEF on March 15, 20X9. As consideration for the acquisition, XYZ agrees to pay an initial cash payment and additional cash payments based on certain EBITDA targets over the next two years. The contingent payments are not dependent on continued employment of any individual. These payments are initially made to ABC, which then distributes them to its shareholders.

The ABC shareholders will continue to work for XYZ after the acquisition. A separate agreement is in place between the shareholders and ABC, requiring the shareholders to forfeit their shares in ABC if they leave XYZ before the end of the two-year period.

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Because the forfeiture of shares would prevent the shareholders from receiving the contingent payments if the targets are met, their ability to receive these payments is effectively linked to their continued employment with XYZ.

XYZ accounts for the contingent payments as compensation expense in its post-combination financial statements. The nature of this arrangement is to retain the employees, and therefore the payments are not reflected as consideration transferred to the seller.

TRANSITION SERVICE AGREEMENTS (TSAS)

11.021c An acquirer and seller commonly enter into TSAs in connection with a business combination for the acquirer to obtain transitional support for a specified period of time post-acquisition. TSAs typically provide the acquirer with a continuation of certain operational tasks or functions, such as IT, accounting, and HR until the acquirer can integrate the tasks or functions within its organization.

Generally, a TSA is a transaction separate from the business combination and is accounted for in accordance with other relevant GAAP. The consideration transferred to the seller should be allocated between the business combination and the TSA on a relative fair value basis. If the TSA is priced at market rates for the services, it would generally be accounted for based on the contractual amount. In contrast, if the seller charges a below market rate for the transitional services, some portion of the consideration transferred for the business combination likely would be allocated to the TSA.

FORGIVENESS OF FULL-RECOURSE LOANS

11.022 Full-recourse loans previously granted to employees of an acquiree may be forgiven in connection with a business combination. This could include loans granted to employees in connection with the exercise of stock options, as well as loans granted for other purposes. If it is not clear whether the forgiveness of the loans is part of the exchange for the acquiree or is a transaction separate from the business combination, all relevant facts and circumstances, including those identified in ASC paragraph 805-10-55-25, should be considered in making the determination. For example:

- If the loans were entered into prior to the commencement of negotiations for the business combination, and the original terms of the notes require forgiveness in the event of a change-in-control, such forgiveness would generally not be accounted for by the acquirer as a transaction separate from the business combination, as long as the forgiveness does not include any post-combination service requirements and is not tied to another agreement (entered into in connection with the loan agreement) that includes post-combination service requirements.
- If the acquisition agreement includes a provision requiring forgiveness of loans, a determination as to why the provision was included, as well as a

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review of other arrangements entered into with the participating employees, will be helpful in making the determination. For example, if the provision was included at the request of the acquirer, and a termination agreement was also entered into with the employee before the combination, the forgiveness might constitute what is, in effect, a severance payment to the employee that should be accounted for as a transaction separate from the business combination. An acquirer cannot avoid the recognition of a severance cost that it would otherwise expect to incur immediately following a business combination by arranging for the acquiree to make the payment before the business combination or by putting provisions in an acquisition agreement that effectively provide for the payments.

11.023 In reviewing arrangements such as those discussed above, all arrangements with the participating employees should be considered. For example, if two arrangements are entered into at or about the same time, such as an arrangement providing for the forgiveness of a loan with no service requirement, and a second arrangement that includes a service requirement, consideration should be given as to whether the service requirement included in the second arrangement should impact the determination of whether the first arrangement is part of the exchange for the acquiree or is a transaction separate from the business combination.

ACQUIRER SHARE-BASED PAYMENT AWARDS EXCHANGED FOR AWARDS HELD BY THE GRANTEES OF THE ACQUIREE

ASC Paragraph 805-30-30-9

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. [ASC] Topic [805] refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with [ASC] Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree's awards if replacement is required by any of the following:

a. The terms of the acquisition agreement

b. The terms of the acquiree's awards

c. Applicable laws or regulations.

ASC Paragraph 805-30-30-10

In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not

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obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the post-combination financial statements. That is, none of the fair value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

ASC Paragraph 805-30-30-11

To determine the portion of a replacement award that is part of the consideration transferred for the acquiree, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with [ASC] Topic 718. The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting.

ASC Paragraph 805-30-30-12

The acquirer shall attribute a portion of a replacement award to postcombination vesting if it requires postcombination vesting, regardless of whether grantees had rendered all of the service or delivered all of the goods required in exchange for their acquiree awards before the acquisition date. The portion of a nonvested replacement award attributable to post-combination vesting equals the total fair-value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting.

ASC Paragraph 805-30-30-13

[ASC] paragraphs 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see [ASC] paragraph 805-30-55-17) provide additional guidance and illustrations on distinguishing between the portion of a replacement award that is attributable to precombination vesting, which the acquirer includes in the consideration transferred in the business combination, and the portion that is attributed to postcombination vesting, which the acquirer recognizes as compensation cost in its postcombination financial statements.

11.024 An acquirer may issue share-based payment awards (replacement awards) to employees or nonemployees of an acquiree in exchange for share options or other share-based payment awards previously issued by the acquiree. Such exchanges are modifications of share-based payment awards under ASC Topic 718, *Compensation-Stock Compensation.*

ATTRIBUTION OF REPLACEMENT AWARDS TO CONSIDERATION TRANSFERRED AND POST-COMBINATION VESTING

11.025 If the acquirer is obligated to replace the acquiree awards, all or a portion of the fair-value-based measure of the acquirer's replacement awards is included in measuring

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the consideration transferred in the business combination. If the acquirer is not obligated to replace the acquiree awards, but chooses to do so voluntarily, all of the fair-value-based measure of the replacement awards is recognized as compensation cost in the acquirer's post-combination financial statements (and thus none of the fair-value-based measure of the replacement awards is included in measuring the consideration transferred in the business combination). Therefore, an acquirer would make a determination as to whether it is obligated to replace the acquiree awards. This determination is based on whether the acquiree or its grantees have the ability to enforce replacement. ASC paragraph 805-30-30-9 indicates, for example, that the acquirer would be obligated to issue replacement awards if replacement is required by:

a. The terms of the acquisition agreement

b. The terms of the acquiree's awards

c. Applicable laws or regulations.

MEASUREMENT

ASC Paragraph 805-20-30-21

The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with the method in [ASC] Topic 718. [ASC] Topic [805] refers to the result of that method as the *fair-value-based measure* of the award. Paragraphs 805-30-30-9 through 30-13 and 805-30-55-6 through 55-13 provide additional guidance.

11.026 Share-based payment awards are an exception to the fair value measurement principle of ASC Topic 805. This exception requires that replacement awards be measured at the acquisition date in accordance with ASC Topic 718, and refers to the amounts so determined as the *fair-value-based measure* of the award. This applies regardless of whether the fair-value-based measurement of a replacement award is included in measuring the consideration transferred in a business combination, or is recognized as compensation cost in the post-combination financial statements.

11.027 Generally, share-based payments are measured using the fair-value-based measurement method, and the discussion and examples in this Section focus on that method. However, ASC Topic 718 permits nonpublic companies, as a policy election, to use *intrinsic value* for liability-classified awards. Paragraph 718-30-30-2A allows a nonpublic company that elected the fair-value-based measurement method to subsequently change its accounting policy for measuring liability-classified awards to the intrinsic value method without needing to evaluate whether the change in accounting policy is preferable.

11.027a For additional discussion on the use of intrinsic value by nonpublic companies for liability-classified awards, see KPMG Handbook, Share-Based Payment. For example, an acquirer that is a nonpublic entity under ASC Topic 718 should measure replacement awards using intrinsic value if the awards are liability-classified replacement

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awards and that is the acquirer's ASC Topic 718 policy. Although this discussion focuses on the fair-value-based method, the guidance in ASC Topic 805 and in this discussion applies in situations where ASC Topic 718 permits the use of intrinsic value for the replacement awards.

11.028 ASC Topic 805 sets two limits on the amount of the replacement awards' value that can be included in the consideration transferred. The amount included in the consideration transferred cannot exceed the fair-value-based measure of the *replaced* awards. Any excess fair value is charged to post-combination expense (even if fully vested at the acquisition date). In addition, the amount included in the consideration transferred can only include the value attributable to *pre-combination vesting.*

ATTRIBUTION - EMPLOYEE AWARDS

11.029 If the acquiree's employees must render post-combination service under the acquirer's replacement awards, the acquirer determines the portion of the award attributable to pre-combination vesting (and therefore include in the measurement of the consideration transferred in the business combination), and the portion of the award attributable to post-combination vesting (and therefore recognized as compensation cost in the post-combination financial statements). Entities should do so following the framework described below, rather than assuming that vested awards are part of the consideration transferred and unvested awards are allocated between pre-combination vesting and post-combination vesting. The approach is the same, regardless of whether the replacement award is classified as a liability or equity.

11.030 The attribution of a replacement award (between pre-combination and post-combination vesting) is a multi-step process:

(1) The first step requires the measurement at the acquisition date, in accordance with the fair-value-based measurement method (unless the calculated value method or intrinsic value method is appropriate in accordance with ASC Topic 718), of:

  (a) The acquiree award, and

  (b) The replacement award.

(2) The next step requires the determination of the following:

  (a) The requisite service period for the acquiree award (the original service period)*

  (b) The portion of the requisite service period that was completed prior to the acquisition date*

  (c) The post-combination requisite service period, if any, for the replacement award*

  (d) The total service period (i.e., the sum of 2(b) and 2(c)).

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* As specified in ASC Topic 718, the requisite service period includes explicit, implicit, or derived service periods during which employees are required to provide service in exchange for the award.

(3) The portion of the replacement award attributable to pre-combination vesting is then calculated by multiplying the fair-value-based measure of the acquiree award (determined in 1(a)) by the ratio of the pre-combination vesting period (determined in 2(b)) to the greater of the total service period (determined in 2(d)) or the original service period (determined in 2(a)).

(4) The portion of the replacement award attributable to post-combination vesting is then calculated as the difference between the fair-value-based measure of the replacement award (determined in 1(b)) and the amount attributed to pre-combination vesting (determined in 3).

11.031 This process is illustrated in Examples throughout this Section.

11.032 The above process results in the following:

- Even if an acquiree award is fully vested at the time of a business combination, a portion of the replacement award is allocated to post-combination vesting if the acquiree's employee is required to render service in the post-combination period.
- The acquirer measures both the replacement award given to employees by the acquirer as well as the original acquiree award as of the acquisition date. The excess value of the replacement award over the measure of the acquiree award is attributed to post-combination vesting and is not part of the consideration transferred for the acquiree, even if all services have been rendered as of the acquisition date. If the acquirer does not require the acquiree's employees to perform additional services after the acquisition date, the excess value is recognized immediately as compensation cost in the post-combination financial statements of the combined entity. If additional services are required, then the compensation cost is recognized in the post-combination financial statements under ASC Topic 718.

11.033 The following examples, which are based on the examples in ASC paragraphs 805-30-55-17 through 55-24, illustrate the concepts discussed above. Example 11.17c illustrates the difference in accounting for a replacement award if the acquirer elects to estimate forfeitures rather than accounting for forfeitures as they occur under the policy election in ASC paragraph 718-10-35-3.

Example 11.13: Acquirer Replacement Awards That Require No Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Required Services as of the Acquisition Date

AC issues replacement awards of $110 (fair-value-based measure) at the acquisition date for TC awards of $100 (fair-value-based measure) at the acquisition date. No post-

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combination vesting is required for the replacement awards, and TC's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to pre-combination vesting is the fair-value-based measure of TC's awards ($100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to post-combination vesting is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to pre-combination vesting ($100). Because no post-combination vesting is required for the replacement awards, AC immediately recognizes $10 as compensation cost in its post-combination financial statements. ASC paragraphs 805-30-55-18 and 55-19

Example 11.14: Recording Replacement Awards that Provide Additional Fair Value if Post-combination Vesting Is Rendered

ABC Corp. acquires DEF Corp. At the acquisition date, the share based awards held by DEF Corp. employees were fully vested and therefore no additional service is required of the employees. The terms of the business combination require ABC to provide replacement awards for the DEF awards. The replacement awards are fully vested but subject to a 7-year transferability restriction. Earlier transfer is permitted if the employee remains continuously employed for two years during the post-combination period.

The fair value of the DEF awards is $50,000 at the acquisition date. The replacement awards subject to the 7-year transferability restriction have a fair value of $150,000 at the acquisition date. If the post-combination vesting requirement of 2 years is completed, the replacement awards have a fair value of $166,000 at acquisition. ABC Management expects that all of the employees will complete the 2-year post-combination vesting.

It is appropriate to analogize to the guidance on a tandem award as discussed in ASC paragraph 718-10-55-116. A tandem award is an award with 2 or more components in which the exercise of one award cancels out the other.

Under ASC Section 805-30-55, ABC includes $50,000 (the fair value-based measure of the acquiree awards) in consideration transferred in the acquisition of DEF. The remaining fair value-based measure of the replacement awards ($150,000 - $50,000) is recognized as compensation cost by ABC immediately following the consummation of the business combination because the employees are not required to perform additional service. The incremental fair value of $16,000 ($166,000 - $150,000) associated with the 2-year post-combination service period that would eliminate the 7-year transferability restriction is recorded as compensation cost over the 2-year service period.

If ABC determines that employees are not expected to complete the 2-year service period, ABC would cease recognizing the compensation cost for the incremental fair

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value of the award and reverse any portion of compensation cost already recorded, similar to a forfeiture.

Example 11.15: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Rendered the Requisite Service as of the Acquisition Date

AC exchanges replacement awards that require one year of post-combination vesting for share-based payment awards of TC for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, TC's awards had a requisite service period of 4 years. As of the acquisition date, the TC employees holding unexercised awards had rendered a total of 7 years of service since the grant date. Even though TC employees had already rendered all of the requisite service, AC attributes a portion of the replacement award to post-combination vesting in accordance with ASC paragraphs 805-30-30-12 and 30-13 because the replacement awards require one year of post-combination vesting. The total service period is 5 years--the requisite service period for the original acquiree award completed before the acquisition date (4 years) plus the requisite service period for the replacement award (one year). Note that the total service provided prior to the acquisition (7 years) is not relevant to this computation. The portion attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (4 years) to the total service period (5 years). Thus, $80 ($100 × 4 ÷ 5 years) is attributed to pre-combination vesting and therefore included in the consideration transferred in the business combination. The remaining $20 is attributed to post-combination vesting and therefore is recognized as compensation cost in AC's post-combination financial statements in accordance with ASC Topic 718. ASC paragraph 805-30-55-20

Example 11.16: Acquirer Replacement Awards That Require Post-combination Vesting Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

AC exchanges replacement awards that require one year of post-combination vesting for share-based payment awards of TC for which employees had not yet rendered all of the required services as of the acquisition date. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, the awards of TC had a requisite service period of 4 years. As of the acquisition date, the TC employees had rendered 2 years' service, and they would have been required to render 2 additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of the TC awards is attributable to pre-combination vesting.

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The replacement awards require only one year of post-combination vesting. Because employees have already rendered 2 years of service, the total requisite service period is 3 years. The portion attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (2 years) to the **greater of** the total service period (3 years) or the original service period of TC's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to pre-combination vesting and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to post-combination vesting and is therefore recognized as compensation cost over the remaining one year vesting period in AC's post-combination financial statements. ASC paragraphs 805-30-55-21 and 55-22

Example 11.17: Acquirer Replacement Awards for Which No Post-combination Vesting Is Required Exchanged for Acquiree Awards for Which Employees Have Not Rendered All of the Requisite Service as of the Acquisition Date

Assume the same facts as in Example 11.16, except that AC exchanges replacement awards that require no post-combination vesting for share-based payment awards of TC for which employees had not yet rendered all of the requisite service as of the acquisition date. The terms of the replaced TC awards did not eliminate any remaining requisite service period upon a change in control. (If the TC awards had included a provision that eliminated any remaining requisite service period upon a change in control, the guidance in Example 11.13 would apply.) The fair-value-based measure of both awards is $100. Because employees have already rendered 2 years of service and the replacement awards do not require any post-combination vesting, the total service period is 2 years. The portion of the fair-value-based measure of the replacement awards attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the pre-combination vesting period (2 years) to the **greater of** the total service period (2 years) or the original service period of TC's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to pre-combination vesting and therefore included in the consideration transferred in the business combination, and the excess of the fair value-based measure of the replacement award ($100) over the $50 attributed to the consideration transferred, or $50, is attributed to post-combination vesting. Because no post-combination vesting is required following the acquisition, the $50 attributed to post-combination vesting is recognized immediately as compensation cost in the post-combination financial statements. ASC paragraphs 805-30-55-23 and 55-24

11.033a Paragraph not used.

Example 11.17a Example not used.

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ATTRIBUTION - NONEMPLOYEES

ASC Paragraph 805-30-55-9A

The portion of a nonemployee replacement award attributable to precombination vesting is based on the fair-value based measure of the acquiree award multiplied by the percentage that would have been recognized had the grantor paid cash for the goods or services instead of paying with a nonemployee award. For this calculation, the percentage that would have been recognized is the lower of:

a. The percentage that would have been recognized calculated on the basis of the original vesting requirements of the nonemployee award

b. The percentage that would have been recognized calculated on the basis of the effective vesting requirements. Effective vesting requirements are equal to the services or goods provided before the acquisition date plus any additional postcombination services or goods required by the replacement award.

11.033b When determining the amount of nonemployee awards attributable to pre-combination vesting, the acquirer considers the effective vesting requirements, which are the goods or services provided before the acquisition date plus the additional goods or services required by the replacement award. The portion of the compensation expense attributed to post-combination vesting should be recognized in the same manner as if the grantor had paid cash for the goods or services, consistent with the attribution of other nonemployee share-based payment awards.

Example 11.17b: Acquirer Replacement Awards That Require Post-Combination Vesting Exchanged for Acquiree Awards for Which Nonemployees Have Not Delivered all of the Goods or Services as of the Acquisition Date

In a business combination, AC (the acquirer) exchanges replacement awards that require the delivery of 10 widgets post-combination for share-based payment awards of TC (the acquiree) for which the grantee had not met the necessary vesting condition to deliver 40 widgets before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. As of the acquisition date, TC grantee has delivered 20 widgets, and would have been required to deliver an additional 20 widgets after the acquisition date for its awards to vest. However, AC concluded that it needed only 10 additional widgets after the acquisition date, rather than the 20 remaining under the original contract. Only a portion of TC's awards is attributable to pre-combination vesting.

The portion attributable to pre-combination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the percentage that would have been recognized on the award. The percentage that would have been recognized is the lower of the percentage that would have been recognized on the basis of the original vesting requirements and the percentage that would have been recognized on the basis of the effective vesting requirements. The percentage that would have been recognized

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on the basis of the original vesting requirements equals 50%, which is calculated as 20 widgets delivered divided by 40 widgets required to be delivered. The percentage that would have been recognized on the basis of the effective vesting requirements equals 66.67%, which is calculated as 20 widgets delivered divided by 30 widgets (the sum of 20 widgets delivered plus 10 widgets required post-combination). Thus, $50 ($100 × 50%) is attributed to vesting and is included in the consideration transferred in the business combination. The remaining $50 is attributed to the post-combination vesting and is recognized as compensation cost in AC's post-combination financial statements. ASC paragraphs 805-30-55-32 and 55-33

ACCOUNTING FOR FORFEITURES OF REPLACEMENT AWARDS IN A BUSINESS COMBINATION

11.033c Regardless of its accounting policy election for forfeitures in its ongoing accounting for employee or nonemployee share-based payment awards under ASC paragraphs 718-10-35-3 and 718-10-35-1D, respectively, the acquirer will reduce the value of the nonvested replacement awards to reflect the estimate of the awards expected to vest. As a result, the value of the nonvested replacement awards attributable to pre-combination vesting and included in consideration transferred reflects the acquirer's estimate at the acquisition date of the number of replacement awards not expected to vest. That is, the portion of a nonvested replacement award included in consideration transferred reflects the acquirer's estimate of the number of replacement awards for which the service is expected to be rendered (or goods are expected to be delivered).

11.033d However, the acquirer's accounting policy election for forfeitures will affect the accounting for post-combination compensation cost as follows:

- An acquirer that has a policy to estimate forfeitures of awards also will reduce the number of replacement awards attributable to post-combination vesting for its estimate at the acquisition date of the number of replacement awards not expected to vest. Changes in the acquirer's forfeiture estimate for replacement awards attributable to both the pre- and post-combination vesting periods are reflected in compensation cost for the periods in which the changes in estimates occur rather than as adjustments to the consideration transferred.
- An acquirer that has a policy to recognize forfeitures of awards as they occur will attribute the amount to consideration transferred in the same way (i.e., using an estimate of forfeitures). It will then *gross up* the portion allocated to post-combination vesting assuming that no forfeitures will occur and recognize this amount as compensation cost over the post-combination vesting period. Any forfeitures of replacement awards are reflected as a reduction in compensation cost in the periods in which the forfeitures occur. As is the case when forfeitures are estimated, the effect of actual forfeitures does not change the value of the replacement awards included in the consideration transferred.

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Example 11.17c: Effect of Acquirer's Forfeiture Accounting Policy on Post-Acquisition Accounting for Replacement Share-Based Payment Awards

AC acquires TC. AC is obligated to replace share-based payment awards of TC. The replacement awards require one year of post-combination vesting by TC employees for the awards to vest. TC employees completed 4 of the 5 years of the requisite service period before the date of the business combination. The fair value of TC's awards and the replacement awards is $100 on the acquisition date. At the acquisition date, AC estimates that the requisite service period will be rendered for 90% of the awards, and 10% of the awards will be forfeited before the end of the requisite service period.

If AC elects to estimate forfeitures

The amount attributable to pre-combination vesting and included in consideration transferred is $72 [$100 acquisition date fair value of TC's replaced award × (1 - 10% forfeiture rate) × (4 years' pre-combination vesting ÷ 5-year service period)].

The amount attributable to post-combination vesting and recorded as post-combination compensation cost is $18 [$100 acquisition date fair value of AC's replacement award × (1 - 10% forfeiture rate) - $72 included in consideration transferred]. The post-combination compensation cost is recognized over the remaining one-year service period. Any changes in the 10% forfeiture estimate are reflected as an adjustment to compensation cost as those changes in estimate occur and ultimately trued-up to the actual number of awards that vest. If, for example, the actual forfeiture rate is 5%, AC will recognize compensation cost of $23 ($100 acquisition date fair value of AC's replacement award × (1 - 5% actual forfeiture rate) - $72 (allocated to consideration transferred).

If AC elects to recognize forfeitures as they occur

The amount attributable to pre-combination vesting and included in consideration transferred is $72 (same as if AC's accounting policy is to estimate forfeitures).

The initial amount attributable to post-combination vesting and recorded as post-combination compensation cost is $28 ($100 acquisition date fair value of its replacement award - $72 included in consideration transferred). The post-combination compensation cost is recognized over the remaining one-year requisite service period. The effects of any forfeitures are reflected as a reduction to compensation cost as they occur. If the 10% forfeiture estimate ultimately is accurate and all the forfeitures occur in the last quarter before vesting, the compensation cost recognized each quarter after the business combination will be: 1st Q: $7, 2nd Q: $7, 3rd Q: $7 (in each case the amount recognized as compensation cost is $28 ÷ 4 quarters), 4th Q: -$3 (actual value vested of $90 - consideration transferred of $72 - compensation cost previously recognized of $21).

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AWARDS WITH GRADED VESTING - EMPLOYEE AWARDS

11.034 If the acquirer issues a replacement award that has a graded vesting schedule, we believe that ASC paragraphs 805-30-55-11 and 55-12 require the acquirer to follow its own policy with respect to straight-line or accelerated attribution for awards with graded vesting features, regardless of the policies of the target entity. The acquirer does not carry over the acquiree's attribution election for these types of awards. The result may be that some compensation cost is never recognized by either party or that some compensation cost is recognized by both parties.

11.034a In some cases, a portion of awards with graded vesting may have vested and been exercised as of the acquisition date. In that case, the amount of the replacement awards attributed between pre-combination and post-combination periods should only relate to awards that were outstanding at the acquisition date. For example, if the acquiree had issued 100 share options and 25 of those options were vested and exercised before the acquisition, the acquirer should only attribute amounts related to the 75 share options that were replaced. This is because the amount of consideration transferred to acquire the 25 outstanding shares (i.e., exercised options) would already be included in the purchase price.

Example 11.18: Graded Vesting Replacement Awards

ABC Corp. acquires DEF Corp. on January 1, 20X9. ABC issues a replacement award of 100 share options with a fair value of $1,000 to replace share options with a fair value on the acquisition date of $1,000 held by DEF employees.

The vesting for the original DEF awards is graded, with 25% vesting each year over 4 years. At the acquisition date, DEF's employees have provided two years of service. DEF's share option plan does not contain a change of control provision. However, the terms of the business combination require ABC to issue to DEF employees a replacement award with identical vesting provisions. Both ABC and DEF's attribution policy is to recognize compensation cost on a graded vesting schedule. DEF's accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero. The amount of the award attributed to pre-combination and post-combination vesting is determined as follows:

The total service period is determined on a tranche-by-tranche basis based on ABC's policy of using accelerated attribution.

	ABC's Awards Vesting Schedule			
	20X7	**20X8**	**20X9**	**20X0**
Tranche 1	25.00%			
Tranche 2	12.50%	12.50%		
Tranche 3	8.33%	8.34%	8.33%	
Tranche 4	6.25%	6.25%	6.25%	6.25%
	52.08%	27.09%	14.58%	6.25%

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Scenario 1 - None of the original awards were exercised

Amount attributed to pre-combination vesting

$1,000[1] × 79.17%[2] (52.08% + 27.09%) = $792

[1] Fair-value-based measure of DEF's award immediately before the acquisition.
[2] Service rendered as of 1/1/20X9 based on ABC's attribution election.

Amount attributed to post-combination vesting

$1,000[3] - $792[4] = $208

[3] Fair-value-based measure of ABC's award immediately before the acquisition.
[4] Amount attributable to pre-combination vesting

Amount of compensation expense recognized in the post-combination period

First post-combination year: $1,000 × 14.58% = $146

Second post-combination year: $1,000 × 6.25% = $62

The measurement of pre-combination vesting is based on ABC's policy of using the accelerated attribution methodology. In this case, both parties used that method. However, the answer would be the same even if DEF had elected to use the straight-line methodology (i.e., as discussed above, we believe ASC paragraphs 805-30-55-11 and 55-12 require the acquirer to follow its own policy with respect to attribution of awards with graded vesting features). Additionally, the calculation uses the entire award as the unit of measure. As a result, the attribution of the $208 allocated to the remaining tranches is based on the total service period associated with those tranches and is allocated and measured as if the acquirer had been accounting for them from inception. In many cases (and in this example), entities would get the same answer regardless of whether the unit of account is the entire award or each tranche, because the fair value and the requisite service period are the same before and after the transaction. However, differences would arise if one or both of them were different.

Scenario 2 - Portion of the original awards were exercised

If Tranche 1 had been exercised at the acquisition date, the amount attributed to pre-combination and post-combination vesting would decrease by $250. This could be calculated by excluding the fair value of Tranche 1 from the amount attributed to pre-combination vesting using the calculation above (Option A) or performing the above calculation excluding the fair value of Tranche 1 (Option B).

Option A – Exclude from amount attributed to the pre-combination vesting

$792[1] - $250[2] = $542

[1] Fair-value-based measure of DEF's award immediately before the acquisition prior to factoring exercised options (see above).
[2] Fair value of exercised 25 options from Tranche 1 at $10 fair value per option.

The amount attributed to post-combination vesting would not change (i.e., $1,000 - 792 = $208).

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Option B – Perform calculation excluding vested tranche

	ABC's 75 Remaining Awards Vesting Schedule			
	20X7	**20X8**	**20X9**	**20X0**
Tranche 1	Exercised			
Tranche 2	16.67%	16.67%		
Tranche 3	11.11%	11.11%	11.11%	
Tranche 4	8.33%	8.33%	8.33%	8.33%
	36.11%	36.11%	19.44%	8.33%

Amount attributed to pre-combination vesting

$750[1] × 72.22%[2] (36.11% + 36.11%) = $542

[1] Fair-value-based measure of DEF's award immediately before the acquisition excluding Tranche 1.
[2] Service rendered as of 1/1/20X9 based on ABC's attribution election.

Amount attributed to post-combination vesting

$750[3] - $542[4] = 208

[3] Fair-value-based measure of ABC's award immediately before the acquisition.
[4] Amount attributable to pre-combination vesting.

Example 11.18a: Graded Vesting Replacement Awards – Part II

ABC Corp. acquires DEF Corp. on January 1, 20X8. ABC issues a replacement award of 100 share options with a fair value of $1,000 to replace share options with a fair value on the acquisition date of $1,000 held by DEF employees.

The vesting for the original DEF awards is graded, with 33.3% vesting each year over three years. At the acquisition date, DEF's employees have provided two years of service. DEF's share option plan does not contain a change of control provision. However, the terms of the business combination require ABC to issue to DEF employees a replacement award with a four-year graded vesting schedule. ABC's attribution policy is to recognize compensation cost on a straight-line basis, subject to a floor. DEF's accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero.

ABC's legal counsel has interpreted the contract terms to mean that any previously vested tranches (67 shares or 66.7%) remain vested, the 20X8 tranche will vest at its *full* 25% amount (i.e., 25 share options for a cumulative amount vested of 91.7%) and then the 20X9 tranche will be the remaining 8 share options (i.e., 8.3%). The graded vesting schedule for the ABC replacement awards and the DEF original awards is:

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	ABC's Replacement Awards Graded Vesting Schedule			
	20X6	**20X7**	**20X8**	**20X9**
Straight-line without floor	25%	25%	25%	25%
Straight-line with floor	33.3%	33.3%	25%	8.3%

	DEF's Original Awards Graded Vesting Schedule		
	20X6	**20X7**	**20X8**
	33.3%	33.3%	33.3%

Although ABC's policy is to recognize compensation cost on a straight-line basis for the entire award, the replacement award has a front-loaded vesting schedule that is subject to the floor. ASC paragraph 718-10-35-8 states that the amount of compensation cost recognized at any date must at least equal the portion of the grant-date fair value of the award that has vested at that date.

Amount attributed to pre-combination vesting

$1,000[1] × 66.7%[2] = $667

[1] Fair-value-based measure of DEF's award immediately before the acquisition.
[2] Amount attributed to pre-combination vesting in accordance with acquirer's policy for the greater of straight-line attribution (2 of 4 years' service provided) or the floor (66.7% vested).

Amount attributed to post-combination vesting

$1,000[3] - $667[4] = $333

[3] Fair-value-based measure of ABC's award immediately before the acquisition.
[4] Amount attributable to pre-combination service.

Amount of compensation cost recognized in the post-combination period

Post-combination compensation cost year 20X8 (based on the floor): $1,000 × 25.00% = $250

Post-combination compensation cost year 20X9: $1,000 × 8.3% = $83

The compensation cost to be recognized in the post-combination period will be recognized on a straight-line basis but subject to the floor. Given the front-loaded vesting schedule of the replacement awards, this will result in 25% in 20X8 and 8.3% in 20X9.

SETTLEMENT OF SHARE-BASED AWARDS

11.034b In some transactions, share-based payment awards of the acquired entity are settled as part of the business combination. In the acquirer's financial statements, the accounting for the settlement of awards in the business combination will be the same whether the acquirer settles the awards as part of the business combination or the

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acquired entity settles the awards on the instructions of the acquiring entity and the acquiring entity reimburses the acquired entity for the cost of the settlement. An acquiring entity reimbursement sometimes is a direct addition to the consideration transferred and sometimes is indirect – such as through the mechanics of a working capital calculation specified in the acquisition agreement. In any of these instances, the acquiring entity should follow the accounting guidance in Paragraphs 11.025 and 11.030 to determine the portion of the amount paid that will be accounted for as additional consideration and the portion of the amount paid that will be accounted for as post-combination compensation cost.

11.035 If an acquirer is permitted to settle acquiree awards that are not fully vested by either issuing a replacement award with identical vesting provisions or by settling the awards in cash, and the acquirer elects to settle the awards in cash, any compensation cost attributed to post-combination vesting would be immediately recognized by the acquirer in its post-combination financial statements. In this scenario, the acquirer has effectively released the award holders from their post-combination vesting requirements. Alternatively, the acquirer may replace the share-based payment awards with a cash settlement that is paid only on the completion of future service. The portion of the payment attributable to future services as determined using the guidance in Paragraphs 11.025 and 11.030 would be recognized as future services are performed under ASC Topic 710, *Compensation-General*.

Example 11.19: Acquirer Cash Settles an Acquiree's Award

ABC Corp. acquires DEF Corp. on January 1, 20X9. ABC pays DEF's employees $1,100 in cash to replace share options held by DEF employees with a fair value on the acquisition date of $1,000.

The original service period for DEF awards is 4 years, of which 2 years have been completed at the acquisition date. The original vesting for DEF's awards is graded with 25% vesting each year. DEF's share option plan does not contain any change-of-control provisions. However, the terms of the business combination require ABC to either issue to DEF employees replacement awards with identical vesting provisions or, at ABC's election, a cash payment equal to 110% of the fair value of the award ($1,000 × 110%, or $1,100) at the acquisition date. ABC elected to settle the awards in cash.

ABC's attribution policy based on ASC Topic 718 is to recognize the compensation cost ratably (straight-line method) over the service period of the longest vesting tranche. DEF's attribution policy is to recognize compensation cost on a graded vesting schedule and, therefore, as of the acquisition date DEF has attributed 79.17% (Example 11.18 illustrates the calculation of this percentage) of the compensation cost associated with the DEF awards to pre-combination vesting. DEF’s accounting policy is to estimate forfeitures expected to occur. Assume estimated forfeitures are zero. The amount of the award attributed to pre-combination and post-combination vesting is determined as follows:

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Amount attributed to pre-combination vesting

$1,000[1] × 50% (2 years / 4 years)[2] = $500

[1] Fair-value-based measure of DEF's award immediately before the acquisition.
[2] Service rendered as of 1/1/20X9 based on ABC's attribution election.

Amount attributed to post-combination vesting

$1,100[3] - $500[4] = $600

[3] Entity ABC's cash settlement
[4] Amount attributable to pre-combination vesting

The cash settlement of an award that is not vested at the acquisition date is similar to the acquirer cash settling the acquiree's employee share options, because the settlement eliminates any remaining requisite service periods. Because there is no post-combination vesting required, ABC recognizes $600 of compensation cost immediately in its post-combination financial statements. The measurement of pre-combination vesting is based on ABC's policy of recognizing compensation cost ratably, rather than DEF's accelerated attribution methodology (which is discussed in ASC paragraphs 718-20-55-29 and 55-30) and illustrated in Example 11.18).

CHANGE-IN-CONTROL PROVISIONS

11.036 Share option or other share-based compensation award plans often include a provision that accelerates the award's vesting in the event of a change in control of the issuer (a *change-in-control provision).* Consistent with the guidance in ASC paragraphs 805-20-55-50 and 55-51, entities should not anticipate the consummation of a business combination.

11.037 In other instances, existing awards are sometimes modified to add a change-in-control provision in contemplation of a change in control of an acquiree. The accounting for the change-in-control provision by the acquirer (i.e., whether the cost is part of the business combination or post-combination expense) depends on how the change-in-control provision arose and the nature of the provisions (i.e., single trigger versus double trigger).

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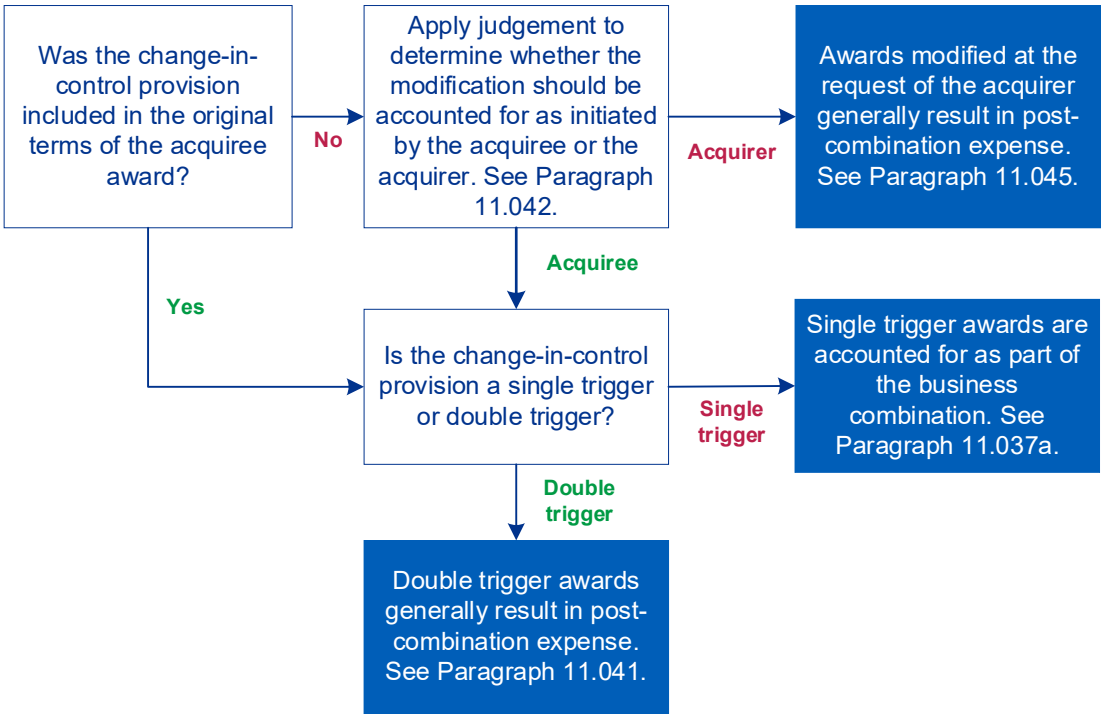

11.037a If the acquirer issues cash, other assets or equity instruments to settle a pre-existing change-in-control provision, the acquirer evaluates whether to recognize amounts as consideration transferred or as a liability assumed. Payments made by the acquirer to settle the acquiree's awards that were equity-classified in the acquiree's pre-combination financial statements are accounted for as consideration transferred because the acquiree's employee is considered an owner of the acquiree due to the equity-classified award. However, if the acquiree's awards were liability-classified in the acquiree's pre-combination financial statements, the acquirer would need to consider whether the awards are a liability assumed.

Recognition by an Acquiree of the Effect of Acceleration of Vesting of Awards When a Change-in-Control Provision Is Triggered (Single Trigger)

11.038 If a change-in-control provision was included in the original terms of an acquiree award and that provision requires unvested awards to immediately vest at the acquisition date, the shortened vesting period resulting from the triggering of the change-in-control provision would be used for purposes of attributing the replacement award to pre-combination and post-combination vesting. No post-combination vesting is required and, if the fair value of both awards is the same, the total fair value-based measure of the replacement award would be attributed to the consideration transferred in the business combination, and no amount would be attributed to post-combination compensation cost. This is illustrated in Example 11.19a.

11.039 If separate financial statements of an acquiree are issued when push-down accounting is not being elected, the remaining unrecognized compensation cost measured from the acquiree's perspective (i.e., based on grant-date fair value when the award is equity-classified) will be recognized in the acquiree's financial statements in the period

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that includes the date that the acceleration of vesting is triggered (i.e., the acquisition date).

11.040 If an acquiree issues separate financial statements and elects push-down accounting, the acquiree recognizes the remaining unrecognized compensation cost in either the predecessor period or *on-the-line*. See discussion in Paragraph 27.032.

Acceleration of Awards With a Change in Control and a Secondary Event (Double Trigger)

11.041 In some situations the acceleration of vesting is contingent on an event in addition to the change in control event (commonly referred to as a double trigger). In these situations, if the additional triggering event is substantive and within the control of, or for the benefit of, the acquirer or the combined entity, any expense related to the acceleration of vesting would be recognized by the acquirer as post-combination compensation cost.

11.041a These types of triggers that are at the discretion of the acquirer could be in the form of either taking an action or an inaction. For example, if the acquiree award contains a double trigger such that the acceleration is triggered by both the change in control and severance of an individual by the combined company (similar to Example 11.12 related to double trigger cash severance payments), any expense related to the acceleration of vesting would be recognized by the acquirer as post-combination expense. Another example would be if the acceleration is contingent on approval by the acquirer. There also may be instances when an acquiree award contains a change-in-control provision that vesting accelerates if the acquirer does not issue new and/or replacement awards. Such inaction by the acquirer that triggers the accelerated vesting would also be within the control of the acquirer, and therefore, the compensation expense related to the accelerated vesting would be recognized in the post-combination period.

Modification of Acquiree Share-Based Compensation Awards Initiated by the Acquiree in Contemplation of a Change in Control

11.042 If the original provisions of an acquiree's awards do not require accelerated vesting on a change of control and the acquiree modifies the terms of the awards to provide for acceleration of vesting in the event of a change in control, the accounting will depend on the facts and circumstances. Judgment should be used to determine whether the modification was initiated by the acquiree in contemplation of the business combination or initiated by the acquirer. Factors to consider include whether the entity is actively pursuing potential targets and suitors, actively exploring strategic alternatives, or is in the initial process of strategic planning that may evolve into more specific strategic initiatives.

11.042a If the acquiree effects the modification at its own initiative in contemplation of a possible change in control but prior to specific discussions with the acquirer, that may indicate that the modified terms will be incorporated into the acquirer's accounting for the business combination. In those circumstances, the total vesting period and the original vesting period would be the same for purposes of attributing the award to pre-combination and post-combination vesting because of the modification of the award. Accordingly, no post-combination vesting is required and if the fair value of both awards

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is the same, the total fair-value-based measure of the replacement awards would be attributed to the consideration transferred in the business combination and no amount would be attributed to post-combination compensation cost. However, there may be accounting required in the acquired entity's financial statements. This is illustrated in Example 11.20a Scenario 1.

11.043 From the perspective of the acquiree, the modification of the award to include the change-in-control provision may be a *Type III* modification (i.e., an *improbable-to-probable* modification) and, as such, the acquiree would recognize cumulative compensation cost associated with the modification in accordance with ASC paragraphs 718-20-55-109A, 55-109B, 55-116, 55-117, and 55-121, as applicable depending on whether the award is to employees or nonemployees. However, if the modification was determined to be a *Type I* modification (i.e., a *probable-to-probable* modification), the acquiree would recognize cumulative compensation cost in accordance with ASC paragraphs 718-20-55-110 through 55-112.

11.044 In contrast, if the acquiree initiates the modification once discussions with the acquirer have moved beyond a preliminary stage, that action may indicate that the modified terms should not be incorporated into the acquirer's accounting for the business combination. In those circumstances, the accounting would be the same as when the acquirer requests a modification of the terms of share-based payment awards as discussed below and illustrated in Example 11.20a Scenario 2.

Modifications of Acquiree Share-Based Compensation Awards at the Request of the Acquirer in Contemplation of a Change in Control

11.045 If, at the request of the acquirer, an acquiree's share-based payment award is modified to accelerate vesting on a change of control, the accounting would be the same as if the acquirer issued a fully vested replacement award in exchange for the original unvested award. See discussion in this Section of Other Payments to an Acquiree (or Its Former Owners) That Are not Part of the Consideration Transferred. For example, an acquirer may request an acquiree to offer an acceleration of an existing award to a member of the acquiree's senior management in exchange for termination of an employment contract because the acquirer intends to integrate the roles and responsibilities of the senior management member into those of the acquirer's existing senior management group. This is illustrated in Example 11.20a Scenario 2.

11.046 Paragraph not used.

Example 11.19a: Accelerated Vesting of Awards When a Change-in-Control Provision Is Triggered as Part of the Award's Original Terms

On July 1, 20X7, XYZ Corp pays cash to acquire all of the outstanding equity securities of ABC Corp., including outstanding equity-classified share options. The share option awards contain a single trigger change-in-control provision that was included in the original award terms such that they immediately vest on a change in control of ABC.

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The grant-date fair value of the share options was $8 million. The fair value of the share options on July 1, 20X7 is $12 million. All share awards vested at the date of the business combination and the cash paid to redeem the share options was $12 million. ABC had previously recognized $2 million of compensation cost related to the share options.

Acquirer's Accounting

From XYZ's perspective, it paid $12 million to settle fully vested awards. Accordingly, the entire $12 million is included in the consideration paid by XYZ because there is no future service required for either the original awards (which vested on change of control included in the original terms) or the replacement award (cash settlement) and XYZ paid an amount equal to the acquisition-date fair value of the awards.

Acquiree's Accounting

Scenario 1. ABC elects not to apply pushdown accounting in its stand-alone financial statements. In which period and how should ABC record the compensation costs?

Consistent with the guidance in ASC paragraphs 805-20-55-50 and 55-51, the remaining compensation cost (based on the grant-date fair value) is recognized in the period that includes July 1, 20X7.

Financial statements for the period ended June 30, 20X7 will disclose the cost to be recognized in the subsequent period. On July 1, 20X7, ABC will record the settlement of the share options as follows:

	Debit	Credit
Compensation cost	6,000,000[1]	
Paid-in capital-share options	2,000,000[2]	
APIC	4,000,000	
Contributed capital from XYZ		12,000,000[3]

[1] Grant-date fair value ($8,000,000) less compensation cost previously recognized ($2,000,000)
[2] Eliminate paid-in capital from compensation cost previously recognized
[3] Cash payment by XYZ to settle the share options

Scenario 2. ABC elects to apply pushdown accounting in its stand-alone financial statements. How should the $6 million of unrecognized compensation cost be reflected in the predecessor (period prior to the acquisition) and successor (period following the acquisition) financial statements of ABC?

Because the recognition of compensation cost occurs on consummation of the business combination, we believe that ABC can choose either to:

- present the amount as compensation cost in the predecessor financial statements (i.e., it is recognized immediately before the consummation of the business combination as in Scenario 1) or
- reflect the amount in equity of the successor financial statements as part of acquisition accounting adjustments, in which case no compensation cost would be presented in either the predecessor or successor financial statements

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(i.e., the compensation cost is recognized concurrent with the consummation of the business combination and, therefore, falls on the *black line* that separates the predecessor / successor periods). (See discussion in paragraph 27.032.)

ABC should apply the same accounting for all liabilities triggered by the consummation of the business combination. In either case, ABC should disclose the accounting for these items.

Example 11.20 Example not used.

Example 11.20a: Accelerated Vesting of Awards When a Change-in-Control Provision Is Added

Assume the same facts as in Example 11.19a, except that the original award terms did not contain a change-in-control provision.

Scenario 1

In January 20X6, ABC owners considered future liquidity event scenarios, including the sale of ABC. ABC modified all share-based compensation agreements to add a single trigger change-in-control provision such that awards immediately vest upon a change in control of ABC. In January 20X7, ABC entered into discussions with XYZ regarding the sale of ABC.

Scenario 1 Analysis. Because the change-in-control provision was added by ABC during the process of strategic planning and before discussions with XYZ, XYZ concludes that the modification was not initiated by or for the benefit of XYZ. Therefore, the accounting for the awards by XYZ would be the same as Example 11.19a, and ABC would need to consider the accounting impact, if any, in its pre-combination financial statements.

Scenario 2

On July 1, 20X6, ABC granted share options with a grant date fair value of $8 million and a 48-month vesting period. In January 20X7, ABC entered into discussions with XYZ regarding the sale of ABC to XYZ. As a result, ABC modified all share-based compensation agreements to include a single trigger change-in-control provision such that awards immediately vest upon a change in control of ABC.

Scenario 2 Analysis**.** Because the change-in-control provision was added as a result of merger discussions with XYZ that had extended beyond a preliminary stage, XYZ concludes that the modification should be accounted for as if it was initiated by XYZ. Therefore, the $4,000,000[1] attributed to pre-combination vesting is included in consideration transferred on July 1, 20X7 (the acquisition date), and XYZ recognizes the remaining acquisition-date fair value as post-combination compensation cost of $8,000,000. See Paragraph 11.030 for the detailed formula.

[1] 25% (12/48 months) of the $12 million acquisition-date fair value.

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Example 11.21 Example not used.

Example 11.21a: Acceleration of Awards With a Change in Control and a Secondary Event (Double Trigger)

Assume the same facts as in Example 11.19a, except that the original award terms stated that the vesting accelerates upon a change in control and termination of the employee without cause. On July 1, 20X6, ABC granted the $8 million share options with a 48-month vesting period. Shortly after the July 1, 20X7 acquisition date (i.e., in the same accounting period), the employee is terminated.

Analysis

Because the employee was terminated shortly after the acquisition date, XYZ determined that it was for the benefit of the acquirer or combined company. Therefore, the accounting is the same as in Example 11.20a Scenario 2.

Example 11.22 Example not used.

AWARDS WITH PERFORMANCE CONDITIONS

11.047 Under ASC Topic 718, awards with performance conditions require that compensation cost be recognized when the achievement of the performance condition is considered probable of achievement. If an award has multiple performance conditions (and thus, for example, the number of options or shares to be awarded varies depending on the performance condition(s) satisfied), compensation cost is accrued if it is probable that a performance condition will be satisfied, based on the most likely outcome. When an acquirer issues replacement awards, and both the original and replacement awards include performance conditions, the determination of the pre-combination and total vesting periods will be affected by the probability of achieving the performance conditions. Specifically, the original vesting period of the acquiree's award should be the vesting period used by the acquiree to accrue compensation cost as of the acquisition date in accordance with ASC Topic 718. Similarly, the total vesting period should be based on the original vesting period for the acquiree's award (determined as above), plus the vesting period of the replacement award, determined in accordance with ASC Topic 718.

11.048 If, at the acquisition date, it is not probable that all performance conditions (if any) included in either the acquiree's awards or the acquirer's replacement awards will be met, then no amount is recognized as either pre- or post-combination vesting. If, in a period subsequent to the acquisition date, it becomes probable that the performance condition for the replacement award will be achieved, the acquirer recognizes the related cumulative compensation cost in the post-combination financial statements in which such period falls. In other words, the acquirer does not make adjustments to the consideration transferred in the business combination or the compensation cost recognized in the previously issued post-combination financial statements.

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11.049 Depending on the entity's operations subsequent to the business combination, it may be challenging for an acquirer to structure a replacement award that has equivalent performance conditions. For example, for employee awards, an entity may integrate the operations of the target into the existing operations of one of its subsidiaries. That subsidiary's operations may be such that the performance conditions of the target's original award are not a relevant measure on which to set performance conditions for the replacement award. In these circumstances, an acquirer may be required to issue replacement awards that have only service conditions. Some share-based plans with performance conditions have as part of their original terms that if the entity is acquired and the acquirer is unable to issue replacement awards replicating the performance conditions, the vesting of the replacement awards will automatically accelerate. The accounting described beginning at Paragraph 11.029 is relevant in determining how the award is allocated between pre-combination and post-combination vesting.

AWARDS WITH MARKET CONDITIONS

11.049a Under ASC Topic 718, market conditions affect the valuation of share-based payment awards, and compensation cost is recognized if the service condition is met regardless of whether the market condition is met. Similarly, in a business combination, market conditions affect the measurement of both the acquiree's replaced award and the acquirer's replacement award, based on circumstances at the acquisition date. Otherwise, exchanges of awards with market conditions follow the same accounting treatment as awards with service conditions. Unlike awards with performance conditions, for which compensation is reversed if the condition is not achieved, compensation cost is not reversed if a market condition is not achieved, provided the requisite service has been rendered. For awards with market conditions, the allocation of pre-combination and post-combination services is consistent with the analysis for awards with service conditions, except that the market condition also is considered when determining the post-combination service period.

POST-ACQUISITION CHANGES IN ESTIMATES

11.050 If an entity’s policy is to estimate forfeitures expected to occur, changes in the number of replacement awards for which requisite service is expected to be rendered is reflected as an adjustment to compensation cost in the period in which the changes in estimated forfeitures occur. The acquirer therefore does not adjust consideration transferred in periods subsequent to the acquisition date if actual forfeitures differ from the forfeitures estimated at the acquisition date. An acquirer that elects to recognize forfeitures as they occur also attributes the post-acquisition forfeiture experience to post-acquisition compensation cost and will only reflect forfeitures as they occur. Stated differently, any difference between the estimated and actual forfeitures of replacement awards is reflected in compensation cost regardless of the acquirer’s policy for forfeitures; however, the pattern of recognition will differ under the two policies as illustrated in Example 11.17c.

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11.051 Likewise, an acquirer would not adjust the amount of consideration transferred for other changes resulting from changes in estimates related to performance conditions or other events or modifications occurring after the acquisition date, except for measurement period adjustments. Judgment will sometimes be necessary to distinguish measurement period adjustments from changes attributed to subsequent events. In general, the more time that elapses following the acquisition date, the more likely it is that the adjustments do not relate to facts and circumstances that existed at the acquisition date and should therefore be reflected in post-combination earnings. See the discussion of *Adjustments to Provisional Amounts during the Measurement Period* in Section 10.

11.052 The acquirer applies the same guidance as described above for determining consideration transferred, regardless of the classification of the award. If the award is liability classified, any subsequent changes in value (other than measurement period adjustments), including the related tax effects, are recognized in the acquirer's post-combination financial statements and not as an adjustment to the consideration transferred.

11.052a Consistent with the accounting for awards issued to continuing employees, if employee awards that were vested at the acquisition date subsequently expire unexercised, no adjustment is made to either the consideration transferred or compensation cost. In addition, for nonemployee awards, the same applies in that no adjustment is made to either the consideration transferred or compensation cost when there are expired unexercised awards.

LAST-MAN-STANDING PLANS

11.053 Occasionally, as part of a business combination, the acquirer will establish a share-based payment award plan that provides for a specified number of awards with the following conditions:

- Awards issued to employees under the terms of the business combination are forfeited if employment is terminated within a certain time period; and
- Awards that are forfeited through termination of employment are reallocated to the remaining employees.

11.054 These plans are sometimes referred to as *last-man-standing plans.* The forfeiture and reallocation to other employees holding share-based payment awards issued as part of a business combination constitutes the forfeiture of one award by a participant and a grant of a new award to other participants. The acquiring entity should account for the reallocated shares as a new grant (i.e., using a fair-value-based measure on the date of the reallocation), and recognize the resulting compensation cost over the requisite service period from the reallocation date. This accounting applies even though the awards issued can never revert to the acquirer.

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Example 11.23: Last-Man-Standing Plans

ABC Corp. acquires DEF Corp. on January 1, 20X9. As required by the acquisition agreement, ABC issues a replacement award of 500 share options with a fair value of $7,500 ($15 /option) to replace share options for DEF's Last-Man-Standing Plan with a fair value of $7,500.

Other relevant information about DEF's Last-Man-Standing Plan is as follows:

- On January 1, 20X7, DEF issued 500 share options with a fair value of $5,000 to 5 of its executives (100 options each).
- The original share options provided for cliff vesting at the end of the 3-year period ending January 1, 20Y0.
- If any of the executives terminate employment prior to January 1, 20Y0, the forfeited awards are reallocated in equal amounts to the executives that remain employed. On December 31, 20X8, one of the executives terminated employment and 100 share options were reallocated to the four remaining executives.

Amount of Replacement Awards Attributed to Pre-combination Vesting

The portion of the replacement awards attributed to pre-combination vesting is $4,000. The determination of this amount requires two computations, because the originally issued DEF awards that remain outstanding at the acquisition date and the options reissued at December 31, 20X8 are accounted for as two separate awards. The portion of the replacement award for the originally issued DEF awards and the reissued awards attributed to pre-combination vesting is $4,000 and $0, as shown below.

Originally Issued and Outstanding Options

400 share options × $15 × 2/3 = $4,000

Computed as the acquisition-date fair-value-based measure of DEF's originally issued and outstanding options at the acquisition date (400 × $15 = $6,000) multiplied by the ratio of the pre-combination vesting period (2 years) to the greater of the total service period or the original service period (both of which are 3 years).

Reissued Options

100 share options × $15 × 0 = $0

Computed as the acquisition-date fair-value-based measure of DEF's reissued options at the acquisition date (100 × $15 = $1,500) multiplied by the ratio of the pre-combination vesting period (none) over the greater of the total service period or the original service period (both of which are 1 year). Because there was no pre-combination vesting period (i.e., the reissued awards were issued on December 31, 20X8), none of the fair-value-based measure of the replacement awards is attributed to pre-combination vesting.

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Amount of Replacement Awards Attributed to Post-combination Vesting

The portion of the replacement awards attributed to post-combination vesting is $3,500, which is equal to the sum of the fair-value-based measure of each of the replacement awards less the amount attributed to pre-combination vesting, as shown below.

Fair-value-based measure of replacement awards for originally issued and outstanding DEF awards ($6,000) less amount attributed to pre-combination vesting ($4,000)	$ 2,000
Fair-value-based measure of replacement awards for reissued awards ($1,500) less amount attributed to pre-combination vesting ($0)	$ 1,500
	$ 3,500

These computations assume that no additional forfeitures are expected. If, after the acquisition, replacement options held by the former DEF executives are forfeited and new options are reallocated and reissued by ABC to the remaining former DEF executives, the reissued options would be accounted for as a forfeiture of the awards issued at the acquisition date by ABC, and as a grant of new awards in its post-combination financial statements.

ACQUISITION OF NONCONTROLLING INTEREST

11.054a Ordinarily, settling an outstanding share option in a subsidiary, either in cash or by issuing stock or share-based awards in the parent, is treated as a modification of an award. However, the exchange of share-based awards or awards for consideration from the parent is treated as the acquisition of a noncontrolling interest if:

- Those share-based awards were outstanding at the date the parent first gained control of the subsidiary, and
- Those share-based awards have not been modified subsequent to the parent gaining control.

11.054b If there is a future requisite vesting period associated with the new awards issued by the parent, the proportionate amount of the consideration issued in the acquisition of the noncontrolling interest related to the future vesting should be recognized as post-acquisition compensation cost.

11.054c Example 11.23a summarizes whether an exchange of awards as part of a transaction that is the acquisition of noncontrolling interest for five different circumstances should be accounted for as either (1) acquisition of noncontrolling interest or (2) a modification of awards.

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Example 11.23a: Treatment of the Exchange of Awards in the Acquisition of Noncontrolling Interest

	Acquisition of Noncontrolling Interest	Modification
Awards fully vested at the date of the acquisition of the subsidiary	X	
Awards partially vested at the date of the acquisition of the subsidiary and vest before the exchange	X	
Awards partially vested on the date of the acquisition of the subsidiary and not fully vested at the date of the exchange[1]	X	
Awards fully vested but issued after the date of the acquisition of the subsidiary[2]		X
Awards partially vested but issued after the date of the acquisition of the subsidiary[3]		X

[1] In this scenario, the exchange of awards would be treated as the acquisition of a noncontrolling interest. However, the proportionate amount of the consideration relating to the future requisite service period should be recognized as post-combination compensation cost and unrecognized compensation would be recognized immediately.
[2] In this scenario, the exchange of awards would be treated as a modification. Changes to the terms of awards in conjunction with a business combination are modifications, with modification accounting applied when there are changes to the fair value, vesting conditions or classification of awards. Accordingly, a calculation to determine whether there is incremental compensation cost of the modification is required. The amount paid for the fully vested awards that is equal to or less than the fair value of the award before the exchange would be treated as the acquisition of a noncontrolling interest.
[3] In this scenario, the exchange of awards would be treated as a modification. Changes to the terms of awards in conjunction with a business combination are modifications, with modification accounting applied when there are changes to the fair value, vesting conditions or classification of awards. Accordingly, a calculation to determine whether there is incremental compensation cost of the modification is required and incremental compensation cost relating to the modification of an unvested award is recognized for the remaining vesting term.

Example 11.23b: Accounting for the Exchange of Partially Vested Awards at the Acquisition Date of the Subsidiary

DEF Corp. issued 1,000 share options to employees on January 1, 20X5. The share options vest over a three-year period with a grant-date fair value of $5 and an exercise price of $10. DEF's accounting policy is to account for forfeitures as they occur. However, no share options were forfeited. On January 1, 20X7, ABC Corp. acquired 60% of DEF. The share options had an acquisition date fair value of $6.

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On January 1, 20X8, ABC exchanged fully vested replacement share options for the DEF fully vested share options outstanding. Both the replacement share options and the outstanding share options had a fair value of $8 on the date of replacement.

ABC would account for the exchange as an acquisition of noncontrolling interest as the original share options were outstanding as of the acquisition date. ABC would record the following entries from January 1, 20X7 through January 1, 20X8:

	Debit	Credit
January 1, 20X7 (acquisition date)		
APIC	4,000	
Noncontrolling interest		4,000[1]
December 31, 20X7		
Expense	2,000	
Noncontrolling interest		2,000[2]
January 1, 20X8 (replacement date)		
Noncontrolling interest	6,000	
APIC		6,000

[1] Pre-combination portion of the award based on acquisition date fair value (1,000 awards × $6 × 2/3)
[2] Post-combination compensation cost based on the proportion of service rendered in the post-combination period (1,000 awards × $6 × 1/3)

Example 11.23c: Accounting for the Exchange of Fully Vested Awards Issued after the Acquisition Date of the Subsidiary

ABC Corp. acquired 60% of DEF Corp. on January 1, 20X4. Subsequent to the acquisition date, on January 1, 2005, DEF issued 1,000 share options to employees that vest over a three-year period. The share options had a grant-date fair value of $5 and an exercise price of $10. DEF's accounting policy election is to account for forfeitures as they occur. However, no share options were forfeited. On January 1, 20X9, ABC exchanged fully vested replacement share options for each DEF fully vested share option outstanding. The replacement share options had a fair value of $8 on the date of exchange. The fair value of the share options of DEF immediately before the modification is $6. Assume no share options in DEF have been exercised.

ABC would account for the exchange as a modification as the share options were issued subsequent to the acquisition date. ABC would immediately recognize additional compensation cost for the incremental fair value of $2,000 representing the post-acquisition compensation cost, because the replacement share options do not have a future requisite service period. In addition, ABC would record the amount paid for the fair value of the fully vested share options prior to the exchange as an acquisition of noncontrolling interest. Noncontrolling interest would be capped at the grant-date fair

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value of $5,000 (i.e., the amount of noncontrolling interest recognized related to the share options ($5 × 1,000 share options)). ABC would record the following:

	Debit	Credit
Compensation cost	2,000	
Noncontrolling interest	5,000	
APIC		7,000

ACQUIRER'S ACCOUNTING FOR UNREPLACED AWARDS

11.055 In some business combinations, the acquirer may not replace outstanding acquiree employee or nonemployee share-based payment awards. This may occur in situations where the acquirer acquires less than 100% of the shares of the acquiree and the terms of the acquiree's awards permit them to remain outstanding and continue to vest under their original terms. In that situation, the acquirer determines the fair value of the acquiree's awards at the acquisition date. This amount constitutes the grant-date fair value of the awards for the acquirer's post-combination accounting. That is, the acquisition date fair value of the acquiree share-based awards that remain outstanding is used as the basis for determining the compensation cost in the acquirer's post-combination financial statements based on the proportion of service required (or goods expected to be delivered for nonemployee awards) in the post-combination period. The pre-combination portion of the award is reflected as noncontrolling interest in the acquirer's consolidated financial statements. For example, if the acquiree's employee awards had a fair value of $50,000 at the acquisition date and the employees had provided three years of service out of a requisite service period of five years, the acquirer would reflect $30,000 as noncontrolling interest in its acquisition accounting. It would then recognize compensation cost of $20,000 over the remaining two-year service period.

ACQUIRER'S SUBSEQUENT GRANT OF AWARDS WHEN ACQUIRER DID NOT EXCHANGE ACQUIREE'S AWARDS IN THE BUSINESS COMBINATION TRANSACTION

11.055a In some business combinations, the acquirer may not replace outstanding acquiree share-based awards. Subsequently, the acquirer may grant new share-based awards to those former target company employees and nonemployees. Generally, these awards should not be part of the consideration transferred in the acquisition of the acquiree unless the acquirer was obligated to replace the awards under the terms of the acquisition agreement, the terms of the acquiree's award agreements or applicable law.

When the new grants are made shortly after the acquisition date, judgment may be required to determine whether there was a legal obligation to replace the outstanding share-based awards if not explicitly stated in the acquisition agreement or terms of the acquiree's award agreements. In that case, it may be necessary to consult with legal counsel to evaluate the obligation under the applicable laws and regulations.

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Example 11.24: Employee Share Options of Acquiree That Are Not Assumed by the Acquirer

Background

ABC Corp (an acquirer in a business combination) was not legally obligated to, and did not, assume, acquire, or exchange the outstanding share options of DEF Corp. (the Acquiree). In accordance with the terms of DEF's outstanding share options, the employees had 90 days after a change in control to exercise vested share options. Because these share options were *out-of-the-money,* the share options expired unexercised. Subsequently, ABC granted share options to employees, including employees that were formerly employed by DEF, in an amount and with terms that were consistent with ABC's past practice for annual grants. Employees in similar positions received the same number of share options regardless of whether they were previously employed by DEF.

Q. Should ABC record the fair value of the share options granted to DEF's former employees as additional consideration transferred in the acquisition of DEF?

A. No. ABC should not record the fair value of the share options as additional consideration transferred. ABC was not obligated to assume DEF's outstanding share options. Additionally, ABC did not agree to compensate DEF employees for their lapsed share options. ABC granted new share options in an amount that was consistent with its past practices for annual grants and did not grant a disproportionate amount of share options to DEF's former employees. Accordingly, ABC should not record any portion of the fair value of the new share options as additional consideration or otherwise attribute the new awards to the acquisition of DEF.

11.055b Paragraph not used.

Example 11.25 Example not used.

PAYROLL TAXES ON SHARE-BASED AWARDS

11.055c The liability for employer payroll taxes should be recognized on the date that measurement and payment of the payroll tax is required (triggering event), which generally is the exercise date of share options. A liability should not be recognized as part of the consideration transferred if the triggering event has not occurred at the acquisition date. Additionally, no adjustment to the consideration transferred should be made when the triggering event occurs after the acquisition date. This view is consistent with ASC paragraph 718-10-25-22, which addresses recognition of employer payroll taxes on employer share-based compensation.

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ACCOUNTING FOR THE INCOME TAX EFFECTS OF REPLACEMENT AWARDS CLASSIFIED AS EQUITY ISSUED IN A BUSINESS COMBINATION

See KPMG Handbook *Accounting for Income Taxes,* Section 6, The Tax Effects of Business Combinations.

11.056 - 11.060 Paragraphs not used.

ACQUISITION-RELATED COSTS

ACQUISITION-RELATED COSTS INCURRED BY THE ACQUIRER

> **ASC Paragraph 805-10-25-23**
>
> Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

11.061 Acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred, but rather are accounted for as expense in the period incurred. However, costs incurred to issue debt or equity securities should be recognized in accordance with other applicable GAAP. Success fees incurred by the acquirer for external advisors (such as an investment banker) that are contingent on the closing of an acquisition are not recorded as a liability or expense until the completion of the acquisition, as the expense is not incurred until the closing of the business combination. Therefore, the success fee expense is recorded in the financial statement period that includes the acquisition date.

11.062 If acquisition-related costs incurred by an acquirer are paid by the acquired entity or selling shareholders, those costs are accounted for as a separate transaction and are not part of the accounting for the business combination. See Other Payments to an Acquiree (or its Former Owners) That Are Not Part of the Consideration Transferred below.

11.062a There may be circumstances in which the combined entity pays transaction-related costs incurred by an acquiree. In these scenarios, the factors outlined in ASC paragraph 805-10-55-18 (see Paragraphs 11.000 to 11.005) should be considered to determine whether the costs form part of the business combination. For example, if a contingent finder’s fee arrangement was entered into by the acquiree for its own benefit without the acquirer's involvement, the expense would not be recorded on the post-acquisition financial statements of the combined entity. In that case, the assumed liability would be recorded as part of the accounting for the business combination. In contrast, if

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the acquiree entered into the contingent fee arrangement for services provided to and for the benefit of the acquirer, the costs would be an expense of the acquirer in the financial statement period that includes the acquisition date rather than a liability assumed in a business combination. See Paragraph 27.032 for a discussion of contingent expenses of the acquiree when pushdown accounting is applied to the acquiree's financial statements.

Example 11.26: Acquisition-Related Costs

ABC Corp. acquires 100% of the stock of DEF Corp., a foreign company, for cash. The foreign government requires a 1% stamp duty to be paid by ABC within 30 days of the transfer of stock to legally document the transfer of ownership. The stamp duty is the legal obligation of ABC.

The stamp duty paid by ABC is not part of the consideration transferred for the acquisition of DEF and therefore is expensed in the period in which the cost is incurred.

Q&A 11.1: Costs Related to Directors and Officers Liability Insurance

Background

Following an acquisition, several of an acquiree's former executives and officers were terminated. The acquirer obtained directors and officers insurance to insure against issues that might arise from the period that the former executives and officers served in their capacity for the acquiree.

Q. How should an entity account for the cost of a directors and officers liability insurance policy acquired to cover former officers of an acquiree?

A. The entity should expense the costs when incurred. It would not be appropriate to amortize the costs over the statute of limitations period or other periods because the periods over which the acquirer would receive a benefit from this cost is indeterminable. Furthermore, the cost relates to issues that may arise from actions taken before the acquisition. The cost of the insurance policy is not part of consideration transferred for the acquisition.

Q&A 11.2: Costs Related to Representations and Warranties Insurance

Background

ABC Corp. purchases Target Corp. in a business Combination. ABC purchases representation and warranties insurance from a third-party insurance company, effective at the date of acquisition, to cover losses in the event of the seller’s breach of the representations and warranties in the purchase agreement (e.g., that the information provided was complete and accurate or the seller was compliant with laws and regulations). ABC does this instead of putting consideration in escrow for a period of

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time pending seller's satisfaction of the representations and warranties (see Paragraph 6.020b). The policy covers events that occurred before or at the date of the business combination.

Q. How should ABC account for the cost of the representation and warranty insurance?

A. The cost of the insurance policy is separate from the business combination. Even though ABC could have put some of the purchase price in escrow instead of obtaining the policy, the transaction is still separate from the business combination because it is with a third party and for the benefit of the acquirer. Because the insurance policy relates to issues that arise from events or actions before or at the date of the business combination, ABC expenses the cost at the acquisition date.

Costs Related to the Issuance of Equity Securities

11.063 An acquirer may incur costs related to the issuance of equity securities issued to effect a business combination. Such costs may include direct, incremental costs of the issuance, such as fees charged by underwriters, attorneys, accountants, and printers. These costs effectively reduce the proceeds from the stock issuance and, therefore, should reduce the amount recognized in equity. An entity should record internal costs, such as salaries, as current period expenses, because such costs would have occurred even without the issuance of the equity securities.

Costs Related to the Issuance of Debt

11.064 An acquirer may incur costs in connection with the issuance of debt associated with a business combination. For example, such costs may include fees paid to creditors, attorneys, and rating agencies. Debt issue costs reduce the proceeds from the debt issued, and are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the proceeds change the nature of such costs. Direct costs paid to third parties in connection with a debt issuance, whether in a transaction related to a business combination or otherwise, should be capitalized and amortized over the term of the debt as a component of interest cost. Entities should not capitalize internal costs related to the issuance of debt.

Allocation of Financing and Acquisition Costs

11.065 An entity may incur fees in connection with the issuance of debt or equity (i.e., financing) and also pay fees to the same service provider/creditor in a related business combination. The fees allocated to the financing issuance and the cost of the acquisition should be representative of the actual services provided. For example, if an entity pays fees to an investment banker in connection with a business combination and financing, those fees should be allocated between the costs of the acquisition and financing issuance costs considering factors such as the fees charged by investment bankers in connection with other similar recent transactions (e.g., fees charged by an investment banker solely for advisory services for an acquisition or fees charged by an investment banker solely for arranging financing). For debt financing, whether these or other factors are

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considered, the allocation should normally result in an effective debt service cost (interest and amortization of debt issuance costs) that is comparable to the effective cost of other recent debt issues of similar investment risk and maturity. SAB Topic 2A.6

Cost Related to Excise Tax on Net Share Repurchases

11.065a The Inflation Reduction Act of 2022 (IRA) imposes a 1% excise tax on net share repurchases in a tax year that are made by certain publicly traded corporations. The tax applies to repurchases of common and preferred shares, net of issuances (including exercises of options or vesting of restricted shares) in a tax year. In certain business combination structures, the acquiree repurchases its own stock either directly or through a disregarded entity, which results in the acquiree incurring excise tax. In these situations, the excise tax is accounted for as a transaction cost and recognized as a liability by the acquiree. As a result, the acquirer would recognize the excise tax as an assumed liability, which would lead to an increase in goodwill. If the acquiree issues separate financial statements and elects push-down accounting, the acquiree recognizes the excise tax either in the predecessor period or *on-the-line*. See discussion in Paragraph 27.032.

OTHER PAYMENTS TO AN ACQUIREE (OR ITS FORMER OWNERS) THAT ARE NOT PART OF THE CONSIDERATION TRANSFERRED

Statement 141(R)

B370. The Boards also considered concerns about the potential for abuse. Some constituents, including some respondents to the 2005 Exposure Draft, said that if acquirers could no longer capitalize acquisition-related costs as part of the cost of the business acquired, they might modify transactions to avoid recognizing those costs as expenses. For example, some said that a buyer might ask a seller to make payments to the buyer's vendors on its behalf. To facilitate the negotiations and sale of the business, the seller might agree to make those payments if the total amount to be paid to it upon closing of the business combination is sufficient to reimburse the seller for payments it made on the buyer's behalf. If the disguised reimbursements were treated as part of the consideration transferred for the business, the acquirer might not recognize those expenses. Rather, the measure of the fair value of the business and the amount of goodwill recognized for that business might be overstated. To mitigate such concerns, [ASC Topic 805] requires any payments to an acquiree (or its former owners) in connection with a business combination that are payments for goods or services that are not part of the acquired business to be assigned to those goods or services and accounted for as a separate transaction. [ASC Topic 805] specifically requires an acquirer to determine whether any portion of the amounts transferred by the acquirer are separate from the consideration exchanged for the acquiree and the assets acquired and liabilities assumed in the business combination. [ASC paragraphs 805-10-25-20 through 25-23 and 55-18] provide guidance for making that determination.

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11.066 The guidance in the above paragraph, and the guidance in ASC paragraphs 805-10-25-20 through 25-23 and 55-18 previously discussed, was included in ASC Topic 805 in part to mitigate concerns over whether an acquirer might arrange for an acquiree to make payments for goods or services on behalf of the acquirer that are unrelated to the acquisition. That guidance requires an acquirer to determine whether any portion of the consideration transferred relates to such transactions and, if so, to exclude such transactions from the acquisition accounting and, instead, assign a portion of the consideration transferred to such transactions and account for them as separate transactions in accordance with other relevant guidance. Since the costs are a separate transaction, the acquirer should recognize an expense and liability for reimbursement to the acquiree as these costs are incurred.

Example 11.27: Acquisition-Related Payments Made by an Acquiree

ABC Corp. acquires DEF Corp. for $10,000. The acquisition agreement states that the price is comprised of $9,500 as consideration for DEF and $500 as reimbursement of DEF's acquisition-related transaction costs. The cost of $500 is entirely DEF's cost and no costs were incurred by DEF on behalf of ABC.

The following amounts are the value of DEF's assets and liabilities measured in accordance with ASC Topic 805 on the acquisition date:

Current assets	$3,000
Current liabilities (excluding accruals for transaction costs)	$2,000
Long-lived assets	$8,000
Debt	$5,000

ABC treats the entire $10,000 as consideration transferred for the purpose of determining goodwill. This is based on the guidance in ASC paragraph 805-10-55-18. As the reimbursement by ABC of DEF's costs is for the primary benefit of DEF, the costs are more likely part of the exchange for the acquiree. Accordingly, ABC would record the following:

	Debit	Credit
Current assets	3,000	
Long-lived assets	8,000	
Goodwill	6,000	
Current liabilities		2,000
Debt		5,000
Cash		10,000

Conversely, if the transaction costs were included in the acquiree's accounts payable to be paid by the combined company, it would be expected that the offer price would be reduced to $9,500 and ABC would record the following:

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	Debit	Credit
Current assets	3,000	
Long-lived assets	8,000	
Goodwill	6,000	
Current liabilities		2,500
Debt		5,000
Cash		9,500

This example only applies to costs incurred by and related to the acquiree.

OTHER TRANSACTIONS

CHANGES IN INTEREST RATE ON ACQUIRER'S DEBT RESULTING FROM A CHANGE IN CONTROL

11.067 The acquirer in a business combination may have outstanding debt with provisions that could result in an increase in the interest rate in the event of a merger or acquisition. If the interest rate on debt of the acquirer is increased as a result of a business combination, the additional interest costs are not part of the business combination transaction and therefore are not included in the consideration transferred. The additional interest costs are recognized by the acquirer as incurred or accreted.

RESTRUCTURING OR EXIT ACTIVITIES

11.068 In connection with a business combination, an acquirer may choose to exit an activity of the acquiree, involuntarily terminate employees of the acquired entity, or relocate employees of the acquired entity. Costs resulting from such activities are costs of the combined entity and are not part of the consideration transferred. The accounting for such costs is discussed in ASC Subtopic 420-10, *Exit or Disposal Cost Obligations - Overall.* Costs incurred to integrate the acquired entity into the operations of the accounting entity would also not be part of the consideration transferred. See discussion of *Liabilities Associated with Restructuring or Exit Activities of the Acquiree* in Section 7.

HEDGING A FORECASTED TRANSACTION CONTINGENT ON CONSUMMATION OF A BUSINESS COMBINATION

11.069 ASC paragraph 815-20-25-43 prohibits fair value hedge accounting of a firm commitment to enter into a business combination or to acquire a subsidiary, minority interest, or equity method investee. ASC paragraphs 815-20-25-15(g) and 25-15(h) are explicit in their guidance in prohibiting cash flow hedge accounting for a forecasted transaction involving a business combination or acquisition of a subsidiary, noncontrolling interest, or equity method investee. The FASB's Derivatives Implementation Group (DIG) has discussed whether it is appropriate to designate the

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occurrence of a forecasted transaction that is contingent on consummating a business combination as the hedged item in a cash flow hedge.

Example 11.28: Derivative Transaction That Will Lock In the Interest Rate Today on the Forecasted Issuance of Debt Expected to Occur in Six Months

The following example is derived directly from DIG Agenda Item 14-13:

Company A enters into a definitive agreement to acquire the outstanding common stock of Company B for cash. The transaction is expected to close in six months. Given the significance of the purchase price relative to its cash balance, Company A needs to borrow money immediately before the closing of the transaction to fund the acquisition. However, in the unlikely event that the transaction with Company B is not consummated, Company A will not incur the debt as it has sufficient working capital to meet its operational needs. Company A is concerned that interest rates will increase during the next six months and, therefore, desires to enter into a derivative transaction that will lock in the interest rate today on the forecasted issuance of the debt expected to occur in six months.

11.070 While the FASB staff has not reached a definitive conclusion on the appropriate accounting treatment for the above example, we believe that it is acceptable to hedge a forecasted transaction that is contingent on the consummation of a business combination if the forecasted transaction does not directly affect the accounting for the acquisition and meets the criteria for being the hedged item as defined by ASC paragraph 815-20-25-15. In the above example, the forecasted issuance of debt does not directly affect the accounting for the acquisition.

11.071 If Company A determines that it is probable that the business combination will be consummated, that the forecasted transaction is likely to occur, and that all the other relevant hedging criteria in ASC paragraphs 815-20-25-3, 25-15, 25-75, 25-94, and 25-95 have been met, then cash flow hedge accounting would be appropriate for the forecasted transaction. It is important to note that the facts and circumstances related to the forecasted business combination need to be evaluated to determine whether the transaction is probable.

11.072 Certain constituents have argued that the consensus reached in EITF Issue No. 95-14, "Recognition of Liabilities in Anticipation of a Business Combination" (which was nullified by ASC Subtopic 420-10), does not support the assertion that a forecasted business combination can be probable of occurring before the consummation of the business combination. We believe that reference to EITF 95-14 is not appropriate, as the Issue was narrow in scope and addressed only the recognition of liabilities in anticipation of a business combination. EITF 95-14 did not specifically address whether a forecasted business combination could ever be considered likely to occur.

11.073 Furthermore, to the extent an entity concludes that a business combination is probable of occurring for purposes of hedging a forecasted transaction contingent on the

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consummation of a business combination, an entity also would conclude that the business combination is probable of occurring for purposes of SEC Rule 3-05 of Regulation S-X. This rule provides, in part, that audited financial statements prepared under Regulation S-X are required if the consummation of a significant business combination is considered probable.

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Section 12 - Subsequent Measurement and Accounting

Detailed Contents

Reacquired Rights

Example 12.1: Reacquired Right Subsequently Sold to a Third Party

Assets and Liabilities Arising from Contingencies

Indemnification Assets

Example 12.2: Subsequent Accounting for Indemnification Asset When Estimated Collectibility Changes

Example 12.3: Subsequent Accounting for an Indemnification Asset When the Amount of the Related Indemnified Liability Decreases and the Fair Value of the Assets Securing the Indemnification also Decreases

Derecognition of Indemnification Assets

Example 12.4: Subsequent Settlement of an Indemnified Tax Uncertainty at Less Than the Liability and Related Indemnification Asset Recognized at the Acquisition Date

Defensive Intangible Assets

Defensive Assets Used in IPR&D Activities

Other Defensive Intangible Assets

Example 12.5: Acquired Trade Name the Acquirer Intends to Hold for Defensive Purposes

Contingent Consideration

Subsequent Measurement of Contingent Consideration

Subsequent Measurement of Equity-Classified Contingent Consideration

Subsequent Measurement of Liability-Classified Contingent Consideration

Example 12.5a: Attribution of Changes in a Contingent Consideration Liability to a Noncontrolling Interest

Contingently Issuable Debt

Other Applicable GAAP

Example 12.5b: Subsequent Accounting for a Liability for an Unfavorable Executory (Revenue) Contract

Consistency of Accounting Policies

Error Discovered after a Business Combination

Example 12.6: Subsequent Discovery of Errors in Acquiree's Financial Statements

Example 12.7: Litigation with Dissenting Shareholders

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ASC Paragraph 805-10-35-1

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable generally accepted accounting principles (GAAP) for those items, depending on their nature. However, [ASC] Topic [805] provides guidance on subsequently measuring and accounting for any of the following assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination:

a. Reacquired rights (see [ASC] paragraph 805-20-35-2)

b. Assets and liabilities arising from contingencies recognized as of the acquisition date (see [ASC] paragraph 805-20-35-3)

c. Indemnification assets (see [ASC] paragraph 805-20-35-4)

d. Contingent consideration (see [ASC] paragraph 805-30-35-1)

e. Contingent consideration arrangements of an acquiree assumed by the acquirer (see [ASC] paragraph 805-30-35-1A).

12.000 Recognition and measurement of the assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination is discussed in Section 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree.* Subsequent to an acquisition, an acquirer accounts for most of the assets acquired, liabilities assumed or incurred, and equity instruments issued in an acquisition in accordance with other applicable GAAP. However, for the items specified in ASC paragraph 805-10-35-1, guidance is provided in ASC paragraphs 805-20-35-2 through 35-4C and 40-2 and 40-3. Additionally, as discussed beginning at Paragraph 12.015, guidance on accounting for defensive intangible assets is provided in ASC paragraphs 350-30-25-5, 35-5A and 35-5B, 55-1 and 55-1B, 55-28H, 55-28I, 55-28K, 55-28L.

REACQUIRED RIGHTS

ASC Paragraph 805-20-35-2

A reacquired right recognized as an intangible asset in accordance with [ASC] paragraph 805-20-25-14 shall be amortized over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

12.001 Consistent with the exception to the fair value measurement principle with respect to the initial measurement of a reacquired right, ASC Topic 805 requires the acquirer to amortize a reacquired right over the remaining contractual period of the related contract in which the right was granted, even if market participants would consider potential contract renewals in determining fair value. Thus, ASC paragraphs 350-30-50-4 through 50-5, 55-1C, and 275-10-50-15A are not applicable to the determination of the useful life

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of a reacquired right. Section 7 discusses the initial recognition and measurement of reacquired rights at the acquisition date.

12.002 If an acquirer subsequently sells a reacquired right to a third party, the carrying amount of the intangible asset is included in the determination of the gain or loss on the sale.

Example 12.1: Reacquired Right Subsequently Sold to a Third Party

ABC Corp., a franchisor, acquires DEF Corp. on April 30, 20X8 in a business combination. ABC had a preexisting relationship with DEF and recognizes an intangible asset related to a reacquired franchise right previously granted to DEF. ABC applied the measurement principle in ASC paragraph 805-20-30-20 and determined the value of the reacquired franchise right to be $100,000, based on the remaining contractual period of five years as of the acquisition date. ABC did not consider potential contract renewals in determining fair value, even though a market participant would consider such renewals. Consistent with the term used for measuring the reacquired franchise right, ABC will amortize the reacquired right over the remaining contract period (five years). ABC did not recognize any settlement gain or loss on the business combination because the royalty rate that DEF was paying under the franchise agreement was consistent with the current market rate at the acquisition date. Two years later on April 30, 20X0, ABC sells the reacquired franchise right to XYZ Corp. for cash of $210,000, with an initial contract period of 10 years. Assume that all material services related to the sale of the franchise right to XYZ have been substantially performed by ABC, and that all of the requirements for recognition of revenues from franchise sales have been met.

ABC should derecognize the intangible asset of $60,000 ($100,000 less two-year amortization of $40,000) and reflect the net effect of $150,000 ($210,000 received from XYZ—carrying amount of $60,000 for the intangible asset) in earnings, presented in its income statement in a manner consistent with its reporting of other revenues from franchise sales (see ASC Subtopic 952-605, *Franchisors - Revenue Recognition).*

ASSETS AND LIABILITIES ARISING FROM CONTINGENCIES

ASC Paragraph 805-20-35-3

An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.

12.003 ASC Topic 805 requires that assets and liabilities arising from contingencies of an acquiree be recognized and measured at fair value at the acquisition date if fair value can be determined during the measurement period. If not, these items are recognized in accordance with the recognition and measurement provisions of ASC Topic 450, *Contingencies.* Any gains or losses attributable to pre-acquisition contingencies that are not recognized at acquisition date or within the measurement period are recorded outside

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of purchase accounting. See Section 7 for a discussion of initial recognition and measurement of assets and liabilities arising from contingencies.

12.004 ASC paragraphs 805-10-35-1, 805-20-25-15A, 25-18A, 25-19 through 25-20B, 30-9, 30-9A, 30-23, 35-3 and 35-4C, 50-1, and 805-30-35-1A do not provide guidance on the subsequent accounting for contingencies recognized in a business combination. Instead, the FASB directs entities to "develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature."

12.005 We expect that in most circumstances entities will continue their current practices when contingencies are recognized and measured in the acquisition accounting using an ASC Topic 450 approach—which likely is a continuation of the ASC Topic 450 approach until the contingency is resolved (see related discussion in Paragraphs 7.156 - 7.157). However, in the case of warranty obligations or other contingencies that are initially recognized at fair value, ASC paragraphs 805-20-25-17 and 25-28 suggest that ASC Subtopic 460-10, *Guarantees - Overall,* might be a potential source of guidance on the subsequent accounting. In accordance with ASC Subtopic 460-10, entities might amortize the initially measured amount to income over the contingency period (i.e., the warranty period) or they might continue to measure the contingency at its acquisition-date fair value until its resolution.

12.005a After adopting ASC Topic 606, the accounting for warranties is differentiated between assurance-type and service-type warranties. In both cases, the assumed liability is measured at fair value. The subsequent accounting for assurance-type warranties is consistent with the methods described in Paragraph 12.005. However, service-type warranties are accounted for as unfulfilled performance obligations under ASC Topic 606. See Section 4.5.20 in KPMG Handbook, Revenue recognition.

INDEMNIFICATION ASSETS

ASC Paragraph 805-20-35-4

At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

ASC Paragraph 805-20-35-4B

An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. For example, if the expected cash flows on indemnified assets increase such that a

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previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification assets immediately in earnings.

ASC Paragraph 805-20-40-3

The acquirer shall derecognize the indemnification asset recognized in accordance with [ASC] paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

12.006 Indemnification assets are an exception to the recognition and measurement principles of ASC Topic 805. An acquirer recognizes indemnification assets at the same time and measures them on the same basis as the indemnified item, subject to any contractual limitations on the amount of the indemnification and, for indemnification assets not measured at fair value, the need for a valuation allowance for uncollectible amounts. The acquirer would not recognize a valuation allowance for an indemnification asset measured at fair value, because the collectibility considerations are reflected in the measurement of fair value. An acquirer should not present indemnification assets as a reduction of the associated liability, but rather should include them in assets in the balance sheet. See the discussion of *Indemnification Assets* in Section 7.

12.007 Subsequent to initial recognition, the acquirer continues to measure an indemnification asset recognized at the acquisition date on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount and, for an indemnification asset not subsequently measured at fair value, the need for a valuation allowance for uncollectible amounts.

12.008 The initial and subsequent accounting for indemnification assets recognized at the acquisition date also applies to assets and liabilities that are exceptions to the recognition or measurement principles of ASC Topic 805. For example, an acquirer would initially and continue to subsequently recognize and measure an indemnification asset related to a liability from an uncertain tax position using assumptions consistent with those used to measure the indemnified item (i.e., ASC Subtopic 740-10, *Income Taxes - Overall).*

12.009 ASC paragraphs 805-20-35-4 and 40-3 address the subsequent accounting for an indemnification asset recognized at the acquisition date. However, as discussed in ASC paragraphs 805-20-25-28, 30-18 through 30-19, indemnification may relate to an item not recognized at the acquisition date. For example, an indemnification may relate to an environmental contingency whose fair value is not determined at the acquisition date and for which it is less than probable that a liability exists at the acquisition date in which case an acquirer would not recognize the contingent liability at the acquisition date. Because the related indemnified item was not initially recognized at the acquisition date, the indemnified item is subsequently accounted for under other applicable GAAP, including ASC Topic 450, as appropriate. Likewise, the indemnification asset is not recognized at the acquisition date, and is subsequently accounted for under other applicable GAAP, including ASC Topic 450, as appropriate. In these circumstances, we also believe the indemnification asset should be recognized and measured at the same time and on the same basis as the indemnified item, subject to any contractual limitations

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on the amount of the indemnification and the need for a valuation allowance for uncollectible amounts.

12.009a An acquisition agreement may require a portion of the consideration transferred to be placed in an escrow account to allow the acquirer to make indemnification claims against the former shareholders of the acquiree and retrieve the funds if the acquiree fails to meet the terms of the agreement. If so, the funds placed into escrow are treated as part of the consideration transferred, and the acquirer recognizes assumed contingencies and related indemnification assets as described in Section 7. Funds released from the escrow account to the acquirer would be recorded as a reduction in a related indemnification asset, if any, or otherwise as a reduction to purchase consideration if they are released because of facts and circumstances that existed as of the acquisition date. A release of escrow to the acquirer related to anything other than a specific indemnification provided in the purchase agreement (e.g., a dispute or litigation over false or misleading representations) may need to be accounted for outside of the business combination (see Paragraphs 12.033 and 12.034 for additional details). In addition, see Paragraph 6.020b for discussion of consideration held in escrow for general representations and warranties.

12.010 Examples 12.2 through 12.3 illustrate the subsequent accounting for indemnification assets that were initially recognized at the acquisition date (other than those covered by ASC paragraph 805-20-35-4B). Example 12.4 illustrates the subsequent accounting for indemnification assets covered by ASC paragraph 805-20-35-4B.

Example 12.2: Subsequent Accounting for Indemnification Asset When Estimated Collectibility Changes

ABC Corp. has been fully indemnified for a liability arising from a contingency assumed in the acquisition of DEF Corp. The liability recognized at the acquisition date was $10 million. Because of management's collectibility assessment, ABC measured the indemnification asset at the acquisition date at $9 million.

Subsequent to the acquisition, the carrying amount of the liability remains at $10 million. However, the concerns about the collectibility of the indemnification asset no longer exist (due to events following the acquisition).

Because there are no longer concerns about the collectibility of the indemnification asset, ABC would reverse the valuation allowance. Because the change in estimated collectibility resulted from events that occurred after the acquisition date, the change in the valuation allowance would be recognized in earnings.

Example 12.3: Subsequent Accounting for an Indemnification Asset When the Amount of the Related Indemnified Liability Decreases and the Fair Value of the Assets Securing the Indemnification also Decreases

ABC Corp. was fully indemnified for a liability arising from a contingency that was assumed in the acquisition of DEF Corp. The liability recognized at the acquisition

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date was $10 million. ABC also recognized an indemnification asset of $10 million at the acquisition date. The indemnification is secured by, and limited to, collateral held in escrow, and the initial fair value of the collateral was $10 million.

Following the acquisition, ABC obtains new information and measures the liability at $6 million. The fair value of the escrowed assets (e.g., ABC shares included in the consideration transferred for the acquisition of DEF) has subsequently declined to $4.5 million.

In this case, the liability would be measured at $6 million and ABC would reduce the indemnification asset to $6 million. However, the carrying amount of the indemnification asset would be reduced by a valuation allowance of $1.5 million, with a corresponding charge against current earnings, due to the decline in fair value of the assets that collateralize the indemnification.

DERECOGNITION OF INDEMNIFICATION ASSETS

12.011 Consistent with the derecognition of the related asset or liability recognized at the acquisition date, ASC paragraphs 805-20-35-4 and 40-3 specify that the acquirer derecognizes an indemnification asset only when it collects the asset, sells it, or otherwise loses the right to it.

12.012 If the amounts recognized by an acquirer for an indemnified liability and a related indemnification asset recognized at the acquisition date do not change subsequent to the acquisition and are ultimately settled at the amounts recognized in the acquisition accounting, there would be no effect on the statement of income. However, if either or both of the recognized amounts change subsequent to the acquisition, either because of new information or ultimate settlement, and the indemnified liability relates to an expense, we believe there would be an effect on the income statement, even if both the indemnified liability and the related indemnification asset change by equal and offsetting amounts. In such situations, we believe the acquirer should present the effect on the income statement on a *gross*, rather than a *net* basis.

12.013 For example, if an acquirer has been indemnified for losses from a specific litigation matter, and a liability and an indemnification asset were recognized at the acquisition date in the amount of $5 million, and both the liability and the indemnification asset are subsequently increased to $9 million because new information was obtained following the acquisition date, we believe the income statement generally should be presented gross and reflect a $4 million charge related to the recognized increase in the liability, and a $4 million credit related to the recognized increase in the indemnification asset. Both the charge and the credit should be classified in accordance with other applicable GAAP (e.g., ASC Section 220-20-45 and EITF Issue No. 01-10, "Accounting for the Impact of the Terrorist Attacks of September 11, 2001"), which could, in certain circumstances, be classified in the same income statement line item.

12.013a If either or both of the amounts recognized by an acquirer for an indemnified liability and a related indemnification asset at the acquisition date change subsequent to

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the acquisition, either because of new information or ultimate settlement, and the indemnification relates to the cost of a capital asset, we believe the change would not be recorded through the income statement given the indemnified item is a capital asset, and there would be no expense in the absence of an indemnification arrangement.

12.013b For example, in 20X3, ABC Corp. acquired a business from XYZ Corp. The property on which the business operates was subject to environmental review by the state. In the purchase agreement, XYZ agreed to indemnify ABC for environmental remediation costs exceeding $7 million. In 20X5, ABC received a final ruling from the state that the environmental issue could be addressed by ABC constructing a new waste water treatment plant on the site. ABC constructed the plant in 20X5 at a cost of $10 million, and submitted a claim to XYZ for reimbursement of $3 million. Upon meeting the probable and reasonably estimable criteria for recognition in 20X5, ABC recorded the cost of the waste water treatment plant asset of $7 million, an indemnification asset of $3 million and recognized the construction cost of $10 million. During 20X6, XYZ challenged ABC's management of the construction costs and ABC agreed to settle for a $2 million reimbursement. As a result, ABC increased its cost basis in the water treatment plant by $1 million and decreased the indemnification asset by $1 million. We believe no effect on the income statement (assuming there is no impairment of the related asset) is recognized when the indemnified item is a capital asset, and there would be no expense in the absence of an indemnification arrangement, only a higher cost basis in the asset. Therefore, it is appropriate for any change to the measurement of the indemnification asset, even when recorded subsequent to the measurement period, to be offset against the cost basis in the capital asset with no income statement effect, as the construction of a capital asset does not represent an expense. We believe this conclusion is further supported by the principles described in paragraphs B301 to B303 of Statement 141R. In the guidance for indemnification assets, the Board made certain exceptions to the acquisition date recognition and fair value measurement provisions of the accounting for business combinations to permit entities to prevent *recognition or measurement anomalies.*

12.014 Another example is the ultimate settlement of an indemnified tax uncertainty at an amount other than the amount recognized at the acquisition date, as illustrated in Example 12.4.

Example 12.4: Subsequent Settlement of an Indemnified Tax Uncertainty at Less Than the Liability and Related Indemnification Asset Recognized at the Acquisition Date

ABC Corp. acquired DEF Corp. in a business combination on April 30, 20X8. In accounting for the acquisition, ABC recognized a $10 million liability at the acquisition date related to an uncertain tax position of DEF, measured in accordance with FIN 48 (ASC Subtopic 740-10). ABC was fully indemnified for any liability resulting from the ultimate resolution of the tax uncertainty, and there were no

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concerns about the collectibility of the indemnification. Thus, ABC also recognized an indemnification asset of $10 million at the acquisition date.

There were no changes in the amounts recognized by ABC with respect to either the liability for the uncertain tax position or the indemnification asset until September 30, 20X9, when the liability for the uncertain tax position was effectively settled (ASC paragraphs 740-10-25-10 through 25-11), with no payment being required by ABC (note that for illustrative purposes, the accrual of interest and penalties, if any, related to the tax uncertainty are ignored in this example). As a result, ABC derecognized the $10 million liability it recognized at the acquisition date on September 30, 20X9, with an offsetting credit to income tax expense in accordance with ASC Subtopic 740-10.

ABC also derecognized the indemnification asset of $10 million at September 30, 20X9. However, the offsetting charge to the income statement would not be to income tax expense, but rather would be classified as an expense based on other applicable GAAP.

DEFENSIVE INTANGIBLE ASSETS

ASC Paragraph 805-20-30-6

To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the nonfinancial asset in accordance with [ASC] Subtopic 820-10 assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

12.015 A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as defensive intangible assets or locked-up assets. In accordance with ASC Topic 805, an acquirer would recognize and measure all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Subtopic 820-10. This has led to questions as to how defensive intangible assets should be accounted for subsequent to their acquisition. The EITF considered and reached a consensus on this issue, which is contained in ASC paragraphs 350-30-15-15, 25-5, 35-5A through 35-5B, 55-1, 55-1B, and 55-28H through 55-28L.

DEFENSIVE ASSETS USED IN IPR&D ACTIVITIES

12.016 The EITF's conclusions require that intangible assets acquired in a business combination that are used in research and development activities (regardless of whether

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they have an alternative future use) are accounted for in accordance with ASC paragraph 350-30-35-17A, which provides that:

> **ASC Paragraph 350-30-35-17A**
>
> Intangible assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered *indefinite lived* until the completion or abandonment of the associated research and development efforts. During the period those assets are considered indefinite lived they shall not be amortized but shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in [ASC] Section [350-30-35]. Consistent with the guidance in [ASC] paragraph 360-10-35-49, intangible assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that have been temporarily idled shall not be accounted for as if abandoned.

12.017 Thus, when intangible IPR&D assets are acquired in a business combination, they are considered to be indefinite lived until completion or abandonment of the associated research and development efforts, and are not amortized during the period of development. Additional research and development costs incurred subsequent to the acquisition of the IPR&D asset are expensed as incurred, in accordance with *ASC Subtopic 730-10, Research and Development - Overall.* Once the development effort is completed, the useful life of the asset is determined based on the guidance in ASC paragraph 350-30-35-3, and the IPR&D asset recognized in the acquisition accounting is amortized over its estimated useful life. Additionally, the acquirer performs a final impairment test under the indefinite-lived intangible asset model in accordance with ASC paragraph 350-30-35-18 immediately prior to reclassifying the asset to definite-lived. If the development effort is abandoned, and the IPR&D has no future alternative use, the IPR&D asset is written off. During the development period, the IPR&D asset is tested for impairment.

12.018 When an IPR&D asset is intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. For instance, if the IPR&D asset is acquired in a business combination to protect an existing, ongoing R&D project of the acquirer, the acquired IPR&D asset should be measured at its acquisition-date fair value and considered an indefinite-lived intangible asset until the completion or abandonment of the existing R&D project of the acquirer. Upon completion or abandonment of the acquirer's existing R&D project, the IPR&D asset's useful life would be determined in accordance with the guidance in ASC paragraph 350-30-35-3. Alternatively, if the IPR&D asset is acquired in a business combination to defend an existing, completed product of the acquirer, and further development of the acquired IPR&D asset is not planned, its useful life is determined, and the asset would be amortized over that period, consistent with the guidance in ASC

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paragraphs 350-30-35-6 through 35-13. The determination of the useful life of an IPR&D asset to be used for defensive purposes will require the exercise of judgment. The assumptions used in determining the useful life and the amortization methodology of an IPR&D asset should be consistent with the assumptions used in determining its fair value. See the discussion of the determination of fair value of IPR&D assets in Section 17.

OTHER DEFENSIVE INTANGIBLE ASSETS

12.019 ASC Subtopic 350-30 provides the following guidance for defensive intangible assets:

- The determination of whether an acquired intangible is a defensive intangible asset is based on the intentions of the acquirer. That determination may change as the acquirer's intentions change. For example, an intangible asset that was accounted for as a defensive intangible asset on the acquisition date will cease to be a defensive asset if the acquirer subsequently decides to actively use the asset.
- A defensive intangible asset should be accounted for as a separate unit of accounting. It should not be included as part of the acquirer's cost of an existing intangible asset, because the defensive intangible asset is separately identifiable.
- A defensive intangible asset should be assigned a useful life in accordance with ASC paragraphs 350-30-35-3. The useful life should reflect the acquirer's consumption of the expected benefits related to that asset (i.e., the benefit a reporting entity receives from holding a defensive intangible asset in the form of direct and indirect cash flows resulting from the prevention of others from realizing any value from the intangible asset (defensively or otherwise).
- It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors.
- If an intangible asset meets the definition of a defensive intangible asset, it cannot be considered immediately abandoned.

12.020 The following example, taken from ASC paragraph 350-30-55-28H, illustrates the determination of whether an intangible asset is within its scope.

Example 12.5: Acquired Trade Name the Acquirer Intends to Hold for Defensive Purposes

ABC Corp., a consumer products manufacturer, acquires an entity that sells a product that competes with one of ABC's existing products. ABC plans to discontinue the sale of the competing product within the next six months, but will maintain the rights to the

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trade name, at minimal expected cost, to prevent a competitor from using the trade name. As a result, ABC's existing product is expected to experience an increase in market share. ABC does not have any current plans to reintroduce the acquired trade name in the future.

Analysis. Because ABC does not intend to actively use the acquired trade name, but intends to hold the rights to the trade name to prevent others from using it, the trade name meets the definition of a defensive intangible asset.

CONTINGENT CONSIDERATION

ASC Paragraph 805-30-35-1

Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with [ASC] paragraphs 805-10-25-13 through 25-18 and [ASC] Section 805-10-30. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which [ASC] Topic 815 requires the changes to be initially recognized in other comprehensive income.

ASC Paragraph 805-30-35-1A

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in [ASC paragraph 805-30-35-1].

12.021 Contingent consideration is initially recognized by an acquirer at the acquisition date as part of the consideration transferred, measured at its acquisition-date fair value. See the discussion of *Contingent Consideration* in Section 6, and the discussion of determining the fair value of contingent consideration issued in a business combination in Section 18.

12.022 Changes in the fair value of contingent consideration initially recognized that result from additional information about facts and circumstances that existed at the acquisition date that the acquirer obtains during the measurement period are measurement

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period adjustments. Those changes are recognized as adjustments to the amount provisionally recognized as of the acquisition date, and therefore are adjustments to the acquisition accounting. See the discussion of *Adjustments to Provisional Amounts during the Measurement Period* in Section 10.

12.022a Contingent consideration arrangements could be altered in certain instances, such as disputes over the terms of the arrangement or changes in the terms. We believe that any adjustment due to disputes over the terms of a contingent consideration arrangement should be recognized in current earnings, unless there is a clear and direct link to the consideration transferred based on facts and circumstances that existed as of the acquisition date. If a clear and direct link is established between the dispute and the amount of consideration transferred, the consideration transferred is adjusted. See discussion of clear and direct link at Paragraph 12.033. Any additional consideration transferred to the selling shareholders due to litigation over the value of the consideration transferred should be expensed unless the settlement occurs during the measurement period and meets the clear and direct link criteria. Any post-acquisition change to the contingent consideration terms is accounted for separately from the business combination.

SUBSEQUENT MEASUREMENT OF CONTINGENT CONSIDERATION

12.023 The accounting for changes in fair value of contingent consideration after the acquisition date, other than measurement period adjustments, depends on whether the contingent consideration is classified as equity (equity-classified) or a liability (liability-classified). The classification is reassessed at each reporting period. Contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity. Contingent consideration that is liability-classified (or in some instances asset-classified), including pre-existing contingent consideration arrangements of the acquiree, is remeasured to fair value at each reporting date until the contingency is resolved, with the change in fair value recognized in earnings. We believe that changes in fair value are generally recognized in operating income (expense) when such a caption is presented (otherwise recorded in earnings), unless the arrangement is a hedging instrument in a cash flow hedge for which ASC Topic 815 requires the changes to be initially recognized in other comprehensive income. However, we have observed diversity in practice with some entities presenting the amounts as a nonoperating item. For guidance on presenting contingent consideration in the statement of cash flows, see chapter 18 of KPMG Handbook, Statement of cash flows.

Subsequent Measurement of Equity-Classified Contingent Consideration

12.024 An acquirer does not remeasure contingent consideration classified as equity and its subsequent settlement is accounted for within equity. Each reporting period, the acquirer reassesses the classification of contingent consideration based on the

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classification of the underlying instrument. Along with the other criteria in ASC Section 815-40-25, an instrument continues to be equity classified if:

(a) Currently authorized, but unissued shares less the maximum number of shares that could be required to settle the existing commitments that may require the issuance of stock during the length of the contingent consideration are greater than the

(b) Maximum number of shares required to be delivered under the contingent consideration.

If these criteria are no longer met by the underlying instrument, the contingent consideration is remeasured at fair value with the change recognized as an adjustment to stockholders' equity and the underlying instrument is reclassified to a liability.

Subsequent Measurement of Liability-Classified Contingent Consideration

12.025 The FASB concluded that an acquirer should account for all liabilities for contingent payments (including contingent consideration) similarly, and should remeasure such liabilities at fair value after the acquisition date until settled. An acquirer recognizes such changes in fair value in earnings as they occur (unless the changes result from measurement period adjustments, or the contingent consideration has been used as a hedging instrument in a cash flow hedge as discussed in Paragraph 12.023). An acquirer should classify changes in fair value resulting from (1) the passage of time (i.e., accretion expense) and (2) revisions to the amount or timing of the initial measurement of the contingent consideration in the same line item (see Paragraph 12.023). The amounts related to the passage of time should not be presented as interest income or expense.

12.026 Many obligations for contingent consideration that qualify for classification as liabilities meet the definition of a derivative instrument in ASC Topic 815, *Derivatives and Hedging.* However, before issuance of ASC Topic 805, contingent consideration issued in a business combination was excluded from the scope of ASC Topic 815. In deliberating ASC Topic 805, the FASB concluded that all contracts that would otherwise be within the scope of ASC Topic 815 (if not issued in a business combination) should be subject to the requirements of ASC Topic 815. As a result, liabilities for contingent consideration arising from a business combination that are subject to the requirements of ASC Topic 815, are subsequently measured at fair value, with changes in fair value recognized in earnings, unless the arrangement is a hedging instrument in a cash flow hedge for which ASC Topic 815 requires the changes to be initially recognized in other comprehensive income. We are not aware of situations where contingent consideration has been used as a hedging instrument, and expect that any situations where this might apply will be rare.

12.026a The classification of contingent consideration is reassessed each reporting period to assess potential changes to the classification of the underlying instrument. On the date the underlying instrument is reclassified to equity, the contingent consideration is remeasured at fair value with the gain or loss recognized in earnings immediately before

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the underlying instrument is reclassified to equity. Previously recorded fair value adjustments on liability classified contingent consideration are not reversed.

Example 12.5a: Attribution of Changes in a Contingent Consideration Liability to a Noncontrolling Interest

ABC purchased a 70% controlling interest in Entity X in a business combination for an initial cash payment of $1,000 plus $500 to be paid to Seller on the achievement of a future research and development milestone. Assume the contingent payment is liability-classified contingent consideration with an acquisition date fair value of $400 and that the fair value of the noncontrolling interest (NCI) is $600 (for simplicity disregard the effects of any control premium). At the date of acquisition ABC records the following:

Net assets	2,000	
Cash		1,000
Contingent consideration liability		400
NCI		600

In the period following the acquisition, the milestone is achieved and ABC pays $500 to Seller. ABC records the following:

Contingent consideration liability	400	
Operating expense	100	
Cash		500

As the contingent consideration relates to the agreement between ABC and Seller rather than the income (loss) of Entity X, none of the expense related to the change in the liability would be attributed to the noncontrolling interest (i.e., it is entirely attributed to the parent). See Chapter 15, *Noncontrolling Interests in Consolidated Financial Statements,* for further details on attributing net income or loss between the parent and NCI.

CONTINGENTLY ISSUABLE DEBT

12.027 An acquisition agreement in a business combination may provide for the issuance of additional consideration in the form of notes, with interest payable during the contingency period to an escrow agent who holds the notes. ASC Topic 805 requires that an acquirer initially measure and recognize all contingent consideration, including contingently issuable debt, at its acquisition-date fair value and include the amount so determined in the consideration transferred to effect the acquisition. The initial fair value measurement would include consideration of all appropriate information, including any difference between the stated rate and market rate of interest on the contingently issuable debt. Because the note instruments would be liability-classified contingent consideration, an acquirer would remeasure the notes to fair value at each reporting date until the contingency is resolved, and recognize the changes in fair value in earnings. Such increases or decreases would include the effect of the accrual of interest and all other

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changes affecting the fair value measurement, including (but not limited to) any changes in fair value arising from changes in the appropriate market interest rate and changes in the estimate of the amount of the contingently issuable consideration that will ultimately be issued.

12.028 An acquirer may also be obligated to make payments of interest on the contingently issuable debt into an escrow account. In those situations, an intangible asset (or liability) would be recognized at the acquisition date, in an amount equal to the fair value derived from the difference, if any, between the interest rate that will be earned on the amounts paid into escrow and the interest rate a market participant would expect to earn on the amounts paid into escrow during the period of the contingency. The intangible asset (or liability) would be accreted to interest income such that, along with the interest earned on the escrowed funds, the acquirer would recognize interest income on the escrowed funds at the market rate determined as of the acquisition date. Amounts paid into escrow, and any interest earned thereon, would be recognized by the acquirer as a deposit throughout the period of the contingency and would ultimately be eliminated when the amount in escrow is either transferred to the seller as a part of payment of the recognized liability for the contingently issuable debt or returned to the acquirer in cash.

OTHER APPLICABLE GAAP

12.029 As previously noted, an acquirer would subsequently account for most of the assets acquired, liabilities assumed or incurred, and equity instruments issued in an acquisition, in accordance with other applicable GAAP. ASC paragraphs 805-20-35-5, 35-7, 35-8 and 805-30-35-2 and 35-3 provide the following examples of other relevant GAAP that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination:

(a) ASC paragraph 350-30-15-4 prescribes the accounting for goodwill and identifiable intangible assets acquired in a business combination, including:

  (1) Recognition of intangible assets used in research and development activities, regardless of whether those assets have an alternative future use

  (2) Classification of research and development intangible assets as indefinite-lived until the completion or abandonment of the associated research and development efforts.

(b) ASC Topic 944, *Financial Services—Insurance,* provides guidance on the subsequent accounting for an insurance or reinsurance contract acquired in a business combination.

(c) ASC Topic 740 prescribes the subsequent accounting for deferred tax assets (including valuation allowances) and liabilities acquired in a business combination.

(d) ASC Topic 718 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that is attributable to grantees' future services.

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(e) ASC Topic 810 provides guidance on accounting for changes in a parent's ownership interest in a subsidiary after control is obtained.

Example 12.5b: Subsequent Accounting for a Liability for an Unfavorable Executory (Revenue) Contract

The following facts apply to all 4 scenarios presented below.

ABC Company (ABC) acquires XYZ Corporation in a business combination. Before the acquisition, XYZ entered into a non-cancellable executory contract with a customer to supply parts at fixed prices. At the time of the acquisition by ABC, the rates were below market (i.e., ABC assumed an unfavorable contract). ABC recognized a liability on the balance sheet for the below market component of the contract.

Scenario 1

The contract requires delivery of a fixed number of parts. Subsequent to the acquisition of XYZ, ABC and the customer modify the contract to reduce the number of parts ABC will deliver under the contract.

ABC should account for the change prospectively as a change in estimate. ABC should revise its per-part allocation of the liability at the date of the modification by dividing the remaining balance over the revised number of parts to be delivered at the date of the modification. It would not be appropriate for ABC to make a one-time adjustment to reduce the liability as a result of the change in the number of units to be delivered.

Scenario 2

The contract does not specify the number of parts to be delivered. At the date of the XYZ acquisition, ABC expected XYZ to deliver 80,000 parts over the remainder of the contract. Subsequent to the acquisition, the customer notifies ABC that it will order only 10,000 more parts because it plans to discontinue the product of which XYZ's parts are a component.

Similar to Scenario 1, ABC should account for the change in the estimate of the number of parts to be delivered prospectively by reallocating the remaining liability balance to the remaining parts. ABC should not derecognize a portion of the liability to retain its original estimated per-part allocation of the liability.

Scenario 3

As a result of cost reductions from synergies with its own operations, the contract becomes more profitable to ABC.

The cost savings realized after the acquisition are an economic event that occurred after the acquisition, and therefore ABC should not adjust the liability as a result of this

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event. ABC continues to allocate the liability for the unfavorable contract to the parts based on its original allocation.

Scenario 4

Subsequent to ABC's acquisition of XYZ, the selling prices of similar parts in the marketplace have decreased, such that the contract is now priced at market and no longer unfavorable to ABC.

Similar to Scenario 3, the increase in market price is an economic event that occurred after the acquisition, and therefore ABC should not adjust the liability as a result of this event. ABC continues to allocate the liability for the unfavorable contract to the remaining parts based on its original allocation.

CONSISTENCY OF ACCOUNTING POLICIES

12.030 Accounting policies of the acquiree should be conformed to those of the acquirer after a business combination. Dissimilar operations, assets, or transactions may be a basis for different accounting policies. Alternatively, the acquirer may change its accounting policies to conform to those of the acquiree, which would be considered a change in accounting principle, permitted only if the acquirer can justify use of an allowable alternative accounting principle that is preferable under ASC Subtopic 250-10, *Accounting Changes and Error Corrections - Overall.* If the accounting acquirer does not have an established policy in relation to the asset acquired or liability assumed, in our view, the acquirer and acquiree can apply any accounting policy that is acceptable under U.S. GAAP, including one that is different from what the acquiree had applied. In this scenario, the acquirer would not need to consider whether the accounting policy is preferable as compared to the accounting policy previously applied by the acquiree.

ERROR DISCOVERED AFTER A BUSINESS COMBINATION

12.031 Material errors in the acquiree's financial statements may be discovered subsequent to a business combination. In some situations, if the acquirer had known about the errors at the time of the acquisition, it would have affected the consideration transferred (e.g., where the consideration was determined based on the acquiree's pre-combination financial statements). However, if the consideration would have changed but there is no actual adjustment of the consideration paid by the buyer to the seller as a result of the subsequent identification of the error, there can be no adjustment to the acquisition accounting. Therefore, any change in assets or liabilities resulting from the correction of the error would be recognized in earnings in the acquirer's post-combination financial statements. Alternatively, if it is determined that the nature of the

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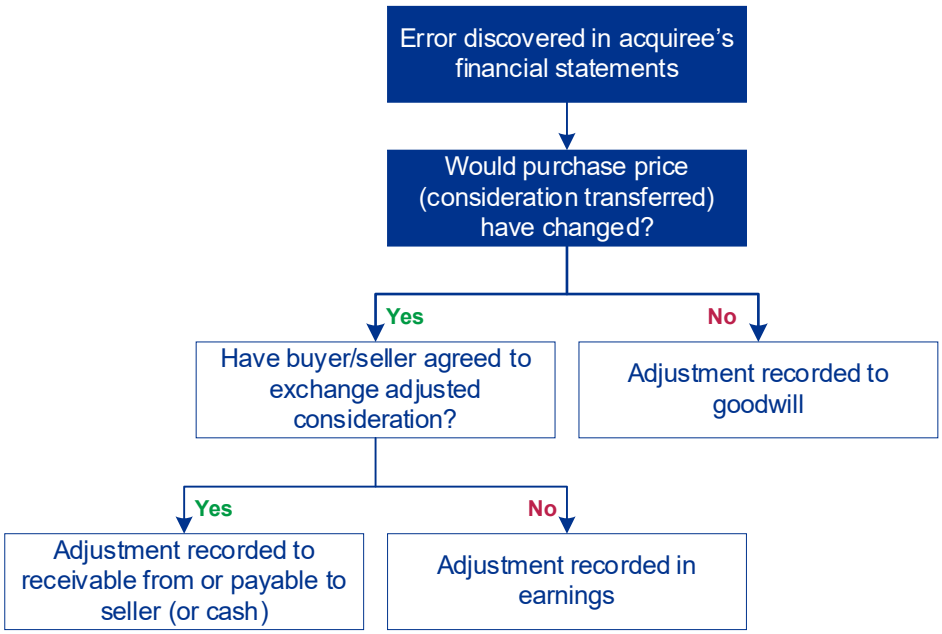
errors discovered would not have affected the consideration transferred, the adjustment would generally be recorded to goodwill.

12.032 These scenarios described in the preceding paragraph are presented in the following decision tree.



Example 12.6: Subsequent Discovery of Errors in Acquiree's Financial Statements

Scenario 1. Company A acquires Target for $100 million on October 31, 20X0. The acquisition agreement provides for a working capital adjustment with a provision for arbitration in the event of a dispute. Four months after the acquisition, Company A determines that Target has failed to accrue a $10 million liability owed to a regulatory authority. This liability was not discovered during Company A's due diligence process. Company A believes that the definition of a liability was met at the acquisition date. The former owner of Target (Seller) refuses to reimburse Company A for the liability and the amount is in dispute. The dispute will be resolved through arbitration per the acquisition agreement.

Company A would record the liability with the corresponding debit to expense rather than to goodwill. The amount in dispute does not represent an asset to Company A. Because Company A would have adjusted the consideration paid had it known about the liability, it cannot record the debit as goodwill even though the amount was discovered during the measurement period. Stated differently, had Company A known about the liability, it would have paid less for Target resulting in the same amount of goodwill as is currently recorded (in essence, the reduction of the consideration paid would have been offset by the liability). The fact that the agreement provided for a

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working capital adjustment does not automatically mean that an adjustment to goodwill is appropriate. If both parties had agreed to an adjustment to working capital, Company A would have recorded a receivable from Seller rather than an adjustment to goodwill. In this example, if Company A were to record the debit as a receivable, it likely would need to record a full valuation allowance through earnings because the amount is in dispute. If Company A subsequently receives a settlement from Seller when the dispute is resolved, the amount would be recorded as a gain in the income statement through the same line item as the expense was recorded in the earlier period.

Scenario 2. DEF Corp. acquires Target in a business combination. The terms of the acquisition agreement require DEF to pay $200 million and do not address potential adjustments to the consideration related to Target's working capital. After finalizing Target's acquisition-date balances, DEF identified an inventory cut-off error that existed at the acquisition date and resulted in a $3 million overstatement of inventory. DEF can demonstrate that the acquisition of Target was important to its future strategic plans and the consideration would have been $200 million regardless of the amount of working capital of Target on the acquisition date. DEF has not filed a claim against Seller for the difference in balances.

DEF should record the adjustment to reduce inventory as an increase to goodwill.

12.033 With respect to litigation over the purchase price, an SEC staff speech noted that contingencies that arise from the dispute and related litigation are not preacquisition contingencies that would be recognized in the acquisition accounting. The staff has only accepted settlement of the litigation over the purchase price as being an adjustment to the consideration transferred in situations where there is a clear and direct link to the consideration transferred such as when the litigation is seeking enforcement of an escrow arrangement that specifies a minimum amount of working capital in the acquired business, which may establish a clear and direct link to the consideration transferred.

12.034 Often the litigation is complicated by claims involving misrepresentation and other assertions by the claimants. In such cases, the acquirer would need to be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the consideration transferred otherwise, subsequent adjustments would be recognized in current earnings. The SEC staff speech notes that in situations where the initial determination of the fair value of the acquired assets and liabilities is incorrect (such as the situation in Scenario 1 above) any adjustment generally would not be reflected as an adjustment to the acquisition accounting. Similarly, claims that one party mislead the other or disputes about the meaning of certain language in the acquisition agreement are not unique to business combinations and therefore such settlements normally would be recognized in current earnings.

Example 12.7: Litigation with Dissenting Shareholders

Company A, a private-equity firm, acquired Target on September 30, 20X0 for $2 billion in cash, or $167 a share, and simultaneously took Target private. A minority number of Target's shareholders dissented to the acquisition and brought litigation

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against Company A to obtain additional consideration for their shares in Target. Under the applicable state law, court judgments of fair value are subject to interest at 5% above the Federal Reserve discount rate of 1.75%, which accrues from the date of the merger through the date of payment of the judgment.

On November 30, 20X0, the court ruled in favor of the dissenting shareholders and awarded them $170 per share. Company A paid this amount on December 15, 20X0, plus interest of $2 per share in accordance with state law. Although one may view the incremental consideration as an additional cost in acquiring Target, the SEC staff has taken the position that the additional consideration of $3 per share ($170 - $167) paid to the dissenting former shareholders of Target is an expense in Company A's post-combination financial statements. Additionally, the related interest of $2 per share paid on December 15, 20X0 is also charged as an expense in Company A's post-combination financial statements. Associated legal costs are charged to expense by Company A as incurred.

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Section 13 - Disclosures

Detailed Contents

Business Combinations Completed during the Reporting Period, or after the Reporting Period but before Issuance of the Acquirer's Financial Statements
- General Information about the Acquisition Transaction
- Consideration Transferred
- Contingent Consideration Arrangements and Indemnification Assets
- Certain Acquired Receivables
- Assets Acquired and Liabilities Assumed
- Contract Assets and Contract Liabilities
- Goodwill
- Bargain Purchases
- Equity Interest Not Acquired (Noncontrolling Interest)
- Business Combinations Achieved in Stages (Step Acquisitions)
- Separately Accounted for Transactions, Including Preexisting Relationships

Additional Disclosures for Public Entities
- Impracticability
- Acquiree Revenue and Earnings Since Acquisition
- Supplemental Pro Forma Information
- Interim Period Pro Forma Information
  - Q&A 13.1: Pro Forma Disclosures in Interim Periods
- Pro Forma Information Required to be Presented in Filings with the SEC
- Immaterial Business Combinations That Are Material in the Aggregate
- Business Combinations Completed after Reporting Date but before Issuance of the Financial Statements
- Disclosure of Adjustments Recognized during the Current Period
- Measurement Period Adjustments
- Contingent Consideration Adjustments
- Reconciliation of Changes in Goodwill during the Reporting Period

Additional Disclosures to Meet Disclosure Objectives

Example Disclosures
  - Example 13.1: Disclosure of a Material Business Combination in the Year of Acquisition, Completed During the Reporting Period

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13.000 ASC Topic 805, *Business Combinations,* outlines the acquirer's disclosure requirements in the context of two overall objectives, which are set out in ASC paragraphs 805-10-50-1 and 50-5. Disclosures should enable financial statement users to evaluate:

(1) The nature and financial effect of a business combination that occurs either during the current reporting period, or after the reporting date but before the financial statements are issued or are available to be issued (determined in accordance with ASC Section 855-10-25); and

(2) The financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

13.001 ASC paragraphs 805-10-50-2, 805-20-50-1, 50-4, 50-4A, and 50-5, 805-30-50-1 and 50-4 include a number of specific disclosure requirements, consistent with these objectives. However, if the disclosures required by ASC paragraphs 805-10-50-2 and 50-6 do not satisfy the overall disclosure objectives of ASC paragraphs 805-10-50-1 and 50-4, ASC paragraph 805-10-50-7 requires the acquirer to disclose whatever additional information is necessary to meet those objectives.

13.002 The disclosures are required for each material business combination during the periods presented. We believe this includes prior periods presented for comparative purposes. For individually immaterial business combinations that are material collectively, the disclosures required by ASC paragraphs 805-10-50-2(e) through 50-2(h), 805-20-50-1(a) through 50-1(e) and 805-30-50-1(a) through 50-1(f) are required in the aggregate. For business combinations occurring after the reporting date but before the financial statements of the acquirer are issued, the disclosures in ASC paragraph 805-10-50-2 are required unless the initial accounting for the business combination is incomplete at the date of issuance of the acquirer's financial statements. In such event, the acquirer is required to disclose the disclosures that could not be made, including the reason they could not be made.

13.003 Additionally, ASC paragraphs 270-10-50-5 and 50-7a note that the disclosure requirements of ASC Topic 805 are applicable to interim financial information.

13.004 Many of the disclosure requirements are illustrated in an example presented in ASC paragraphs 805-10-55-37 through 55-49. The disclosures presented are referenced to the specific disclosure requirements of ASC paragraph 805-10-50-4 that they illustrate. The entire example from ASC paragraphs 805-10-55-37 through 55-49 is presented in Paragraph 13.035.

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BUSINESS COMBINATIONS COMPLETED DURING THE REPORTING PERIOD, OR AFTER THE REPORTING PERIOD BUT BEFORE ISSUANCE OF THE ACQUIRER'S FINANCIAL STATEMENTS

ASC Paragraph 805-10-50-1

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a. During the current reporting period

b. After the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25).

ASC Paragraph 805-10-50-2

To meet the objective in [ASC] paragraph 805-10-50-1, the acquirer shall disclose the following information for each business combination that occurs during the reporting period: …[Information discussed below]

GENERAL INFORMATION ABOUT THE ACQUISITION TRANSACTION

ASC Paragraph 805-10-50-2(a) through 50-2(d)

a. The name and a description of the acquiree

b. The acquisition date

c. The percentage of voting equity interests acquired

d. The primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree

CONSIDERATION TRANSFERRED

ASC Paragraph 805-30-50-1(b)

b. The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as the following:

1. Cash

2. Other tangible or intangible assets, including a business or subsidiary of the acquirer

3. Liabilities incurred, for example, a liability for contingent consideration

4. Equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of determining the fair value of those instruments or interests.

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CONTINGENT CONSIDERATION ARRANGEMENTS AND INDEMNIFICATION ASSETS

ASC Paragraph 805-30-50-1(c)

c. For contingent consideration arrangements, all of the following:

1. The amount recognized as of the acquisition date

2. A description of the arrangement and the basis for determining the amount of the payment

3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

ASC Paragraph 805-20-50-1(a)

a. For indemnification assets, all of the following:

1. The amount recognized as of the acquisition date

2. A description of the arrangement and the basis for determining the amount of the payment

3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

CERTAIN ACQUIRED RECEIVABLES

ASC Paragraph 805-20-50-1(b)

b. For acquired receivables not subject to the requirements of [ASC] Subtopic 326-20 [Receivables - Credit Losses—Measured at Amortized Cost] relating to purchased financial assets with credit deterioration, all of the following:

1. The fair value of the receivables

2. The gross contractual amounts receivable

3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with [ASC] Subtopic 842-30 on leases—lessor, and any other class of receivables.

13.005 The above disclosure requirements about receivables acquired was developed to help in assessing considerations of credit quality included in the fair value measures to address concerns that without additional disclosures, it would be impossible to determine

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the contractual cash flows and the amount of the contractual cash flows not expected to be collected if receivables were recognized at fair value. Statement 141(R), par. B258

ASSETS ACQUIRED AND LIABILITIES ASSUMED

ASC Paragraph 805-20-50-1(c) and 50-1(d)

c. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed (see Example 5 [ASC paragraph 805-10-55-37]).

d. For contingencies, the following disclosures shall be included in the note that describes the business combination:

1. For assets and liabilities arising from contingencies recognized at the acquisition date:

i. The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with [ASC] Topic 450 and [ASC] Section 450-20-25)

ii. The nature of the contingencies.

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

2. For contingencies that are not recognized at the acquisition date, the disclosures required by [ASC] Topic 450 if the criteria for disclosures in that Topic are met.

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

CONTRACT ASSETS AND CONTRACT LIABILITIES

ASC Paragraph 805-20-50-5

For any of the practical expedients in paragraph 805-20-30-29 that an acquirer uses, the acquirer shall disclose all of the following information:

a. The expedients that have been used

b. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

GOODWILL

ASC Paragraph 805-30-50-1(a), 50-1(d), and 50-1(e)

a. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

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d. The total amount of goodwill that is expected to be deductible for tax purposes.

e. If the acquirer is required to disclose segment information in accordance with [ASC] Subtopic 280-10 [*Segment Reporting - Overall],* the amount of goodwill by reportable segment. If the assignment of goodwill to reporting units required by [ASC] paragraphs 350-20-35-41 through 35-44 has not been completed as of the date the financial statements are issued or are available to issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose that fact.

BARGAIN PURCHASES

ASC Paragraph 805-30-50-1(f)

f. In a bargain purchase (see [ASC] paragraphs 805-30-25-2 through 25-4), both of the following:

1. The amount of any gain recognized in accordance with [ASC] paragraph 805-30-25-2 and the line item in the income statement in which the gain is recognized

2. A description of the reasons why the transaction resulted in a gain.

EQUITY INTEREST NOT ACQUIRED (NONCONTROLLING INTEREST)

ASC Paragraph 805-20-50-1(e)

e. For each business combination in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date, both of the following:

1. The fair value of the noncontrolling interest in the acquiree at the acquisition date

2. The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest.

BUSINESS COMBINATIONS ACHIEVED IN STAGES (STEP ACQUISITIONS)

ASC Paragraph 805-10-50-2(g)

g. In a business combination achieved in stages, all of the following:

1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date

2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see [ASC] paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized

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3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination

4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

SEPARATELY ACCOUNTED FOR TRANSACTIONS, INCLUDING PREEXISTING RELATIONSHIPS

ASC Paragraph 805-10-50-2(e) and 50-2(f)

e. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination (see [ASC] paragraph 805-10-25-20), all of the following:

1. A description of each transaction

2. How the acquirer accounted for each transaction

3. The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized

4. If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.

f. The disclosure of separately recognized transactions required in [ASC paragraph 805-10-50-2](e) shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

ADDITIONAL DISCLOSURES FOR PUBLIC ENTITIES

13.006 ASC paragraph 805-10-50-2(h) requires additional disclosures for entities that meet the definition of a public entity as described in ASC Section 805-10-20:

A business entity or not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt 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).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

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c. It provides financial statements for the purpose of issuing any class of securities in a public market.

The additional disclosure requirements apply only to a public entity's financial statements, not to the financial statements of a subsidiary of a public entity. For example, if a subsidiary of a public entity acquires another entity in a business combination, the disclosure requirements in ASC paragraph 805-10-50-2(h) do not apply to the acquiring subsidiary's stand-alone financial statements if that subsidiary is not itself a public entity.

ASC Paragraph 805-10-50-2(h)

h. If the acquirer is *a public entity,* all of the following:

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.

2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year.

3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (*supplemental pro forma information).* For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings *(supplemental pro forma information).*

If disclosure of any of the information required by [ASC paragraph 805-10-50-2](h) is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. In this context, the term *impracticable* has the same meaning as in [ASC] paragraph 250-10-45-9.

IMPRACTICABILITY

13.007 Under ASC paragraphs 250-10-45-9 and 45-10, disclosure of the information required by ASC paragraph 805-10-50-2(h) would be deemed impracticable only if any of the following conditions exist:

(a) After making every reasonable effort to do so, the entity is unable to apply the requirement;

(b) Retrospective application requires assumptions about management’s intent in a prior period that cannot be independently sustained; or

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(c) Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that:

(1) Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and

(2) Would have been available when the financial statements for that prior period were issued.

ACQUIREE REVENUE AND EARNINGS SINCE ACQUISITION

13.008 The disclosure of revenue and earnings of the acquiree since the acquisition date is only required by a public entity for the annual reporting period that includes the acquisition date. (ASC paragraph 805-10-50-2(h)) For example, ABC Corp., a public entity, acquires DEF Corp. in 20X8, and the acquisition is material to ABC. ABC is required to disclose revenue and earnings of DEF included in ABC's consolidated income statement for the period from the acquisition date to the end of ABC's 20X8 fiscal year.

SUPPLEMENTAL PRO FORMA INFORMATION

13.009 ASC paragraph 805-10-50-2(h) specifies that when a public entity has a business combination that occurs during the current reporting period, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period when comparative information is provided (i.e., supplemental pro forma information). Comparable disclosures should be made if the acquisition date is after the reporting date but before the financial statements are issued or are available to be issued.

13.009a While ASC Topic 805 provides no further guidance as to the form, basis of presentation of the pro forma disclosures, or types of adjustments to be made to present the business combination as if it had occurred in the earliest comparative period presented, in practice, common adjustments to pro forma financial information include the following.

Adjustment	Example
Acquisition related costs	Legal fees Accounting and due diligence fees Valuation fees Other incremental consulting and advisory fees

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Adjustment	Example
Conforming accounting policies	Useful life of property, plant, & equipment (PP&E) ASC Topic 842 elections, such as lessees' recognition of right-of-use assets and lease liabilities for short-term leases and separation of lease and non-lease components Inventory cost method
Effects of fair value adjustments	Amortization of acquired intangibles Depreciation expense associated with fair value adjustment to acquired PP&E
Financing	Interest expense incurred for new debt raised to fund acquisition
Income taxes	Tax effects, if any, of the transaction

However, under ASC paragraph 805-10-50-2(h) entities should not reflect pro forma adjustments for indirect effects, such as synergies or dis-synergies.

13.010 The pro forma information required by ASC paragraphs 805-10-50-2(h)(2) to 50-2(h)(4) is not required to be audited. The auditor would, however, be required to perform the procedures prescribed by PCAOB AS 2705, *Required Supplementary Information.*

INTERIM PERIOD PRO FORMA INFORMATION

13.011 ASC paragraph 805-10-50-2(h) requires that pro forma financial information be provided for the current period and, if comparative financial statements are presented, for the comparable prior reporting period. This requirement applies to both annual and interim periods.

Q&A 13.1: Pro Forma Disclosures in Interim Periods

ABC Corp. acquired a significant business in November 20X8. ABC provided the pro forma disclosures required by ASC paragraph 805-10-50-2(h) in its annual financial statements for the year ended December 31, 20X8.

Q. Should ABC include pro forma financial information for the acquired business in its Form 10-Q filing for the quarter ended March 31, 20X9?

A. Yes. While the business combination did not occur in the current period, it is material to the first quarter results because the comparative interim period (first quarter of 20X8) did not include the acquired business. Therefore, we believe ABC should disclose pro forma information for the three months ended March 31, 20X8 in its March 31, 20X9 financial statements.

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ASC paragraph 805-10-50-2 does not specifically discuss the application of the pro forma disclosures to interim periods. However, the discussion in ASC paragraph 805-10-50-2 refers to the reporting period and is similar to the discussion previously found in paragraph 58 of FASB Statement No. 141, which stated that pro forma disclosure in an interim period is required "if a material business combination is completed during the current year."

PRO FORMA INFORMATION REQUIRED TO BE PRESENTED IN FILINGS WITH THE SEC

13.012 In addition to the disclosures for public entities required under ASC Topic 805, Article 11 (Article 8 for smaller reporting companies) of Regulation S-X sets forth the requirements for presentation of pro forma information by SEC registrants that are required when significant business combinations have occurred. The Article 11 pro forma information is not presented in the financial statements, and, when required to be presented, is supplemental to, and more extensive than, the information required by ASC Topic 805 to be disclosed in the notes to the financial statements. Refer to KPMG Handbook, SEC reporting for business combinations, for additional discussion of pro forma financial information requirements for SEC registrants under Article 11.

13.013 – 13.029 Paragraphs not used.

IMMATERIAL BUSINESS COMBINATIONS THAT ARE MATERIAL IN THE AGGREGATE

13.030 Disclosure for business combinations that are individually immaterial but material in the aggregate also are required. In particular, disclosure of the information specified in ASC paragraphs 805-10-50-2(e) through 50-2(h), 805-20-50-1(a) through 50-1(e), and 805-30-50-1(a) through 50-1(f) are required in the aggregate.

BUSINESS COMBINATIONS COMPLETED AFTER REPORTING DATE BUT BEFORE ISSUANCE OF THE FINANCIAL STATEMENTS

ASC Paragraph 805-10-50-4

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-10-50-2 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

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ASC Paragraph 805-20-50-3

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-20-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

ASC Paragraph 805-30-50-3

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in [ASC] Section 855-10-25), the acquirer shall disclose the information required by [ASC] paragraph 805-30-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

DISCLOSURE OF ADJUSTMENTS RECOGNIZED DURING THE CURRENT PERIOD

ASC Paragraph 805-10-50-5

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

MEASUREMENT PERIOD ADJUSTMENTS

ASC Paragraph 805-20-50-4A

If the initial accounting for a business combination is incomplete (see [ASC] paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively to meet the objective in [ASC] paragraph 805-10-50-5:

a. The reasons why the initial accounting is incomplete

b. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete

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c. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with [ASC] paragraph 805-10-25-17, including separately the amount of adjustment to current-period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement.

13.031 Measurement period adjustments are no longer applied retrospectively in the acquirer's financial statements. However, we believe that measurement period adjustments should continue to be reflected in the acquirer's pro forma disclosures on a retrospective basis. See additional discussion of measurement period disclosures starting at Paragraph 10.003.

CONTINGENT CONSIDERATION ADJUSTMENTS

ASC Paragraph 805-30-50-4

[ASC] paragraph 805-10-50-5 identifies the second objective of disclosures about the effects of business combinations that occurred in the current or previous periods. To meet the objective in that paragraph, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a. For each reporting period after the acquisition date until the entity collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires, all of the following:

1. Any changes in the recognized amounts, including any differences arising upon settlement

2. Any changes in the range of outcomes (undiscounted) and the reasons for those changes

3. The disclosures required by [ASC] Section 820-10-50….

RECONCILIATION OF CHANGES IN GOODWILL DURING THE REPORTING PERIOD

ASC paragraph 805-30-50-4(b)

b. A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by [ASC] paragraph 350-20-50-1. A private company or not-for-profit entity that adopts the accounting alternative for amortizing goodwill in Subtopic 350-20 is not required to disclose the reconciliation.

13.032 ASC paragraph 350-20-50-1 was amended by ASC Topic 805 to significantly expand the required disclosure of changes in goodwill during the reporting period. Under

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the amended guidance, an entity is required to provide a rollforward of goodwill reflecting:

- The gross amount of goodwill and the accumulated impairment losses at the beginning of the period
- Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale
- Goodwill included in a disposal group classified as held for sale and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale
- Adjustments resulting from the recognition of deferred tax assets during the period
- Impairment losses recognized during the period
- Net exchange differences arising during the period
- Any other changes in the carrying amounts during the period
- The gross amount of goodwill and accumulated impairment losses at the end of the period.

ASC paragraph 350-20-55-24 provides an example disclosure of the rollforward of goodwill.

13.033 The above disclosures are required for business combinations accounted for under ASC Topic 805. Disclosures about adjustments related to business combinations in which the acquisition date preceded the effective date of ASC Topic 805 are subject to the disclosure requirements under Statement 141.

ADDITIONAL DISCLOSURES TO MEET DISCLOSURE OBJECTIVES

> **ASC Paragraph 805-10-50-7**
>
> If the specific disclosures required by [ASC] Subtopic [805-10] and other generally accepted accounting principles (GAAP) do not meet the objectives set out in [ASC] paragraphs 805-10-50-1 and 805-10-50-5, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

13.034 The FASB concluded that it is not necessary or possible to identify all of the specific information that may be necessary to meet the disclosure objectives for all business combinations. Instead, the FASB decided to include the overall disclosure objectives stated in ASC paragraphs 805-10-50-1 and 50-5, and to specify particular disclosures that are generally required to meet the overall objectives. However, if the specific disclosures required by ASC Topic 805 and the disclosures required by other

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GAAP do not satisfy the overall disclosure objectives, the acquirer is required to disclose the additional information necessary to do so.

EXAMPLE DISCLOSURES

13.035 The following illustrative disclosures are taken from ASC paragraphs 805-10-55-37 through 55-49.

Example 13.1: Disclosure of a Material Business Combination in the Year of Acquisition, Completed During the Reporting Period

Note X: Acquisitions

Paragraph Reference		
ASC paragraphs 805-10-50-2(a) through 50-2(d)	On June 30, 20X0, AC acquired 15 percent of the outstanding common shares of TC. On June 30, 20X2, AC acquired 60 percent of the outstanding common shares of TC. TC is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, AC 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.	
ASC paragraphs 805-30-50-1(a) and 50-1(e)	The goodwill of $2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of AC and TC. All of the goodwill was assigned to AC's network segment.	
ASC paragraph 805-30-50-1(d)	None of the goodwill recognized is expected to be deductible for income tax purposes.	
	The following table summarizes the consideration paid for TC and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date of the noncontrolling interest in TC.	
	At June 30, 20X2	
		$
ASC paragraph 805-30-50-1(b)	**Consideration**	
ASC paragraph 805-30-50-1(b)(1)	Cash	5,000
ASC paragraph 805-30-50-1(b)(4)	Equity instruments (100,000 common shares of AC)	4,000
ASC paragraph 805-30-50-1(b)(3),	Contingent consideration arrangement	1,000

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ASC paragraph 805-30-50-1(c)		
	Fair value of total consideration transferred	10,000
ASC paragraph 805-10-50-2(g)(1)	**Fair value of AC's equity interest in TC held before the business combination**	2,000
		12,000
ASC paragraphs 805-10-50-2(e) and 50-2(f)	**Acquisition-related costs** (included in selling, general, and administrative expenses in AC's income statement for the year ending December 31, 20X2)	1,250
ASC paragraph 805-20-50-1(c)	**Recognized amounts of identifiable assets acquired and liabilities assumed**	
	Financial assets	3,500
	Inventory	1,000
	Property, plant, and equipment	10,000
	Identifiable intangible assets	3,300
	Financial liabilities	(4,000)
	Liability arising from a contingency	(1,000)
	Total identifiable net assets	12,800
ASC paragraph 805-20-50-1(e)(1)	**Noncontrolling interest in TC**	(3,300)
	Goodwill	2,500
		12,000

ASC paragraph 805-30-50-1(b)(4)

The fair value of the 100,000 common shares issued as part of the consideration paid for TC ($4,000) was determined on the basis of the closing market price of AC's common shares on the acquisition date.

ASC paragraphs 805-30-50-1(b)(3), 50-1(c), and ASC paragraph 805-10-50-4(a)

The contingent consideration arrangement requires AC to pay the former owners of TC 5 percent of the revenues of XC, an unconsolidated equity investment owned by TC, in excess of $7,500 for 20X3, up to a maximum amount of $2,500 (undiscounted). The potential undiscounted amount of all future payments that AC could be required to make under the contingent consideration arrangement is between $0 and $2,500. The fair value of the contingent consideration arrangement of $1,000 was estimated by applying the income approach. That measure is based on significant inputs that are not observable in the market,

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	which ASC Section 820-10-35 refers to as Level 3 inputs. Key assumptions include (a) a discount rate range of 20 percent to 25 percent and (b) a probability adjusted level of revenues in XC between $10,000 and $20,000. As of December 31, 20X2, the amount recognized for the contingent consideration arrangement, the range of outcomes, and the assumptions used to develop the estimates had not changed.
ASC paragraph 805-20-50-1(b)	The fair value of the financial assets acquired includes receivables under capital leases of data networking equipment with a fair value of $2,000. The gross amount due under the contracts is $3,100, of which $450 is expected to be uncollectible.
ASC paragraph 805-20-50-4A	The fair value of the acquired identifiable intangible assets of $3,300 is provisional pending receipt of the final valuations for those assets.
ASC paragraphs 805-20-50-1(d) and 50-5	A liability of $1,000 has been recognized for expected warranty claims on products sold by TC during the last 3 years. AC expects that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between $500 and $1,500. As of December 31, 20X2, there has been no change since June 30, 20X2, in the amount recognized for the liability or any change in the range of outcomes or assumptions used to develop the estimates.
ASC paragraph 805-20-50-1(e)	The fair value of the noncontrolling interest in TC, a private company, was estimated by applying the income approach and a market approach. This fair value measurement is based on significant inputs that are not observable in the market and thus represents a Level 3 measurement as defined in ASC Section 820-10-35. Key assumptions include (a) a discount rate range of 20 percent to 25 percent, (b) a terminal value based on a range of terminal EBITDA multiples between 3 and 5 (or, if appropriate, based on long-term sustainable growth rates ranging between 3 percent and 6 percent), (c) financial multiples of companies deemed to be similar to TC, and (d) adjustments because of the lack of control or lack of marketability that market participants

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	would consider when estimating the fair value of the noncontrolling interest in TC.		
ASC paragraph 805-10-50-2(g)(2)	AC recognized a gain of $500 as a result of remeasuring to fair value its 15 percent equity interest in TC held before the business combination. The gain is included in other income in AC's income statement for the year ending December 31, 20X2.		
ASC paragraph 805-10-50-2(h)	The amounts of TC's revenue and earnings included in AC's consolidated income statement for the year ended December 31, 20X2, and the revenue and earnings of the combined entity had the acquisition date been January 1, 20X2 (if comparative financial statements are not presented), or January 1, 20X1 (if comparative financial statements are presented), are:		
		Revenue	**Earnings**
ASC paragraph 805-10-50-2(h)(1)	Actual from 6/30/20X2–12/31/20X2	$4,090	$1,710
ASC paragraph 805-10-50-2(h)(2)	Supplemental pro forma from 1/1/20X2–12/31/20X2	$27,670	$12,870
ASC paragraph 805-10-50-2(h)(3)	Supplemental pro forma for 1/1/20X1–12/31/20X1	$26,985	$12,325

13.036 The disclosure example provided in ASC Topic 805 (shown above) does not include replacement awards or deferred taxes, both of which may be common elements of business combinations and would be included in the required disclosures. Therefore, this example should be seen as illustrative but does not address all possible items for which disclosure would be required.

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Section 14 - Effective Date and Transition

Detailed Contents

Effective Date

Transition

- Acquisitions Prior to the Effective Date of ASC Topic 805
- Income Taxes
- Acquisition-Related Costs Incurred in a Business Combination which Commenced Prior to, but Was Completed after, the Effective Date of ASC Topic 805
- Transition for Contingent Consideration from Acquisitions Prior to the Effective Date of ASC Subtopic 958-805

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EFFECTIVE DATE

Statement 141(R)

74. [ASC Topic 805] shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning after December 15, 2008. Early adoption is prohibited.

14.000 The effective date for ASC Topic 805, *Business Combinations,* means that, for calendar-year companies, the Topic was effective for 2009. The FASB concluded that this date would allow sufficient time for issuers to prepare for implementation of this Topic.

TRANSITION

ACQUISITIONS PRIOR TO THE EFFECTIVE DATE OF ASC TOPIC 805

Statement 141(R)

75. Assets and liabilities that arose from business combinations whose acquisition dates preceded the effective date of ASC Topic 805 shall not be adjusted upon application of this Topic.

14.001 The FASB concluded it would not be feasible to apply ASC Topic 805 retrospectively and, accordingly, specified its application only to acquisitions occurring on or after its effective date. The accounting for the assets and liabilities that arose from business combinations occurring prior to the effective date of ASC Topic 805 is not changed by issuance of ASC Topic 805, with the sole exception of changes after its effective date in the valuation allowance for acquired deferred tax assets and changes in acquired income tax uncertainties that arose from business combinations occurring prior to the Statement's effective date.

14.002 When an entity has acquired other entities (acquirees) both before and after the effective date of ASC Topic 805, there will sometimes be significant differences in the accounting for similar transactions or events related to those acquisitions that occur in subsequent periods. For example, significant differences could result in the accounting for changes in the measurement and the subsequent settlement of contingent consideration arrangements (see *Contingent Consideration* in Sections 6 and 12) and liabilities related to exit activities of the acquiree (see *Liabilities Associated with Restructuring or Exit Activities of the Acquiree* in Section 7). Some of these differences may not be eliminated for a prolonged period following the effective date of ASC Topic 805; for example, a contingent consideration arrangement entered into in connection with a business combination prior to the effective date of ASC Topic 805 will continue to be accounted for under FASB Statement No. 141, *Business Combinations,* and it could be several years after the effective date of ASC Topic 805 before the amount of payments required to settle the contingent consideration arrangement are finally determined and recognized by the acquirer.

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INCOME TAXES

Statement 141(R)

77. For business combinations in which the acquisition date was before the effective date of [ASC Topic], the acquirer shall apply the requirements of [ASC Topic 740], as amended by [ASC Topic 805], prospectively. That is, the acquirer shall not adjust the accounting for prior business combinations for previously recognized changes in acquired tax uncertainties or previously recognized changes in the valuation allowance for acquired deferred tax assets. However, after the effective date of [ASC Topic 805]:

a. The acquirer shall recognize, as an adjustment to income tax expense (or a direct adjustment to contributed capital in accordance with [ASC paragraph 740-10-45-20], changes in the valuation allowance for acquired deferred tax assets.

b. The acquirer shall recognize changes in the acquired income tax positions in accordance with [ASC Topic 740], as amended by [ASC Topic 805].

14.003 Thus, for acquired tax uncertainties and valuation allowances for acquired deferred tax assets arising from business combinations preceding the effective date of ASC Topic 805, the acquirer:

- Does not adjust the accounting for previously recognized changes in acquired tax uncertainties or the valuation allowance for deferred tax assets that were recognized prior to the effective date of ASC Topic 805;
- Recognizes changes in the valuation allowance for acquired deferred tax assets after the effective date of ASC Topic 805 as adjustments to income tax expense (or as a direct adjustment to contributed capital) in the same manner as those changes are recognized for business combinations that occur after the effective date of ASC Topic 805; and
- Recognizes changes in acquired tax uncertainties after the effective date of ASC Topic 805 as adjustments to income tax expense in the same manner as those changes are recognized for business combinations that occur after the effective date of ASC Topic 805.

See KPMG Handbook, Accounting for Income Taxes, Section 10 for a discussion of income tax considerations in a business combination.

ACQUISITION-RELATED COSTS INCURRED IN A BUSINESS COMBINATION WHICH COMMENCED PRIOR TO, BUT WAS COMPLETED AFTER, THE EFFECTIVE DATE OF ASC TOPIC 805

14.004 An entity may initiate a business combination before the effective date of ASC Topic 805 and incur acquisition-related costs. Because ASC Topic 805 prohibits early adoption, the entity would capitalize the acquisition-related costs for this type of business combination as required under Statement 141. However, ASC Topic 805 requires that an

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entity charge acquisition-related costs to expense as incurred. Thus, if an acquisition commences before the effective date of ASC Topic 805, but completion is not expected until after ASC Topic 805's effective date, a question arises as to how the acquisition costs incurred and capitalized before the effective date of ASC Topic 805 should be accounted for.

14.005 Based on discussions with the FASB and SEC staffs, we believe that any of the following three alternatives are acceptable methods to account for acquisition-related costs capitalized by an acquirer before the effective date of Statement 141(R) (ASC Topic 805):

(1) Expense the costs when it becomes probable (or virtually certain) that the acquisition will not be completed until after the effective date of ASC Topic 805. Thus, once it has become probable that the acquirer will not complete the acquisition before the effective date of ASC Topic 805, any acquisition-related costs previously capitalized would be recognized as expense, and any costs incurred thereafter would be charged to expense as incurred.

(2) Expense the costs on the effective date of ASC Topic 805.

(3) Expense the costs retrospectively (in the period incurred), using the guidance for a change in accounting principles in ASC Topic 250, *Accounting Changes and Error Corrections,* on the effective date of ASC Topic 805. This method requires retrospective application of the accounting principle to prior period financial statements.

14.006 The method selected by an acquirer to account for such costs is an accounting policy election and, therefore, should be disclosed in accordance with ASC paragraphs 235-10-50-1 through 50-6, and applied consistently to those costs. See the discussion of the accounting for the income tax effects of acquisition-related costs in KPMG Handbook, Accounting for Income Taxes, Section 10 under *Business Combinations – Specific Application Matters.*

TRANSITION FOR CONTINGENT CONSIDERATION FROM ACQUISITIONS PRIOR TO THE EFFECTIVE DATE OF ASC SUBTOPIC 958-805

14.007 For business combinations occurring in annual reporting periods beginning after December 15, 2009, the requirements of ASC Topic 805 generally applied to business combinations involving not-for-profit entities (see Paragraph 1.017). Similar to the guidance in Paragraph 14.003 for business combinations involving for-profit entities, not-for-profit entities that consummated business combinations prior to the effective date of ASC Subtopic 958-805 (originally Statement No. 164) should continue to account for contingent consideration in those transactions in accordance with APB Opinion No. 16. Any additional consideration that becomes payable under those contingent consideration provisions will result in an adjustment to goodwill from that transaction.

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Section 15 - Noncontrolling Interests in Consolidated Financial Statements

See KPMG Handbook, Consolidation, for details on the subsequent accounting for noncontrolling interests.

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Section 16 - Overview of ASC Subtopic 820-10

Detailed Contents

Fair Value Measurements

- Objectives of ASC Subtopic 820-10
- Application of ASC Subtopic 820-10 to Business Combination Fair Value Measurements

Measurement

- Definition of Fair Value
- The Asset or Liability
- The Price
- The Transaction
- The Principal Market
  - Example 16.1: Determining the Principal Market
- The Most Advantageous Market
  - Example 16.2: Determining the Exit Market
- Market Participants
- Market Participants – Strategic and Financial Buyers
  - Example 16.3: Strategic and Financial Buyers (Highest and Best Use)
- Application to Nonfinancial Assets - Highest and Best Use
  - Example 16.4: Highest and Best Use Valuation Premise
  - Example 16.5: In Combination with Other Assets Valuation Premise
  - Example 16.6: Stand-Alone Valuation Premise
  - Example 16.6a: Impact of Management's Intention on a Valuation
- Application to Liabilities and Instruments Classified in a Reporting Entity’s Shareholders’ Equity
  - Example 16.7: Effect of Nonperformance Risk on the Fair Value of a Liability
  - Example 16.8: Non-Actively Traded Debt Instrument

Fair Value at Initial Recognition

Valuation Approaches

- Market Approach
- Income Approach

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Cost Approach

Example 16.9: Income vs. Cost Approaches – Software Asset

Valuation Analysis Inputs

Fair Value Hierarchy

Level 1 Inputs

Level 2 Inputs

Level 3 Inputs

Inputs Based on Bid and Ask Prices

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are not Orderly

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased

Identifying Transactions That Are Not Orderly

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FAIR VALUE MEASUREMENTS

ASC Paragraph 805-20-30-1

The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.

16.000 ASC Topic 805, *Business Combinations,* requires that the acquirer in a business combination measure the identifiable assets acquired, the liabilities assumed, and any acquired noncontrolling interest in the acquiree at their acquisition-date fair values (with certain exceptions—see Section 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree).* Assets acquired, liabilities assumed, and consideration transferred that are subject to the measurement exceptions are measured in accordance with the guidance specified for those exceptions, rather than at fair value. ASC Topic 805 also requires that the consideration transferred including any contingent consideration be measured at fair value (see Section 6, *Recognizing and Measuring the Consideration Transferred).* This Section provides a general overview for determining fair value for financial reporting purposes and common valuation approaches used to estimate fair value in accordance with ASC Subtopic 820-10, *Fair Value Measurement – Overall.* Fair value measurements require significant judgment and, for some items, the use of complex valuation techniques and methods to determine fair value. The use of valuation professionals to assist in the process is fairly common.

OBJECTIVES OF ASC SUBTOPIC 820-10

16.001 ASC Subtopic 820-10 defines fair value for financial reporting purposes, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. ASC Subtopic 820-10 was developed to provide increased consistency and comparability of fair value measurements required under U.S. GAAP, as well as to require more transparent disclosures about fair value measurements including the levels within the fair value hierarchy for those measurements. ASC paragraph 820-10-05-1A

16.002 ASC Subtopic 820-10 emphasizes that fair value is a market participant-based exit price measurement, and not an entity-specific measurement. ASC Subtopic 820-10 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value should maximize the use of observable inputs.

16.003 Generally, the framework for measuring fair value includes determining:

(a) The particular asset or liability that is the subject of the measurement (consistent with its unit of account);

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(b) For a nonfinancial asset, the valuation premise that is appropriate for the measurement (consistent with its highest and best use);

(c) The principal (or most advantageous) market for the asset or liability;

(d) The valuation approaches and underlying technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorized. ASC paragraph 820-10-55-1

16.004 While ASC Subtopic 820-10 does not specifically address the measurement of noncontrolling interests, the same framework applies. While the following discussion refers to assets or liabilities, the guidance also applies to the fair value measurement of any noncontrolling interests.

16.005 Once the appropriate valuation approaches and underlying technique(s) have been determined for the asset or liability, the inputs used in the fair value measurement are categorized into three hierarchical levels - quoted market prices in active markets for identical assets or liabilities (Level 1), other observable market inputs (Level 2), and unobservable inputs (Level 3). These concepts will be discussed in detail in the following subsections.

APPLICATION OF ASC SUBTOPIC 820-10 TO BUSINESS COMBINATION FAIR VALUE MEASUREMENTS

16.006 ASC Subtopic 820-10 applies to all fair value measurements required by ASC Topic 805. As noted above, ASC Topic 805 generally requires that identifiable assets acquired, liabilities assumed, and noncontrolling interest be measured at acquisition-date fair value. ASC Topic 805 does, however, provide for certain exceptions whereby certain items are measured at an amount other than fair value (see Section 7).

16.007 ASC Subtopic 820-10 does not eliminate the practicability exceptions to fair value measurements that are provided by other ASC Topics. ASC Subtopic 820-10 describes the practicability exceptions, as follows:

(a) The use of a transaction price (an entry price) to measure fair value (an exit price) at initial recognition of guarantees in accordance with ASC Topic 460.

(b) An exemption to the requirement to measure fair value if fair value is not reasonably determinable such as the following:

(1) Nonmonetary assets in accordance with ASC Topic 845.

(2) Asset retirement obligations in accordance with ASC Subtopic 410-20 and ASC Sections 440-10-50 and 440-10-55.

(3) Restructuring obligations in accordance with ASC Topic 420.

(4) Participation rights in accordance with ASC Subtopics 715-30 and 715-60.

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(c) An exemption to the requirement to measure fair value if fair value cannot be measured with sufficient reliability (such as contributions in accordance with ASC Topic 958 and ASC Subtopic 720-25.

(d) The use of particular measurement methods referred to in ASC paragraph 805-20-30-10 that allow measurements other than fair value for specified assets acquired and liabilities assumed in a business combination. ASC paragraph 820-10-15-3.

16.008 Paragraph not used.

16.009 In addition to including the various practicability exceptions that existed in other topics, ASC Topic 820 provides *practical expedients* in applying the fair value framework in certain instances. For example, ASC paragraphs 820-10-35-59 through 35-62 provide a *practical expedient* for investors that have investments in certain investment vehicles, such as hedge funds, private equity funds, venture capital funds, funds of funds, and in foreign or other vehicles (e.g., real estate funds) that calculate and report net asset value (NAV) or an equivalent amount to use that amount as fair value if certain conditions are met. Investors may use NAV to estimate the fair value of investments in investment companies that do not have a readily determinable fair value if the investees have the attributes of investment companies and NAV, or its equivalent, is calculated consistent with the guidance in ASC Topic 946, *Financial Services—Investment Companies,* which generally requires investments to be measured at fair value (see Section Q in KPMG *Fair Value Measurements*). The practical expedient should be applied on an investment-by-investment basis and applied consistently to the investor's entire position in a particular investment unless it is probable as of the reporting date that all or a portion of the investment will be sold at an amount other than NAV (e.g., in a secondary market transaction). In those instances, the investor would instead be required to estimate the fair value of the investment considering all of the rights and obligations inherent in the investment and other market data applicable to the investment interest (see KPMG *Fair Value Measurements* Q&A G70).

16.009a In addition, ASC Topic 820 allows for mid-market pricing or other pricing conventions as a practical expedient when measuring fair value within the bid-ask spread. See Paragraphs 16.068 through 16.070 and KPMG *Fair Value Measurements* Q&A I40 for further details on Inputs Based on Bid and Ask Prices.

MEASUREMENT

DEFINITION OF FAIR VALUE

ASC Paragraph 820-10-35-2

[ASC Subtopic 820-10] defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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16.010 The objective of a fair value measurement under ASC Subtopic 820-10 is to estimate the price that would be received to sell an asset currently or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market for that asset or liability at the measurement date. That is, fair value measurements are based on an *exit price* notion considered from the perspective of a market participant that is prepared to buy an asset from an entity or willing to accept an entity's performance obligation. The fair value of an asset or liability is based on a hypothetical transaction at the measurement date considered from the perspective of a market participant that holds the asset or owes the liability.

THE ASSET OR LIABILITY

> **ASC Paragraph 820-10-35-2B**
>
> A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:
>
> a. The condition and location of the asset
>
> b. Restrictions, if any, on the sale or use of the asset.

16.011 A fair value measurement is for a particular asset or liability, considering various factors such as its condition and location at the measurement date. The asset or liability may be a stand-alone asset or liability such as a financial instrument or a group of assets or liabilities such as a reporting unit. When measuring the fair value of an asset or liability, an entity first determines the item being measured, giving consideration to its unit of account.

16.012 Often, an asset or liability is easily identifiable as an individual asset or liability. For example, the unit of account for a portfolio of identical financial instruments that is actively traded is the individual security within the portfolio. For a group of operating assets in a manufacturing plant that are acquired in a business combination, the unit of account generally is at the level at which the asset is separable or substitutable with other equivalent assets (e.g., a piece of equipment within the manufacturing plant).

16.013 In some circumstances, applicable U.S. GAAP specifies or permits that the unit of account may be at an aggregated level rather than at the individual asset or liability level. For example, ASC Topic 805 permits the aggregation of an operating license and a nuclear power plant into a single asset if the useful lives of those assets are similar. (ASC paragraph 805-20-55-2(b)) To determine the appropriate unit of account for measuring fair value, an entity first identifies whether specific accounting standards require or permit the unit of account to be at a level of aggregation above the individual asset or liability level, such as an asset group, a reporting unit, or a business.

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THE PRICE

ASC Subtopic 820-10-35-9A

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

16.014 A fair value measurement assumes that the asset or liability being exchanged is done so in an orderly transaction between market participants. The concept of an orderly transaction assumes access to the relevant market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving the specific assets or liabilities being measured at fair value. The concept of an orderly transaction distinguishes fair value from forced liquidation value, which reflects the price that would be received or paid in a distressed sale, where a limited marketing period is available for the sale of the assets or liabilities.

16.015 For assets or liabilities that are actively traded in only one market, the exit price is readily available because market participants have engaged in transactions to buy and sell the identical asset or liability. For assets or liabilities that are actively traded in more than one market, it is necessary to identify the appropriate reference market. For assets or liabilities for which there is no active trading of the identical asset or liability, determining the appropriate exit price requires the utilization of valuation techniques or adjustments to the observed prices using assumptions that market participants would consider when transacting for similar assets or liabilities.

THE TRANSACTION

ASC Paragraph 820-10-35-5

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

a. In the principal market for the asset or liability

b. In the absence of a principal market, in the most advantageous market for the asset or liability.

THE PRINCIPAL MARKET

16.016 According to ASC Subtopic 820-10, the principal market is the market with the greatest volume and level of activity for the asset or liability. When more than one market exists for an asset or liability, the source of the exit price used in a fair value measurement depends on whether a principal market exists for the entity with respect to that asset or liability.

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16.017 When an entity engages in transactions to buy or sell an asset or transfer a liability in multiple marketplaces, the entity first considers whether there is a specific marketplace where a majority of transactions (i.e., greatest volume of transactions) for the asset or liability occur. The perspective of the reporting entity is not the primary influence in the market determination.

16.018 The principal market determination takes into account where the asset sale or liability transfer takes place with the most volume. In this way the valuation subject drives the identification of the market. However, the reporting entity will need to have access to the principal market. Thus, the fair value of comparable valuation subjects may differ among entities.

Example 16.1: Determining the Principal Market

ABC Corp.'s common shares trade on both the New York and London Stock Exchanges, with the volume on New York Stock Exchange representing 80% of the total volume for ABC's common shares. DEF Corp., a holder of ABC common shares, principally buys and sells ABC common shares on the London Stock Exchange. What is the principal market for DEF – the New York or London Stock Exchange?

If DEF has access to the New York Stock Exchange, it is the principal market because the majority of ABC's common shares are traded there. If DEF cannot access the New York Stock Exchange, the principal market for DEF is the London Stock Exchange.

16.019 ASC Subtopic 820-10 does not provide detailed guidance for determining a principal market. Specifically, ASC Subtopic 820-10 does not discuss the assessment period for determining the greatest volume and level of activity for the asset or liability to identify the principal market. However, the definition of principal market under ASC Subtopic 820-10 suggests that it may be appropriate for an entity to consider both: (1) the historical volume and level of activity in each of the markets in which the securities are sold and (2) the anticipated volume and level of activity in markets in which securities are sold to the extent the future activity is expected to differ from historical levels. The analysis should be performed for each class of securities (e.g., share investments, debt obligations, investments in loans) traded in multiple marketplaces to assess the volume and level of activity in each market. When contrary evidence does not exist, the market in which the reporting entity normally transacts is presumed to be the principal or most advantageous market. Because an entity's trading activities can change over time, a reassessment of its principal market (or lack thereof) should be performed at regular intervals or based on changes in facts or circumstances when events occur that may change the entity's assessment of its principal market. The reporting entity is not required to perform an exhaustive search of all possible markets but it would consider reasonably available information.

16.020 There may be circumstances when no single market represents the principal market for a particular asset or liability that is measured at fair value. When there is no principal market for the asset or liability, then fair value is determined based on the price in the most advantageous market for the asset or liability.

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16.020a See Section E in KPMG *Fair Value Measurements* for more discussion and Q&As on principle market.

THE MOST ADVANTAGEOUS MARKET

16.021 According to ASC Subtopic 820-10, the most advantageous market is defined as the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs. Determining the most advantageous market requires that an entity review multiple markets in which it sells assets or transfers liabilities to identify the most advantageous market. This assessment should be performed in each reporting period when a principal market does not exist for the asset or liability.

16.022 As with a principal market, the most advantageous market should be considered first taking into account where the asset sale or liability transfer takes place. Also, the reporting entity's access to the most advantageous market is evaluated. This can result in different fair values among comparable valuation subjects from entity to entity.

16.023 There may be differences between exit prices indicated by the principal market and the most advantageous market. If a principal market is identified, the price from the principal market should be used in the fair value measurement even if the price from the most advantageous market is higher.

Example 16.2: Determining the Exit Market

An asset is sold in two different active markets at different prices. A reporting entity enters into transactions in both markets and can access the price in both markets at the measurement date. In Market A, the price that would be received is $26, transaction costs in that market are $3, and the costs to transport the asset to that market are $2 (i.e., the net amount that would be received is $21). In Market B, the price that would be received is $25, transaction costs in that market are $1, and the costs to transport the asset to that market are $2 (i.e., the net amount that would be received in Market B is $22).

(a) If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transportation costs ($24 per share).

(b) If Market B is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transportation costs ($23 per share).

(c) If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximizes the amount that would be received to sell the asset after taking into account transaction

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costs and transportation costs (i.e., the net amount that would be received in the respective markets). Because the reporting entity would maximize the net amount that would be received for the asset in Market B ($22), the fair value of the asset would be measured using the price in that market ($25), less transportation costs ($2), resulting in a fair value measurement of $23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for transaction costs (although it is adjusted for transportation costs).

ASC paragraphs 820-10-55-43 through 45A

MARKET PARTICIPANTS

ASC Master Glossary: Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price of a related party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. They are able to enter into a transaction for the asset or liability

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

ASC Paragraph 820-10-35-9

A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally, considering factors specific to all of the following:

a. The asset or liability

b. The principal (or most advantageous) market for the asset or liability

c. Market participants with whom the reporting entity would enter into a transaction in that market.

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16.024 Market participants are buyers and sellers in the principal (or most advantageous) market for an asset or liability. ASC Subtopic 820-10 emphasizes that fair value is a market participant-based measurement, not an entity-specific measurement, and that fair value measurements should be determined based on assumptions that market participants would use in pricing the asset or liability. ASC paragraph 820-10-35-9

16.025 When evaluating the assumptions that a market participant uses when pricing an asset or liability, an entity would first use observable market information, if such information exists. If observable market information does not exist, the entity may use its own entity-specific assumptions, but it would modify those assumptions to remove any entity-specific characteristics (i.e., synergies) or expertise not available to other market participants. For example, any asymmetry of information where a reporting entity has information about an asset or liability that is not available to market participants, even through the market participants' due diligence efforts, would not be reflected in the determination of fair value. ASC Subtopic 820-10 specifies that measurements based only on entity-specific assumptions, if those assumptions are contrary to, or not all-inclusive of, assumptions that market participants are expected to use, are not consistent with the fair value measurement objective.

16.026 ASC Subtopic 820-10 states that it is reasonable to assume that a market participant that is both able and willing to transact for an asset or liability would undertake efforts necessary to understand all of the rights and obligations inherent in the asset or liability based on all available information and would factor any related risks into the fair value measurement.

16.027 Risks that are considered in fair value measurements include market, nonperformance (including credit), liquidity, and volatility risk. Fair value measurements should consider the assumptions of market participants related to the asset or liability's utility and related future cash flows, including the risks and uncertainties surrounding those cash flows and the amount that market participants would demand for bearing those risks and uncertainties. For example, an entity applies a liquidity factor when measuring the fair value of a particular financial instrument if it believes market participants would apply such a factor, even in circumstances in which the entity deems such a factor unnecessary for its own purposes. Similarly, an entity should consider a risk-adjusted discount rate that is deemed appropriate by market participants even when the entity believes its inherent risk is lower for that financial instrument as compared to other market participants due to the entity's specific expertise.

MARKET PARTICIPANTS – STRATEGIC AND FINANCIAL BUYERS

16.028 When identifying the characteristics of market participants for a particular asset or liability, an entity should consider whether the market participants are strategic or financial buyers. Strategic buyers are considered buyers that have related, complementary, or substitute assets to the subject asset, while financial buyers do not. Fair value measurements may differ depending on whether the market participants for a particular asset or liability are strategic or financial buyers, reflecting, for instance, different uses for an asset and different operating strategies among the market participant

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buyers within those groups. In determining whether the market participants are strategic or financial buyers, it is important to consider the highest and best use of the asset (see Application to Nonfinancial Assets - Highest and Best Use in this Section for additional discussion).

Example 16.3: Strategic and Financial Buyers (Highest and Best Use)

ABC Corp., a strategic buyer, acquires a group of assets (Assets A, B, and C) from DEF Corp. in a business combination. Asset C is billing software developed by DEF for its own use in conjunction with Assets A and B (related assets). ABC measures the fair value of each of the assets individually, consistent with the specified unit of account for the assets. ABC determines that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (highest and best use is in combination with other assets as a group).

In this instance, the market in which ABC sells the assets is the market in which it initially acquired the assets (that is, the *entry* and *exit* markets from the perspective of ABC are the same). Market participant buyers with whom ABC transacts in that market have characteristics that are representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets. As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

(a) *Strategic buyer asset group.* ABC, as a strategic buyer, determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). The assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold stand-alone at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are $360, $260, and $30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is $650.

(b) *Financial buyer asset group.* ABC determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the financial buyer asset group are $300, $200, and $100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is $600.

The fair values of Assets A, B, and C are determined based on the use of the assets as a group within the strategic buyer group ($360, $260, and $30). Although the use of the

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assets within the strategic buyer group does not maximize the fair value of each of the assets individually, it maximizes the fair value of the assets as a group ($650).

ASC paragraphs 820-10-35-10E and 820-10-35-11A

APPLICATION TO NONFINANCIAL ASSETS - HIGHEST AND BEST USE

ASC Paragraph 820-10-35-10A

A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

ASC Paragraph 820-10-35-10B

The highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financially feasible as follows:

a. A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).

b. The use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property).

c. The use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

ASC Paragraph 820-10-35-10C

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

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ASC Paragraph 820-10-35-10E

The highest and best use of the nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

a. The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).

1. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and associated liabilities) would be available to market participants.

2. Liabilities associated with the asset and the complementary assets include liabilities that fund working capital, but do not include liabilities that fund assets other than those within the group of assets.

3. Assumptions about the highest and best use of a nonfinancial asset shall be consistent for all of the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.

16.029 Highest and best use is a valuation concept that refers broadly to the use of an asset in a manner that would maximize the value of the asset or group of assets to market participants, even if the intended use of the asset by the entity is different. A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. As an example, an entity may intend to continue the operations of a recently acquired asset in a business combination as a manufacturing facility; if market participants consider the highest and best use of the asset as residential property because it will produce a greater fair value, then the fair value measurement would be considered from the perspective of market participants as residential property rather than the entity's intended use as a manufacturing facility. The fair value measurement would reflect the costs and risks associated with the change to this highest and best use. ASC paragraphs 820-10-35-10A, 35-10C, and 35-10D

16.030 The highest and best use is a valuation concept that only applies to nonfinancial assets (e.g., real estate and intangible assets). The valuation concept of highest and best

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use does not apply to liabilities as the fair value measurement for liabilities assumes the liability is transferred to a market participant in its existing condition (including credit-standing) at the measurement date. Additionally, the concept does not apply to financial assets.

16.031 Under the highest and best use valuation concept, the fair value of an asset is measured in combination with other assets as a group or under a stand-alone valuation premise. When the highest and best use is determined to be in combination with other assets and liabilities as a group, the valuation premise assumes the highest and best use of an asset will provide maximum value to market participants if combined with other assets as a group and that those assets are already owned or are available to market participants. The stand-alone valuation premise assumes the highest and best use of an asset will provide maximum value to market participants if used on a stand-alone basis. Assumptions about the highest and best use of a nonfinancial asset would need to be consistent for all of the assets (for which highest and best use is relevant) of the group of assets and liabilities within which the asset would be used. A reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

16.031a See Section J in KPMG *Fair Value Measurements* for more discussion of highest and best use.

Example 16.4: Highest and Best Use Valuation Premise

ABC Corp. acquires land in a business combination. The land is currently developed for industrial use as a site for a manufacturing facility. The current use of land often is presumed to be its highest and best use. However, nearby sites have recently been developed for residential use as sites for high-rise condominiums. Based on that development and recent zoning and other changes to facilitate that development, ABC determines that the land currently used as a site for a manufacturing facility could be developed as a site for residential use (for high-rise condominiums).

In this instance, the highest and best use of the land is determined by comparing:

(a) The fair value of the land in combination with the manufacturing operation, which presumes that the land would continue to be used as currently developed for industrial use (in combination with other assets as a group); and

(b) The fair value of the land as a vacant site for residential use, considering the demolition and other costs necessary to convert the land to a vacant site (stand-alone).

The highest and best use of the land is determined based on the higher of those values.

ASC paragraph 820-10-35-10E

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Example 16.5: In Combination with Other Assets Valuation Premise

ABC Corp. produces camera film for which the production requires a multiple-step process whereby chemicals are applied to a cellulose material to produce the film. Individually, the machinery necessary to produce the celluloid, along with the machinery and other chemicals necessary to bond the materials for film production, have little or no market value to market participants. However, the machinery taken as a group has significant value to market participants due to the high margins resulting from the sale of the film. In this case, the highest and best use to market participants is use of the related assets in combination as a group.

Example 16.6: Stand-Alone Valuation Premise

DEF Corp. provides worldwide oceanic transportation services via the entity's deep draft cargo ships. DEF is in the process of estimating the fair value of one of its older ships for purposes of impairment due to a new federal regulation requiring cargo ships past a certain age to be decommissioned and removed from service. Due to a current market slump for oceanic transportation services, the stand-alone fair value estimate is $4 million. Based on DEF's historical experience, this fair value estimate is consistent with how other market participants in the oceanic transportation market would value similar-age draft cargo ships.

Oilfield drilling and production companies also use decommissioned ships as permanent moorings to their offshore drilling and production platforms for storage, tankage, etc. The current market price offered by several oilfield drilling and production companies to purchase similar-age draft cargo ships is $5 million.

DEF would measure the fair value of its deep draft cargo ship using the stand-alone valuation premise resulting in a fair value measurement of $5 million, as it represents the highest-and-best-use for the asset. This valuation premise would be used even if DEF does not have the current intent or ability to sell its draft cargo ship in an in-exchange transaction.

Example 16.6a: Impact of Management's Intention on a Valuation

DEF Corp. owns and operates a chain of convenience stores. DEF often acquires single stores, or a portfolio of stores, to rebrand and remodel them. DEF also acquires competitor stores as a strategy to remove them from the market.

DEF enters into an agreement with ABC Corp. (a competitor) to purchase one of ABC's convenience stores with the intention of closing it, placing a deed restriction on the property that prohibits it from being used to operate a convenience store, and reselling the property.

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When estimating the fair value of the property, DEF should apply the highest and best use concept and not consider management's intent to place a restriction on the deed and resell it. Therefore, assuming the highest and best use by a market participant is the continued operation of the store, DEF's estimate of the fair value of the property should reflect that assumption.

APPLICATION TO LIABILITIES AND INSTRUMENTS CLASSIFIED IN A REPORTING ENTITY'S SHAREHOLDERS' EQUITY

ASC Paragraph 820-10-35-16

A fair value measurement assumes that a financial or nonfinancial liability or an instrument classified in a reporting entity's shareholders' equity (for example, equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an instrument classified in a reporting entity's shareholders' equity assumes the following:

a. Subparagraph superseded by Accounting Standards Update No. 2011-04.

b. A liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

c. An instrument in a reporting entity's stockholders' equity would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

16.032 The fair value of a liability is the price that would be paid to transfer it to a market participant at the measurement date. The fair value measurement of a liability assumes that the liability is not settled with the counterparty and the obligation continues with the market participant. Because the liability is assumed to be transferred to a market participant and the liability continues to exist, the fair value measurement also should consider the effect of nonperformance risk (i.e., the risk the obligation will not be fulfilled). In accordance with ASC Subtopic 820-10, the nonperformance risk associated with the liability is assumed to be the same before and after its transfer. Nonperformance risk affects the price at which a liability would be transferred. Therefore, the fair value of a liability should reflect the nonperformance risk for that liability at the measurement date.

16.033 Nonperformance risk includes, but may not be limited to, the entity's own credit risk. The effect of nonperformance risk (e.g., credit standing) on the fair value of a liability may differ depending on the liability. For example, a liability that represents an obligation to deliver cash (a financial liability) may have a different nonperformance risk than an obligation to deliver goods or services (a nonfinancial liability). Additionally, the terms of credit enhancements related to the liability, if any, will affect its nonperformance risk.

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16.034 When a quoted price for the transfer of an identical or a similar liability or instrument classified in a reporting entity's shareholders' equity is not available, and the identical item is held by another party as an asset, a reporting entity would measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date. In these cases, a reporting entity would measure the fair value of the liability or equity instrument as follows:

(1) Using the quoted price in an active market for the identical item held by another party as an asset, if that price is available.

(2) If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.

(3) If the observable prices are not available, using another valuation approach, such as an income or market approach. ASC paragraph 820-10-35-16BB

16.035 The holder of an instrument as an asset incorporates nonperformance risk in the measurement of fair value. Because fair value assumes the transfer, rather than the settlement, of a liability, the issuer of the instrument likewise should include nonperformance risk in its measurement of fair value. Consideration of nonperformance risk in the measurement of a liability results in symmetry in the fair value measurement for a financial liability between the issuer and the holder. That is, to the issuer, the instrument is a liability, but to the holder, the instrument is an asset. If both parties have access to the same market and have similar views about market participants and their related assumptions, then it is reasonable to expect that both parties would arrive at substantially the same fair value measurement for the instrument. A reporting entity should adjust the quoted price of a liability or an instrument classified in a reporting entity's shareholders' equity held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument.

Example 16.7: Effect of Nonperformance Risk on the Fair Value of a Liability

ABC Corp. and DEF Corp. each enter into a contractual obligation to pay cash ($500) to GHI Corp. in 5 years. ABC has an AA credit rating and can borrow at 6%, while DEF has a BBB credit rating and can borrow at 12%. ABC receives about $374 in exchange for its promise (the present value of $500 in 5 years at 6%). DEF receives about $284 in exchange for its promise (the present value of $500 in 5 years at 12%).

The fair value of the liability to each entity (the proceeds) incorporates that entity's credit standing.

ASC paragraphs 820-10-55-56 through 55-58

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16.036 Measuring the fair value of debt that is not actively traded, for example, notes payable to a lender, typically requires the use of valuation approaches. Although different valuation approaches may be appropriate, a common approach used is the income approach. Specifically, cash flows attributable to the obligation, including future payments of principal and interest, are discounted to present value from the payment dates back to the fair value measurement date, using a discount rate reflective of the risk of the cash flows, including nonperformance risk. Nonperformance risk captures the credit risk associated with the obligor, which may have characteristics of the creditworthiness of the acquirer, the acquiree, or a blending of the two. If an identical item is held by another party as an asset, the reporting entity may apply an income approach that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset.

Example 16.8: Non-Actively Traded Debt Instrument

DEF Corp., a private retail distribution entity, has one primary debt issue outstanding with a consortium of banks. The debt issue, which had an original maturity of 30 years, currently has 10 years remaining to maturity. Due to a recent credit downgrade by DEF's primary rating agency, DEF's cost of borrowing has significantly increased. Specifically, based on discussions with its primary bank, DEF determines the current spread (credit and liquidity) above the risk-free rate for its obligations is approximately 700 basis points.

For most debt issuances, the interest rate on new issuances is determined by adding the pre-determined credit spread required by the debt underwriters to a risk-free market rate (usually the treasury rate that matches the term of the proposed issuance).

Assuming the current interest rate for a 10-year Treasury Bill (10 years is the length of time until maturity of the debt issue being evaluated) is 5%, then the current interest rate for any new DEF obligations is estimated to be 12%. To determine the fair value of its existing debt at the measurement date, DEF discounts all future cash flows attributable to the debt, including contractual interest payments at the stated rate of the debt, and contractual principal payments, adjusted for prepayment considerations, to the measurement date using a 12% discount rate. This discounted amount represents the estimated fair value for the debt instrument at the measurement date.

FAIR VALUE AT INITIAL RECOGNITION

ASC Paragraph 820-10-30-2

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

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16.037 A transaction price represents the price paid to acquire an asset or received to assume a liability. This concept is an entry price notion.

16.038 Under ASC Subtopic 820-10, fair value is defined as the price received to sell an asset currently or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market for that asset or liability at the measurement date. That is, fair value is based on an exit price notion considered from the perspective of a market participant that is prepared to buy an asset from an entity or willing to accept an entity's performance obligation for its liability.

16.039 Conceptually, entry and exit prices are different. Entities do not necessarily sell or transfer assets or liabilities at the prices paid to acquire or assume them, respectively. However, in certain cases the transaction price (entry price) may equal the exit price and, therefore, could provide evidence of the fair value of the asset or liability at initial recognition.

16.040 ASC Subtopic 820-10 includes several examples of factors an entity should consider in determining whether a transaction price provides evidence of the fair value of an asset or liability at initial recognition. For example, a transaction price might not provide evidence of the fair value of an asset or liability at initial recognition if:

(a) The transaction is between related parties. Although the transaction price might be used as an input to the fair value measurement if the reporting entity has evidence to support a conclusion that the transaction was entered into at market terms.

(b) The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, if the seller is experiencing financial difficulty and therefore cannot wait the customary time it would take to market and sell the asset.

(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.

(d) The market in which the transaction takes place is different from the principal or most advantageous market for the asset or liability. For example, those markets might be different if the entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market) while the principal (or most advantageous) market for the exit transaction is with other dealers. ASC paragraphs 820-10-30-3 through 30-3A

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VALUATION APPROACHES

ASC Paragraph 820-10-35-24A

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Three widely used valuation approaches are the market approach, cost approach, and income approach. The main aspects of valuation techniques consistent with those approaches are summarized in [ASC] paragraphs 820-10-55-3A through 55-3G. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

Market Approach

ASC Paragraph 820-10-55-3A

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

ASC Paragraph 820-10-55-3B

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgment, considering qualitative and quantitative factors specific to the measurement.

ASC Paragraph 820-10-55-3C

Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities.

Cost Approach

ASC Paragraph 820-10-55-3D

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

ASC Paragraph 820-10-55-3E

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than

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depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases, the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.

Income Approach

ASC Paragraph 820-10-55-3F

The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

ASC Paragraph 820-10-55-3G

Those valuation techniques include, for example, the following:

a. Present value techniques

b. Option-pricing models, such as the Black-Scholes-Merton formula or a binomial model (that is, a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option

c. The multiperiod excess earnings method, which is used to measure the fair value of some intangible assets.

16.041 The next step in measuring fair value for financial reporting purposes is to determine the appropriate valuation technique, or combination of valuation techniques, to use when measuring fair value. ASC Subtopic 820-10 requires all measurements of fair value to use techniques that are consistent with one or more of the three following valuation approaches: market approach, income approach, and cost approach (see also KPMG *Fair Value Measurements* Q&A F10 for additional examples of these approaches beyond those discussed below).

MARKET APPROACH

16.042 The *market approach* uses prices and other relevant information generated by reference to market transactions involving identical or comparable assets or liabilities (including a business). Valuation techniques under the market approach often use market multiples (e.g., a Price-to-Earnings (P/E) multiple, a multiple of EBITDA, or a price per square foot) derived from a set of comparable transactions. Market multiples from comparable transactions often will indicate a range of possible valuations and the selection within the range requires judgment, considering factors specific to the measurement (qualitative and quantitative), and assumptions of market participants. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

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INCOME APPROACH

16.043 Under the *income approach,* fair value is determined by converting future amounts (e.g., cash flows or earnings) to a single present amount. One of the most common valuation techniques under the income approach is the discounted cash flow method. Under that method, the entity first estimates the net cash flows expected to accrue directly or indirectly resulting from ownership of the asset. Second, the entity discounts those future cash flows to their present value using an appropriate discount rate converting the cash flows or earnings to a single present amount. Variations of the discounted cash flow method are often used to value intangible assets, including: the multi-period excess earnings method, the relief from royalty method, and the incremental cash flow method. A key component in any discounted cash flow technique is the discount rate and, generally, the discount rate should be commensurate with the risk associated with the cash flows reflecting market participant expectations of risk and return for the particular asset or liability. ASC Section 820-10-55 provides additional guidance on the application of present value techniques in a fair value measurement. Other common valuation techniques under the income approach are option-pricing models, such as the Black-Scholes-Merton formula, which is a closed-form model, and binomial models (e.g., a lattice model).

COST APPROACH

16.044 The *cost approach* establishes a value based on the cost of reproducing or replacing the asset, often referred to as current replacement cost. From the perspective of a market participant, the price received for an asset is estimated based on the cost to a market participant to reproduce or to replace the asset with a substitute asset of comparable utility. For nonfinancial assets, the valuation process under the cost approach typically begins with an estimation of the asset's replacement cost adjusted, where applicable, for obsolescence to estimate the replacement cost of the asset's current service potential. Obsolescence includes physical depreciation, functional or technological obsolescence, and economic obsolescence.

16.045 ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value should be appropriate for the circumstances and should be consistent with the market approach, income approach, and/or cost approach. A single valuation approach is appropriate in certain circumstances. For example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities, a market approach is most appropriate. In other cases, multiple valuation approaches may be appropriate. For example, when estimating the fair value of a reporting unit, both a market approach and an income approach may be appropriate. ASC paragraph 820-10-35-24

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Example 16.9: Income vs. Cost Approaches – Software Asset

ABC Corp. acquires a group of assets. The asset group includes an income-producing software asset internally developed for licensing to customers and its complementary assets (including a related database with which the software asset is used) and the associated liabilities. For purposes of measuring the fair value of the software asset, ABC determines that the software asset provides maximum value to market participants through its use in combination with other assets or with other assets and liabilities (that is, its complementary assets and associated liabilities). There is no evidence to suggest that the current use of the software asset is not the highest and best use. Therefore, the highest and best use of the software asset is in its current use. (In this case, the licensing of the software asset, in and of itself, does not indicate that the fair value of the asset would be maximized through its use by market participants on a stand-alone basis.)

ABC determines that in addition to the income approach, sufficient data may be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:

(a) *Income approach.* The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (license fees from customers) over its economic life. The fair value indicated is $15 million.

(b) *Cost approach.* The cost approach is applied using a replacement cost method by estimating the amount that currently would be required to construct a substitute software asset of comparable utility (considering functional, technological, and economic obsolescence). The fair value indicated is $10 million.

Through its application of the cost approach, ABC determines that market participants are unable to replicate a substitute software asset of comparable utility. Certain attributes of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. ABC determines that the fair value of the software asset is $15 million, as indicated by the income approach.

ASC paragraphs 820-10-55-39 through 41

16.046 If multiple valuation techniques are used to measure fair value, the results of each should be evaluated and weighted, as appropriate, in determining fair value. In making that evaluation, an entity should consider, among other things, the reliability of the valuation techniques applied and the related inputs that are used in those techniques. If a particular market approach relies on higher level inputs (e.g., Level 1 – observable market prices) compared to a particular income approach that relies heavily on unobservable inputs (e.g., Level 3 – cash flow projections), the entity should apply greater weight to the market approach to maximize the use of observable inputs.

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16.047 ASC Subtopic 820-10 does not provide guidance for a particular weighting exercise if multiple approaches or techniques are used. Instead, judgment is required depending on the circumstances and available information. If multiple valuation approaches are used, a fair value measurement is the point within the range that is most representative of fair value under the circumstances.

16.048 ASC Subtopic 820-10 emphasizes that valuation approaches and techniques used to measure fair value should be consistently applied. However, a change in a valuation technique is appropriate if the change results in a measurement that is more representative of fair value in the circumstances. Examples include development of new markets, new information becoming available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique should be accounted for prospectively as a change in accounting estimate under ASC Topic 250, *Accounting Changes and Error Corrections*. ASC paragraphs 820-10-35-25 and 35-26, 50-7, 65-2, and 250-10-50-5

16.049 ASC Subtopic 820-10 does not provide specific requirements for selecting an appropriate valuation technique or techniques for measuring fair value. The appropriate valuation technique or techniques depends on the value drivers, the reliability of inputs, and market participants. While ASC Subtopic 820-10 does not provide specific guidelines for determining the appropriate valuation technique, it establishes a fair value hierarchy that prioritizes fair value measurements based on the significance of observable inputs.

VALUATION ANALYSIS INPUTS

ASC Paragraph 820-10-35-36

Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

ASC Paragraph 820-10-35-36B (Before adoption of ASU 2022-03[1])

A reporting entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see [ASC] paragraphs 820-10-35-2B through 35-2C). In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the [ASC] Topic [820] that requires or permits the fair value measurement. Premiums or discounts that reflect size as a characteristic of the reporting entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 820-10-35-44) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. In all cases, if there is a quoted price in an active

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market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.

ASC Paragraph 820-10-35-36B (After adoption of ASU 2022-03)

A reporting entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see [ASC] paragraphs 820-10-35-2B through 35-2C). In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the [ASC] Topic [820] that requires or permits the fair value measurement. Premiums or discounts that reflect size as a characteristic of the reporting entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 820-10-35-44) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. Similarly, a discount applied to the price of an equity security because of a contractual sale restriction is inconsistent with the unit of account being the equity security. A contractual sale restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and, therefore, is not considered in measuring the fair value of an equity security (see paragraphs 820-10-55-52 through 55-52A). A contractual sale restriction prohibiting the sale of an equity security is a characteristic of the reporting entity holding the equity security and shall not be separately recognized as its own unit of account. In all cases, if there is a quoted price in an active market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.

ASC Master Glossary: Observable Inputs

Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

ASC Master Glossary: Unobservable Inputs

Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

16.050 Inputs to valuation techniques refer to assumptions that market participants use in pricing an asset or liability when using a valuation technique. Inputs to valuation techniques may be either observable or unobservable when valuing an asset or liability, including assumptions about risk. Observable inputs are inputs that reflect the

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assumptions market participants use in pricing the asset or liability based on market data that can be obtained from sources independent of the entity. The price of listed equity securities on the New York or London Stock Exchanges are observable inputs. Unobservable inputs are inputs that reflect the entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. For instance, in a business combination using the acquisition method of accounting, observable inputs typically do not exist for many assets acquired when there is no active market for such items. Nevertheless, valuation techniques used to measure fair value should maximize the use of observable inputs to the extent possible when measuring those assets and liabilities acquired and assumed in a business combination.

16.051 ASC Subtopic 820-10 provides examples of markets in which inputs might be observable for some assets and liabilities (e.g., financial instruments), including the following:

(a) *Exchange market.* A market in which closing prices are both readily available and generally representative of fair value. An example of such a market is the New York Stock Exchange.

(b) *Dealer market.* A market in which dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of items for which they make a market. Typically, bid and ask prices (representing the price at which the dealer is willing to buy and the price at which the dealer is willing to sell, respectively) are more readily available than closing prices. Over-the-counter markets (for which prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by Pink Sheets LLC) are dealer markets. For example, the market for U.S. Treasury securities is a dealer market. Dealer markets also exist for some other assets and liabilities, including other financial instruments, commodities, and physical assets (e.g., used equipment).

(c) *Brokered market.* A market in which brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. In other words, brokers to not use their own capital to hold an inventory of the items for which they make a market. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party's price requirements. Brokered markets include electronic communication networks, in which buy and sell orders are matched, and commercial and residential real estate markets.

(d) *Principal-to-principal market.* A market in which transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be made available publicly.

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FAIR VALUE HIERARCHY

ASC Paragraph 820-10-35-37

To increase consistency and comparability in fair value measurements and related disclosures, [ASC] Topic [820] establishes a fair value hierarchy that categorizes into three levels (see [ASC] paragraphs 820-10-35-40 through 35-41, 820-10-35-41B through 35-41C, 820-10-35-44, 820-10-35-46 through 35-51, and 820-10-35-52 through 35-54A) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

16.052 ASC Subtopic 820-10 establishes a three-level fair value hierarchy that prioritizes inputs to valuation techniques used when measuring fair value. The fair value hierarchy is classified into Level 1, Level 2, or Level 3 and is based on the inputs used to measure fair value. The highest priority is given to unadjusted quoted market prices (Level 1) and the lowest priority to unobservable inputs based on the reporting entity's judgments about the assumptions that market participants would use in pricing the asset or liability (Level 3). These three broad levels also provide a framework for related disclosures about fair value measurements. Inputs to the fair value measurements should be consistent with the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.

16.053 In many cases, the inputs used in a particular fair value measurement technique might fall within different levels of the fair value hierarchy. For example, an entity might estimate the fair value of a reporting unit based on a multiple of projected earnings. In that circumstance, the entity might be able to identify observable multiples for similar entities, which could be considered to be Level 2 inputs. However, the earnings projections would likely be based on the reporting entity's judgments about the assumptions that market participants would use in pricing the asset or liability (Level 3). In that circumstance, the measurement in its entirety falls within Level 3 of the hierarchy based on the lowest level input that is significant to the fair value measurement.

16.054 The availability of market inputs relevant to the asset or liability and the relative reliability of the inputs may affect the selection of the appropriate valuation techniques. However, the fair value hierarchy focuses on the inputs to valuation techniques, not the valuation techniques themselves.

LEVEL 1 INPUTS

ASC Paragraph 820-10-35-41

A quoted price in active markets provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in [ASC] paragraph 820-10-35-41C.

16.055 Level 1 inputs are quoted prices in active markets. Level 1 inputs provide the most reliable and verifiable measure of fair value and should be used whenever available.

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An active market for an asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. An entity's determination of whether a market for an asset or liability is active is based on whether there are sufficient transactions to provide ongoing pricing information for the asset or liability. That determination is not affected by the size of the entity's own position in the asset or liability that is being traded on that market. The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability. To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity, a reporting entity should consider factors such as those listed in ASC paragraph 820-10-35-54C.

16.056 The existence of observable quoted prices in active markets for identical assets or liabilities generally preclude the use of other valuation techniques (e.g., internal valuation models) that may result in a different fair value measurement. ASC Subtopic 820-10 emphasizes that valuation techniques used to measure fair value maximize the use of observable inputs and the existence of Level 1 inputs for an asset or liability generally precludes the use of lower level inputs in a valuation technique. For example, assume Entity A holds an option to acquire common shares of Entity B, a public company with actively traded shares on the New York Stock Exchange. Entity A's option to acquire common shares of Entity B is not actively traded; thus, to perform a fair value measurement of the share option, Entity A uses a valuation technique (e.g., Black-Scholes-Merton formula). A required input to the Black-Scholes-Merton formula is the share price (i.e., closing price) of Entity B's common shares, a Level 1 input, at the measurement date. Entity A would use the closing price rather than using a lower level input for Entity B's share price, such as Entity A's discounted cash flow analysis for a contemplated tender offer of Entity B's common shares.

16.057 ASC Subtopic 820-10 provides an exception to the required use of Level 1 inputs in situations when a reporting entity holds a large number of similar (but not identical) assets or liabilities measured at fair value and a quoted price for an identical asset or liability in an active market is available, but it is not readily accessible for each of those assets or liabilities individually. In that case, as a practical expedient, a reporting entity may measure the fair value of the asset or liability using an alternative pricing method that does not rely exclusively on quoted prices (e.g., matrix pricing). However, the use of an alternative pricing method results in a fair value measurement categorized within a lower level of the fair value hierarchy. ASC subparagraph 820-10-35-41C(a)

16.058 The FASB provided the above exception as a practical measure for holders of a large number of assets or liabilities (e.g., debt securities) that require those holders to subscribe to multiple data services and perform extensive research for actively traded prices for each asset or liability held in its portfolios. Generally, this exception can only be used when all of the following criteria are met:

- The entity holds a large number of similar assets or liabilities (i.e., homogenous assets or liabilities);

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- Quoted prices from an active market are not readily accessible for each of the individual assets or liabilities, without undue cost or effort; and
- The use of the alternative pricing method results in a price that the entity believes it would receive to sell an asset or pay to transfer a liability in an orderly transaction with market participants at the measurement date.

16.059 In rare circumstances, a quoted price in an active market might not be representative of the fair value of a particular asset or liability at the measurement date. Adjustments to Level 1 inputs may be necessary. However, adjustments to Level 1 inputs should only occur in limited circumstances and will result in a fair value measurement categorized within a lower level of the fair value hierarchy. ASC paragraph 820-10-35-41C states three situations in which an adjustment to the quoted price is allowed:

- When a reporting entity holds a large number of similar (but not identical) assets or liabilities that are measured at fair value and a quoted price in an active market is available but not readily accessible (discussed in Paragraph 16.057 above);
- Significant events (such as transactions in a principal-to-principal market, trades in a brokered market, or announcements) that take place after the close of the applicable market but before the measurement date; and
- When measuring the fair value of a liability or an instrument classified in a reporting entity's shareholders' equity using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset. If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorized within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorized within a lower level of the fair value hierarchy.

16.060 Adjustments to Level 1 measures for other reasons (e.g., *temporary* market conditions, other reserves, or blockage factors) are not permitted. For instance, the FASB considered whether the appropriate unit of account for a block position in an instrument that trades in an active market is (1) at the individual trading unit where the fair value measurement would be determined as a product of the quoted price of the individual security (P × Q) or (2) the block where the fair value measurement would be determined using the quoted price, adjusted for the size of the position relative to trading volume (i.e., blockage factor). In that instance, where there is a Level 1 price for an individual unit of a block of securities, the aggregated block of securities would be valued as the product of the Level 1 price (unadjusted) multiplied by the quantity of instruments held by the entity at the measurement date (P × Q), excluding consideration of blockage factors. ASC paragraph 805-10-35-36B

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LEVEL 2 INPUTS

ASC Paragraph 820-10-35-47

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

ASC Paragraph 820-10-35-48

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active

c. Inputs other than quoted prices that are observable for the asset or liability, for example:

1. Interest rates and yield curves observable at commonly quoted intervals

2. Implied volatilities

3. Subparagraph superseded by Accounting Standards Update No. 2011-04

4. Subparagraph superseded by Accounting Standards Update No. 2011-04

5. Credit spreads.

6. Subparagraph superseded by Accounting Standards Update No. 2011-04

d. Market-corroborated inputs.

16.061 Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly through corroboration with observable market data. If the asset or liability has a specified contractual term, a Level 2 input should be observable for substantially the full term of the asset or liability.

16.062 Determining if a Level 2 input is observable for substantially the full term of the asset or liability requires judgment. For instance, fair value measurements that use multiple future data points, such as debt involving interpolated yield curve data or over-the-counter commodity forward contracts involving forward curves, should match the term of the asset or liability being measured and also be observable for substantially the entire term of the asset or liability to qualify as Level 2 inputs. It is generally inappropriate to use a 10-year Treasury rate as an input for measuring the fair value of a debt instrument with either an 8-year term or a 12-year term, unless that Level 2 input has been adjusted for the difference in the terms between the reference rate and the term of the debt instrument.

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16.063 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset, the extent to which inputs relate to items that are comparable to the asset, and the volume or level of activity in the markets within which the inputs are observed. Adjustments to a Level 2 input that are significant to the entire measurement might result in a fair value measurement categorized within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.

16.064 ASC Subtopic 820-10 provides the following examples of Level 2 inputs for particular assets and liabilities:

(a) *Receive-fixed, pay-variable interest rate swap based on the London Interbank Offered Rate (LIBOR) swap rate.* A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for the full term of the swap.

(b) *Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency.* A Level 2 input would be the swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.

(c) *Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate.* A Level 2 input would be the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.

(d) *Three-year option on exchange-traded shares.* A Level 2 input would be the implied volatility for the shares derived through extrapolation to year 3 if (1) prices for one-year and two-year options on the shares are observable and (2) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one- and two-year implied volatilities is established.

(e) *Licensing arrangement.* For a licensing arrangement that is acquired in a business combination and that was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would be the royalty rate in the contract with the related party at inception of the arrangement.

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(f) *Finished goods inventory at a retail outlet.* For finished goods inventory that is acquired in a business combination, a Level 2 input would be either a price to customers in a retail market or a price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (that is, similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments should be used for the fair value measurement.

(g) *Building held and used.* A Level 2 input would be the price per square foot for the building (a valuation multiple) derived from observable market data, for example, multiples derived from prices in observed transactions involving comparable (that is, similar) buildings in similar locations.

(h) *Reporting unit.* A Level 2 input would be a valuation multiple (e.g., a multiple of earnings or revenue or a similar performance measure) derived from observable market data (e.g., multiples derived from prices in observed transactions involving comparable (that is, similar) businesses, taking into account operational, market, financial, and nonfinancial factors). ASC paragraph 820-10-55-21

LEVEL 3 INPUTS

ASC Paragraph 820-10-35-52

Level 3 inputs are unobservable inputs for the asset or liability.

ASC Paragraph 820-10-35-53

Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

ASC Paragraph 820-10-35-54A

A reporting entity shall develop unobservable inputs using the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, a reporting entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the reporting entity that is not available to other market participants

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(for example, an entity-specific synergy). A reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, a reporting entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.

16.065 Level 3 inputs are unobservable inputs for an asset or liability. That is, inputs that reflect an entity's own estimates about the assumptions market participants would use in pricing the asset or liability, including assumptions about risk, which have been developed based on the best information available in the circumstances (including the entity's own data). Although Level 3 inputs are not obtained from observable market data, the fair value measurement objective remains the same - an exit price notion reflecting the assumptions of market participants.

16.066 Unobservable inputs should be used to measure fair value only when observable inputs are not available. When developing unobservable inputs, an entity is not required to undertake all possible efforts to obtain information about market participant assumptions. However, the entity cannot ignore information about market participant assumptions that is reasonably available without undue cost and effort. The entity's own data used to develop unobservable inputs is adjusted if information indicates that market participants would use the adjusted assumptions and the information is reasonably available without undue cost and effort.

16.067 ASC Subtopic 820-10 provides the following examples of Level 3 inputs for particular assets and liabilities:

(a) *Long-dated currency swap.* A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.

(b) *Three-year option on exchange-traded shares.* A Level 3 input would be historical volatility, that is, the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participants' expectations about future volatility, even if it is the only information available to price an option.

(c) *Interest rate swap.* A Level 3 input would be an adjustment to a mid-market consensus (nonbinding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.

(d) *Asset retirement obligation at initial recognition.* Level 3 inputs are typically used in applying an expected present value technique. An entity estimates future cash flows based on market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would

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require for taking on the asset retirement obligation. A credit-adjusted risk-free rate is used to discount those future cash flows to estimate fair value.

(e) *Reporting unit.* A Level 3 input would be a financial forecast (e.g., of cash flows or earnings) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions. ASC paragraph 820-10-55-22

INPUTS BASED ON BID AND ASK PRICES

ASC Paragraph 820-10-35-36C

If an asset or a liability measured at fair value has a bid and an ask price (for example, an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorized within the fair value hierarchy (that is, Level 1, 2, or 3). The use of bid prices for asset positions and ask prices for liability positions is permitted but is not required.

16.068 Certain markets for assets and liabilities function such that market prices are quoted in terms of bid and ask prices. Bid and ask prices are common in dealer markets that involve sales and purchases of assets or liabilities between dealers in a particular market. In such markets, the bid price represents the last offer to purchase a particular asset or assume a liability, and the ask price represents the last offer to sell an asset or transfer a liability. The difference between the bid and the ask price is referred to as the *bid-ask spread*. The price paid for the asset or liability is at a value within the boundaries of the bid-ask spread.

16.069 If an input used to measure fair value is based on bid and ask prices, the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value within all levels of the fair value hierarchy provided that the price is consistently determined.

16.070 ASC Subtopic 820-10 allows practical approaches for determining the appropriate price within a bid-ask spread, including the use of a mid-market or other pricing convention for fair value measurements based on bid and ask prices. The two most common approaches are (1) a mid-market pricing convention, which prices all assets and liabilities at the mean price between the bid and ask prices, or (2) the use of bid prices for assets and ask prices for liabilities. However, entities cannot ignore available evidence that suggests that the selected pricing convention produces an amount that is not the most representative of fair value in the circumstances. For example, if an entity selected a mid-market pricing convention and there is available information that suggests market participants currently believe the most representative fair value is closer to the bid price for an asset, then the entity should reconsider if a mid-market pricing convention is appropriate for that specific asset in the circumstances.

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DETERMINING FAIR VALUE WHEN THE VOLUME AND LEVEL OF ACTIVITY FOR THE ASSET OR LIABILITY HAVE SIGNIFICANTLY DECREASED AND IDENTIFYING TRANSACTIONS THAT ARE NOT ORDERLY

16.071 ASC Subtopic 820-10 provides guidance on when the volume and level of activity for the asset or liability have significantly decreased, as well as additional guidance on identifying circumstances that indicate a transaction is not orderly.

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased

16.072 In accordance with ASC paragraph 820-10-35-54C, the fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity for that asset or liability, a reporting entity shall evaluate the significance and relevance of factors such as the following:

- There are few recent transactions.
- Price quotations are not developed using current information.
- Price quotations vary substantially either over time or among market makers (e.g., some brokered markets).
- Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, taking into account all available market data about credit and other nonperformance risk for the asset or liability.
- There is a wide bid-ask spread or significant increases in the bid-ask spread.
- There is a significant decline in the activity of, or there is an absence of, a market for new issues (that is, a primary market) for the asset or liability or similar assets or liabilities.
- Little information is publicly available (e.g., for transactions that take place in a principal-to-principal market).

16.073 ASC paragraph 820-10-35-54G confirms that the objective of a fair value measurement remains the same even if the volume and level of activity in the market for the asset or liability have significantly decreased, regardless of the valuation technique or techniques used. Fair value is the price that would be received to sell the asset or transfer

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the liability in an orderly transaction (that is, not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions.

16.074 If an entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or for similar assets or liabilities), further analysis of the transactions or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. However, if a reporting entity determines that a transaction or quoted price does not represent fair value (e.g., there may be transactions that are not orderly), an adjustment to the transactions or quoted prices will be necessary if the reporting entity uses those prices as a basis for measuring fair value and that adjustment may be significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (e.g., when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale). ASC paragraph 820-10-35-54D

16.075 ASC Subtopic 820-10 does not prescribe how to make significant adjustments to transactions or quoted prices. Regardless of the valuation technique used, a reporting entity would include appropriate risk adjustments, including a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows of an asset or a liability. If there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate.

Identifying Transactions That Are Not Orderly

16.076 Entities should consider whether information indicates that an observed transaction was not orderly. Entities may not assume that all transactions are not orderly even if there has been a significant decrease in the volume and level of activity for the asset or liability. A transaction price that is associated with a transaction that is not orderly is not determinative of fair value or market-participant risk premiums. Entities should use judgment to determine whether evidence indicates that a transaction is not orderly. Although not necessarily determinative, entities should consider factors such as:

- Exposure to the market for a period before the measurement date was not adequate to allow usual and customary marketing activities for transactions involving the asset or liability under current market conditions.
- There was a usual-and-customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller is in or near bankruptcy or receivership (a distressed transaction).
- The seller was required to sell to meet regulatory or legal requirements (the seller was forced).
- The transaction price is an outlier when compared to other recent transactions for the same or a similar asset or liability.

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16.077 Reporting entities should consider all of the following when measuring fair value or estimating market risk premiums:

- Entities should place little, if any, weight (compared with other indications of fair value) on transactions that are not orderly when estimating fair value or market risk premiums.
- Entities should consider the transaction price of orderly transactions when estimating fair value or market risk premiums. The amount of weight placed on that transaction price (compared to the weight placed on other indications of fair value) depends on specific facts, such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.
- If a reporting entity does not have sufficient information to conclude whether a transaction is orderly, it would take into account the transaction price However, that transaction price may not represent fair value (that is, the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When a reporting entity does not have sufficient information to conclude whether particular transactions are orderly, the reporting entity would place less weight on those transactions when compared with other transactions that are known to be orderly.

16.078 Entities need not undertake exhaustive efforts to determine whether a transaction is orderly, but should not ignore information that is reasonably available. When a reporting entity is a party to a transaction, it is presumed to have sufficient information to conclude whether the transaction is orderly.

16.079 ASC paragraph 820-10-35-54K notes that ASC Subtopic 820-10 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, if a reporting entity has determined that the quoted prices provided by those parties are developed in accordance with ASC Subtopic 820-10. However, entities should carefully evaluate those quoted prices to determine whether they are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risk). Entities should place less weight on quotes that do not reflect the result of transactions. Entities should place more weight on quotes based on binding offers than on quotes based on indicative prices.

Endnote

[1] ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*, is effective for annual and periods in fiscal years beginning after December 15, 2023 for public entities and for all other entities annual and interim periods in fiscal years beginning after December 15, 2024. Early adoption is permitted. ASU 2022-03 amends ASC Topic 820, *Fair value measurement*, to clarify that contractual sale restrictions are not considered in measuring the fair value of equity securities.

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Section 17 - Determining the Fair Value of Assets Acquired and Liabilities Assumed in a Business Combination

Detailed Contents

Overview
- FASB Valuation Resource Group
- Use of a Third-Party Valuation Professional

Illustrative Balance Sheet

Assets
- Overview
- Cash and Cash Equivalents
- Trade and Other Receivables
  - Example 17.1: Determination of Fair Value of Acquired Trade Receivables
- Inventories
  - Raw Materials and Supplies
  - Finished Goods and Work-in-Process
  - Q&A 17.1: Acquisition of a Business That Outsources the Manufacturing Process and Has Patent Protection
  - Q&A 17.2: Measurement of the Fair Value of Inventories That Will Be Discontinued
  - Example 17.2: LIFO Method
- Debt and Equity Securities
  - Debt and Equity Securities-Classification
  - Debt and Equity Securities-Measurement
  - Example 17.3: Restriction on Sale of Security
- Other Securities
- Equity Method Investments
- Property, Plant, and Equipment
  - Example 17.4: Apportionment of Unit of Measurement to the Individual Units of Account
  - Example 17.4a: Valuation of Assets That Are Subject to a Government Grant
  - Sales Comparison Method
  - Income Capitalization Method
  - Example 17.4b: Direct Capitalization Method
  - Cost Approach
  - Property, Plant, and Equipment to Be Used

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Property, Plant, and Equipment to Be Sold (Held for Sale)
Mining Assets
Intangible Assets
Valuation Analysis
Market Approach
Income Approaches
Example 17.4c: Applying the Relief-from-Royalty Method
Example 17.4d: Using MPEEM to Value Customer Relationships
Cost Approach
Intangible Assets Commonly Acquired in Business Combinations
Contracts with Customers
Example 17.5: Accounting for an Acquiree's Revenue Contract
Leases (Acquiree Is Lessee)
Leases (Acquiree Is Lessor)
Income Producing Real Estate in the Real Estate Industry
Q&A 17.3: Purchase of a Real Estate Development Company
Liabilities
Overview
Trade Accounts and Notes Payable
Long-Term Debt
Market Approach
Income Approach
Example 17.8: Determining the Fair Value of Debt Assumed in a Business Combination
Asset Retirement Obligation
Derivative Instruments
Redeemable Preferred Stock
Example 17.9: Redeemable Preferred Stock Held by Noncontrolling Interests

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OVERVIEW

17.000 As stated in Section 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree,* ASC Topic 805, *Business Combinations,* requires an acquirer to recognize, separately from goodwill, the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquiree, and to measure such items at their acquisition date fair values in accordance with ASC Subtopic 820-10, *Fair Value Measurement - Overall,* with certain exceptions. This Section provides general guidance on the measurement of certain assets acquired and liabilities assumed in a business combination. A modified balance sheet has been provided to demonstrate commonly used valuation approaches to measure the acquisition-date fair value of those assets and liabilities.

17.001 The guidance herein is based on general valuation principles, and the specific approach may differ for a specific transaction depending on the facts and circumstances, including the relevant market participant assumptions and available information at the measurement date. Fair value measurements require the application of judgment and for some items the use of complex valuation techniques to determine fair value.

FASB VALUATION RESOURCE GROUP

17.002 In June 2007, the FASB formed a FASB Valuation Resource Group (the VRG) to address issues related to valuation for financial reporting consistent with their mission to improve and enhance the quality, consistency, and comparability of financial reporting. The FASB continues to assess whether and to what extent additional and more specific valuation guidance is needed for financial reporting purposes beyond the guidance provided in ASC Subtopic 820-10. As part of this process, the VRG meets periodically to provide the FASB staff with information on existing implementation issues surrounding fair value measurements used for financial reporting purposes and alternative viewpoints associated with those implementation issues. However, the VRG does not make authoritative decisions and ultimately all authoritative decisions are subject to the FASB's normal open due process, including public deliberation by the FASB.

USE OF A THIRD-PARTY VALUATION PROFESSIONAL

17.003 The application of ASC Topic 805 requires fair value measurements for assets acquired and liabilities assumed and noncontrolling interests in a business combination. While ASC Topic 805 does not require an entity to use a third-party valuation professional to determine fair value for such items, an entity should consider whether it employs competent and knowledgeable professionals to perform those measurements. In many situations, an entity may have in-house expertise for valuing some, but not all, of the assets acquired and liabilities assumed. Therefore, the need to use a third-party valuation professional is expected to vary by entity and even by transaction.

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ILLUSTRATIVE BALANCE SHEET

17.004 The table below provides items commonly found on balance sheets that would be subject to fair value measurement in applying the acquisition method. The table provides the valuation approach (market, income, or cost) commonly used for these items; however, in specific situations, depending on the information available, other approaches may be appropriate.

Common Fair Value Measurement Approaches

	Valuation Approaches		
Assets	**Market**	**Income**	**Cost**
Current assets:			
Cash and cash equivalents	F	S	N/A
Trade and other receivables	S	F	N/A
Inventories			
Finished goods	F	F	S
Work-in-process	F	F	S
Raw materials	F	S	F
Long-term assets:			
Debt and equity securities	F	S	N/A
Plant and equipment	See *Plant and Equipment* Section		
Operating lease right-of-use assets (a)	N/A	N/A	N/A
Intangible assets	See *Intangible Assets* Section		
Long-term construction-type contracts	O	F	S
Net investment in lease (a)	N/A	N/A	N/A
Income producing real estate	F	F	S
Liabilities			
Current liabilities:			
Trade accounts payable	F	F	N/A
Deferred revenue	O	F	S
Notes payable	F	F	N/A
Long-term liabilities:			
Long-term debt	F	F	N/A
Obligations under finance leases (a)	N/A	N/A	N/A
Asset retirement obligation	S	F	S
Operating lease liabilities (a)	N/A	N/A	N/A
Derivative instruments	F	F	N/A
Contingent consideration	S	F	S
Deferred income taxes (a)	N/A	N/A	N/A
Liability for pension benefits (a)	N/A	N/A	N/A
Redeemable preferred stock	F	F	S

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(a) Exceptions to the recognition and measurement principles. See Section 7 for further discussion.

Labeling Key

F = Applied Frequently
O = Applied Occasionally
S = Applied Seldom

ASSETS

OVERVIEW

17.005 Concepts Statement 8 defines an asset as "present right of an entity to an economic benefit." With limited exceptions, ASC Topic 805 requires that assets acquired and liabilities assumed in a business combination be measured at fair value determined in accordance with ASC Subtopic 820-10, including the requirement to consider the highest and best use for the unit of measure, regardless of the acquirer's intended use.

17.006 The following section identifies valuation techniques commonly used to measure the acquisition date fair value of *assets acquired* and liabilities assumed in a business combination.

CASH AND CASH EQUIVALENTS

17.007 Cash equivalents are highly liquid investments that are readily convertible to known amounts of cash and generally have a maturity of three months or less when purchased. Given the short-term nature and "insignificant risk of changes in value because of changes in interest rates," according to ASC Section 230-10-20, the carrying amount or nominal amount is often assumed to approximate fair value for cash and cash equivalents. However, the acquiring entity should make its own evaluation of the instruments classified by the acquiree as cash and cash equivalents to determine whether an assumption of insignificant risk of changes in value in response to interest rate changes is supportable, as that conclusion generally is the basis for using carrying amount or nominal amount as the approximation of fair value for such instruments.

TRADE AND OTHER RECEIVABLES

17.007a – 17.007b Paragraphs not used.

17.008 Receivables that are not purchased financial assets with credit deterioration acquired in a business combination are measured at fair value. Receivables that are purchased financial assets with credit deterioration are an exception to the measurement at fair value measurement principle. The acquirer initially recognizes such assets at their fair value plus an allowance for the estimate of expected credit losses determined in accordance with ASC Topic 326. The objective of fair value measurement of receivables is to approximate the amount that would be received if the receivables were sold in a

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transaction with market participants (an exit price) under current market conditions. For some trade receivables, this amount may be approximated by the amount that would be received from factoring the receivables. Alternatively, the fair value of receivables could be measured at the present value of the contractually required payments discounted using an interest rate reflecting market participants' requirements at the measurement date. The effects of timing and uncertainty about future cash flows (i.e., credit and liquidity risk) are included in the measurement of fair value of receivables. See chapter 12A of KPMG Handbook, Credit impairment, for detailed guidance on measuring financial assets acquired in a business combination.

17.009 The interest rate used in the measurement should be commensurate with the risk associated with uncertainty about future cash flows reflecting the expectations of market participants. Paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables* (ASC paragraphs 835-30-25-12 and 25-13), provide guidance in arriving at an appropriate interest rate.

17.010 In September 2008, the VRG noted that in practice some entities recognize components of working capital, including trade accounts receivable, at the acquiree's book value, because the differences resulting from current interest rates are often deemed to be insignificant. However, use of this approach is a non-GAAP policy and, accordingly, entities should evaluate the potential significance of the policy and be able to support that applying the non-GAAP policy is immaterial to the entity's financial statements at the date of acquisition and in subsequent periods.

Example 17.1: Determination of Fair Value of Acquired Trade Receivables

ABC Corp. acquires DEF Corp. in a business combination. At the acquisition date, ABC determines the fair value of the trade receivable of DEF, as follows:

	Acquired Trade Receivables				
	Commercial	Consumer	Other	Total	(a)
Contractually required payments receivable at acquisition date	$ 1,200	575	225	2,000	(b)
Cash flows expected to be collected	1,115	495	210	1,820	(c)
Difference				(180)	(d)
Estimated fair value	$ 1,103	489	208	1,800	(e)
Difference				(20)	(f)

(a) Disaggregated as commercial, consumer, and other trade receivables based on pool of receivables with common attributes and risk characteristics.
(b) Book value of DEF's contractually required payments receivable at date of acquisition.

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(c) Estimated future cash flows expected to be collected, considering uncertainty about future cash flows (i.e., estimated credit risk).
(d) Difference relates to total estimated credit risk of trade receivables.
(e) Present value of estimated future cash flows using an appropriate interest rate, considering estimated timing associated with the cash flows.
(f) Difference between DEF's carrying amount and estimated fair value.

17.011 Because the fair value of a tax-exempt note receivable may be affected by conditions other than changes in interest rates, such as changes in tax laws, determining the fair value of a tax-exempt note acquired in a business combination by adjusting the previous carrying amount for the effects of the difference between current interest rates and the stated rate on the note may not be sufficient. It may be necessary to obtain independent appraisals from an investment adviser or broker in determining the fair value of tax-exempt notes.

INVENTORIES

17.011a The AICPA convened a task force to develop an Accounting and Valuation Guide — Business Combinations (the AICPA Business Combinations Guide), which provides guidance and illustrations for preparers, independent auditors, and valuation specialists regarding the accounting and valuation considerations for business combination transactions. KPMG recommends consulting a valuation professional for additional guidance on the topic.

17.012 FASB Statement No. 141 (Statement 141), *Business Combinations,* provided more guidance than ASC Topic 805 regarding measurement methods for specific assets and liabilities assumed in business combinations, including inventory. While the guidance for valuing inventory in paragraph 37 of Statement 141 has been superseded, it was aligned with the tax guidance for estimating fair market value of inventory specified in IRS Revenue Procedure 2003-51. In practice, methods used for valuing inventory remain consistent with the superseded Statement 141 and Revenue Procedure 2003-51 guidance.

17.013 Conceptually, the analysis of inventory can be thought of as an allocation of value created pre-valuation date by the seller versus post-valuation date by the buyer. The fair value of inventory is estimated as the value created prior to the acquisition date—this represents the process of procuring and manufacturing the inventory. The fair value measurement should provide the seller with fair compensation for the efforts and costs previously incurred and assets used related to the inventory, while allowing the market participant buyer to be fairly compensated for its purchase, risk, future efforts, and assets used to complete and dispose of the inventory after the acquisition date.

17.014 The valuation method used to measure the fair value of inventory acquired in a business combination depends on its stage in the production cycle (finished goods, work-in-process (WIP), or raw materials) on the acquisition date and availability of reliable inputs. Historically, finished goods and WIP inventory have typically been valued using the Comparative Sales Method (Top-down Method) and raw materials were typically

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valued using the Replacement Cost Method (Bottom-up Method). Theoretically, applying a Top-down or Bottom-up Method should result in a consistent measure of the inventory value.

Raw Materials and Supplies

17.015 The fair value of raw materials, including supplies and spare parts, would be the price a market participant could achieve in a current sale. Raw materials inventory is often valued using the Bottom-up Method because typically there are fewer subjective assumptions. If no preparation costs have been incurred, the Bottom-up Method may simply be an analysis of the net book value as of the valuation date. However, adjustments to book value would need to be considered. Supplies purchased to be consumed directly or indirectly in production are measured at fair value, often in the same manner as raw materials.

17.016 If applicable, the target's book value of raw materials prior to the acquisition may be reduced to account for obsolete, defective, and subnormal goods as well as shrinkage, and adjusted to account for variances between actual and standard costs. Shrinkage refers to differences between accounting and actual inventory quantities (e.g., due to theft, damage, miscounting, incorrect units of measure, evaporation). Variances refers to difference between the actual and standard costs, applicable if standard cost is used (e.g., by manufacturing companies). These reserves and variances should be considered in the starting point when using a Bottom-up Method. However, LIFO is not an appropriate starting point for estimating the fair value of raw materials because it does not represent current replacement cost. If the inventory cost accounting is based on LIFO, the starting point for the valuation should be the gross amount, before consideration of the LIFO reserve.[1] Fair value of raw materials may approximate book value as of the valuation date if the following exists: FIFO accounting is used, inventory is measured at actual cost, any preparation costs are minimal, and the reserves fully account for obsolete and defective goods as well as shrinkage.

Finished Goods and Work-in-Process

17.017 In the Top-down Method, the value of finished goods and WIP inventory is based on the estimated selling price less the sum of (a) costs of disposal[2], (b) [any] costs to complete WIP, and (c) a reasonable profit allowance for the efforts contributed and assets used by the buyer (acquirer). Amounts not deducted when using the Top-down Method would have implicitly been added to the book value if valuing inventory using the Bottom-up Method. Thus, in the Bottom-up Method, the value is based on (a) the book value, including costs already incurred toward procurement and manufacturing efforts, and (b) a reasonable profit allowance for the efforts contributed and assets used by the acquiree.

17.018 Similar to raw materials, the book value of finished goods and WIP, after consideration of reserves for obsolescence, defective goods, and shrinkage, as well as variances, may serve as a starting point for the Bottom-up Method. However, the starting

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point should exclude the LIFO reserve, because LIFO does not represent current replacement cost.

17.019 For the valuation of finished goods and WIP inventory, it is relevant to first identify the appropriate baseline projected financial information (PFI). Conceptually, this should represent the market participant PFI for the period consistent with the lifecycle of the subject inventory (i.e., from procurement to sale). The acquiree's PFI may be a good starting point, but adjustments may be needed to reflect a market participant perspective. The baseline PFI should represent the income statement through EBITA, and provide detail on the breakdown of expenses (e.g., R&D, marketing, depreciation, etc.). If projected financial data is not sufficiently detailed, then historical financial statements may be used as a proxy but adjustments may be necessary to be consistent with the lifecycle of the subject inventory (e.g., adjustments for seasonality, etc.).

17.020 The Top-down Method begins with an assessment of the selling price of the inventory to the company's direct customer in the principal or most advantageous market. The selling price should be consistent with the selected baseline PFI used throughout the inventory valuation analysis. Selling prices can be derived directly from observed or listed selling prices on a per unit basis or indirectly through a gross margin analysis, as appropriate. A gross margin analysis estimates the selling price of the inventory by dividing the adjusted net book value of finished goods by the appropriate gross profit margin percentage.

17.020a The analysis of costs of disposal for the Top-down Method and costs already completed for the Bottom-up Method is based on the selected baseline PFI. The first step is to exclude any costs that are intended to benefit future periods, such as R&D costs related to new product development, marketing costs for a new product, training costs to increase the size of the workforce, costs for expansion into a new territory, depreciation of an R&D facility dedicated to future research, or restructuring costs. Removing the future-benefit direct and indirect costs generally results in an adjusted baseline PFI with higher margins. The next step is to identify the proportion of the costs in the adjusted baseline PFI that already have been incurred with respect to the finished goods inventory versus the proportion of costs that will be incurred during the disposal process of finished goods inventory. Costs of disposal would include both direct selling and marketing costs as well as a portion of the indirect overhead costs such as general and administrative expenses and depreciation. Similarly costs incurred would include costs of procuring raw materials and manufacturing as well as a portion of the indirect overhead costs such as general and administrative costs and depreciation.

17.020b The WIP analysis of costs to complete (for the Top-down Method) and manufacturing costs already completed (for the Bottom-up Method) is performed on the subset of the adjusted baseline PFI assumed to have been contributed to finished goods in the functional apportionment above. These costs can be further bifurcated into the completed portion that relates to the effort of procuring raw materials and manufacturing WIP already incurred pre-measurement date versus those costs that relate to the remaining incremental effort to bring the WIP to its finished state. The completion costs should be

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only those that are incremental to the disposal costs that have already been estimated for the inventory once finished.

17.020c The reasonable profit allowance may also be derived from the adjusted baseline PFI. Based on the assumptions above, the acquirer determines a profit margin earned pre- and post-measurement date on the cost structure. However, the acquirer may need to adjust those amounts based on the relative efforts exerted, risks assumed, value added, and assets used with respect to the inventory. In some cases the value added or intangible assets used during the procurement and manufacturing of the inventory pre-valuation date may not be the same as those contributed post-valuation date. For example, the materials portion of cost of goods sold may not contribute any value added benefit and may not drive the profit earned.

17.020c1 When internally developed intangible assets contribute to the level of profitability for the business, to determine the reasonable profit allowance the acquirer should evaluate whether each of those intangible assets has been used during the procurement and manufacturing of the finished goods and WIP inventory or remain to be used during the disposition process. If the intangible asset is used as part of the manufacturing process, the profit allowance for the manufacturing is increased by the profit contribution of the internally developed intangible assets. If it used as part of the disposal process, the profit contribution of the internally developed intangible assets is considered in the profit allowance of the disposal process. Alternatively, rather than adjusting the profit allowance, one can take into account the internally developed intangible asset by considering a hypothetical implied royalty rate as an additional cost element of either the manufacturing process or the disposal process. Under either approach the profit contribution of the intangible asset is assigned to where the intangible asset is used (either manufacturing or disposal), similar to the process described in Paragraph 17.020a.

17.020d Holding costs may be estimated to account for the opportunity cost associated with the time required to sell the inventory (time to sale). This represents the foregone return on investment during the time to sell the inventory. Holding costs are based on the inventory turnover rate and the cost of borrowing. Time to sale may be estimated by analyzing historical inventory turnover rates. The rate of return (borrowing cost) applicable to the inventory is generally lower than the overall rate of the business and may approximate the return on working capital. Diversity in practice exists with respect to including holding costs and, even when included, there is diversity in practice with respect to how to calculate them. Holding costs may be immaterial if the inventory turnover is high or the borrowing rate is low.

Q&A 17.1: Acquisition of a Business That Outsources the Manufacturing Process and Has Patent Protection

Q. Should an entity that acquires a business that outsources the manufacture of its proprietary widgets and enjoys a high gross margin and low selling cost owing to patent protection, record acquired inventory at the historic cost to the acquiree?

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A. No. ASC Topic 805 requires that an entity measure identifiable acquired assets at their acquisition-date fair values using a market participant perspective. In the Top-down Method, the fair value of finished goods inventories is measured from the perspective of a market participant as the selling price less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquirer (selling margin). In this example, the high gross margin realized by the acquiree is inherent in the historical cost of the widget to the acquirer. Because the high gross margin relates to patent protection and the patent is used as part of the manufacturing process, it is contributed to the inventory as part of the manufacturing process and therefore increases the fair value of inventory. The fact that the entity outsources the production to a third party is irrelevant as the third-party contract manufacturer uses the know-how of the patent in the production process.

The acquirer recognizes an intangible asset associated with the patent protection that historically allowed the acquiree to realize the high margins (i.e., the patent was internally generated and not recognized as an asset in the acquiree's financial statements). The fair value of the intangible asset would be adjusted to reflect the portion that has been contributed to inventory and therefore already included in the fair value of the inventory.

Q&A 17.2: Measurement of the Fair Value of Inventories That Will Be Discontinued

ABC Corp. operates retail hardware stores. ABC acquires DEF Corp., also a hardware retailer. In the transaction, ABC acquires inventories of DEF, including certain products that DEF has historically stocked and sold under brand names not sold in ABC stores. Some of the inventories on hand for the DEF products are liquidated as ABC does not intend to continue selling the DEF-branded products. DEF stores will mark down and sell the existing inventory and then will begin to sell ABC's products and brands.

Q. How should inventories of DEF's products that will be discontinued after the acquisition be valued in the acquisition accounting?

A. The fair value of the inventories acquired should be based on the expected selling price of the units from a market participant perspective. If a market participant is expected to continue to sell the DEF-branded products, then the baseline PFI should reflect this. If, however, a market participant is expected to liquidate the DEF-branded products, the baseline PFI should reflect liquidation prices and cost structure.

In general, if a market participant retailer is expected to continue selling the acquired inventory, the fair value of that inventory for a retailer is often similar to its book value. This is because the profit on the selling effort left to be earned post-acquisition is often a large percentage of the overall profit. For retailers, most of the inventory is purchased for resale (i.e., cost of goods sold is not a value-added expense) and the inventory tends to turn quickly.

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Example 17.2: LIFO Method

ABC Corp. acquired DEF Corp. on January 1, 20X0. Before the acquisition, DEF measured its inventory using the LIFO method. ABC's similar inventory is also measured using the LIFO method. The carrying amount of DEF's inventory under the LIFO method as of January 1, 20X0, and the fair value of the inventory at the date of acquisition is as follows:

	LIFO	Fair Value
20X7 – Base year	$ 100	
20X8 – Layer	50	
20X9 – Layer	75	
Total inventory	$ 225	$ 305

Under ASC paragraph 330-10-S99-1 (which supports conclusions reached in AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories),* ABC should measure the acquisition-date fair value of the acquired inventory at $305. If the acquired inventory is deemed to be a separate LIFO pool, this amount becomes the base year layer for the inventory to apply LIFO in periods subsequent to the acquisition. If it is deemed to be part of the existing LIFO pool (i.e., it is similar to ABC's existing inventory), then this amount is included in the current period's purchases to determine the current period LIFO layer.

DEBT AND EQUITY SECURITIES

17.021 Debt and equity securities include investments in U.S. Treasury securities, corporate debt securities, and equity securities publicly traded on an active exchange (e.g., the New York Stock Exchange).

Debt and Equity Securities-Classification

17.022 Debt securities should be classified as held-to-maturity, available-for-sale or trading securities, under ASC Topic 320, *Investments--Debt Securities,* based on the intent and ability of the acquirer rather than the historical classification of the securities by the acquiree. ASC Topic 805 requires that the acquirer make those classifications or designations based on contractual terms, economic conditions, the acquirer's operating or accounting policies, and other relevant conditions existing at the acquisition date. All investments in equity securities (other than those to which consolidation or equity method accounting applies) are accounted for under ASC Topic 321, *Investments--Equity Securities.* Generally, equity securities are initially and subsequently measured at fair value, with changes in fair value reported currently in earnings. However, an entity can elect an accounting policy to measure equity securities without readily determinable fair value at cost minus impairment, if any, plus or minus changes resulting from observable

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price changes. See KPMG Handbook, Investments, for additional guidance. ASC paragraph 805-20-25-6

Debt and Equity Securities-Measurement

17.023 Regardless of classification, securities acquired in a business combination are measured at fair value at the date of acquisition. Quoted market prices (Level 1 inputs), if available, generally provide the most reliable and best evidence of fair value. In certain circumstances, quoted market prices may need to be adjusted downward to recognize the possible effects of security-specific restrictions because other market participants would consider the restrictions when measuring the fair value of the securities. In those circumstances, ASC Subtopic 820-10 requires the fair value of a restricted security be measured based on a quoted price of an otherwise unrestricted security of the same issuer adjusted for the effect of the restriction. In contrast, a contractual restriction that is not an attribute of the security would not be factored into the measurement of the security.

17.024 Consistent with ASC Subtopic 820-10, quoted market prices should only be adjusted for restrictions that are specific to the security and, therefore, would transfer to market participants. For security-specific restrictions, the price used in the measurement of fair value should include an adjustment for the effect of the restriction. Conversely, for entity-specific restrictions, the price used in the measurement of fair value of the securities would not be adjusted to reflect the restriction. Determining whether a restriction is entity-specific or security-specific may require judgment based on the specific facts and circumstances.

17.025 In the absence of an available quoted market price for securities, fair value is often determined using a market approach or income approach, fair value measurements that use Level 2 or Level 3 inputs. See section H in KPMG Handbook, Fair Value Measurements - Questions and Answers for additional discussion.

Example 17.3: Restriction on Sale of Security

The reporting entity holds a security of an issuer for which sale is legally restricted for a specified period. The restriction is determined to be specific to (an attribute of) the security and, therefore, would transfer to market participants.

The fair value of the security is based on the quoted price for an otherwise identical unrestricted security of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment reflects the amount market participants would demand because of the risk relating to the inability to access a public market for the security for the specified period.

The adjustment depends on the nature and duration of the restriction, the extent to which buyers are limited by the restriction (e.g., a large number of qualifying investors), and factors specific to both the security and the issuer (qualitative and quantitative).

ASC paragraph 820-10-55-52

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17.026 If the reporting entity manages a group of financial assets or financial liabilities on the basis of its net exposure to either market risk or credit risk, the reporting entity is permitted to measure the fair value of the group of financial assets or financial liabilities on the basis of the price that would be received to sell a net long position or to transfer a net short position. The reporting entity should measure the fair value of the group consistent with how market participants would price the net risk exposure. The exception does not pertain to financial statement presentation. As such, the reporting entity may need to allocate portfolio-level adjustments to the individual assets or liabilities that make up the group of financial assets and financial liabilities managed on the basis of the reporting entity's net risk exposure.

OTHER SECURITIES

17.027 Determining the fair value of securities that are not quoted in active markets may require the use of valuation techniques. ASC Subtopic 820-10 states that in some instances more than one of the three valuation approaches discussed (market approach, income approach, and cost approach or their underlying techniques) may be required to develop the measurement of fair value.

17.028 In these instances, entities should consider, among other things, the reliability of the valuation approaches and underlying techniques and the inputs used in the techniques. If a particular market-based approach relies on higher level inputs (e.g., observable market prices) compared to a particular income-based approach that relies heavily on projections of income, the reporting entity should apply greater weight to the measurement of fair value generated by the market-based approach, because it relies on higher-level inputs.

17.029 ASC Subtopic 820-10 notes that any, or a combination, of the techniques should be used to measure fair value if the techniques are appropriate in the circumstances. However, when multiple valuation techniques are used to measure fair value, ASC Subtopic 820-10 does not prescribe a mathematical weighting scheme, but requires the use of judgment. Valuation professionals, in many instances, consider multiple valuation approaches and underlying techniques but may conclude that a single valuation technique is appropriate to determine fair value. In instances when multiple valuation techniques are relied on to measure fair value, the techniques should be evaluated for reasonableness and reliability, and the valuation professional should determine if and how the techniques should be weighted. In some cases, a secondary technique is used only to corroborate the reasonableness of the most appropriate technique.

EQUITY METHOD INVESTMENTS

17.029a Equity method investments, like equity securities or other securities, are measured at fair value at the date of acquisition. In accordance with ASC Topic 323, an acquirer is also required to prepare a memo purchase price allocation at the date of acquisition to allocate the fair value of the investment to the net assets of the equity

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method investee. See Section 3.3 of KPMG Handbook, Equity method of accounting, for a further discussion of the memo purchase price allocation.

PROPERTY, PLANT, AND EQUIPMENT

17.030 Property, plant, and equipment includes tangible assets such as land; buildings and improvements, machinery and equipment; leasehold improvements; furniture, fixtures, and office equipment; vehicles; construction-in-progress and other related tangible assets. ASC Subtopic 820-10 requires that an entity determine the highest and best use of a nonfinancial asset. An entity determines the premise of use whereby market participants would maximize value. The highest and best use of an asset could be on a stand-alone basis or in combination with other assets and liabilities as a group. It should be noted that property, plant, and equipment that qualifies as held-for-sale is measured at fair value less cost to sell at the acquisition date in accordance with ASC Section 360-10-35. Because of the cost to sell element, the measurement of property, plant, and equipment that is classified as held-for-sale is an exception to the fair value measurement principle in ASC Topic 805.

17.031 Rate regulated entities generate required revenue based on allowable costs, including the costs incurred to acquire, construct, or develop the assets, and a reasonable return. This economic model is called a cost of service model. These rate-regulated entities are subject to accounting and reporting requirements based on the guidance provided in ASC Topic 980, *Regulated Operations*. For rate-regulated entities that are subject to ASC Topic 980, the carrying amount of property, plant, and equipment is assumed to be fair value because it is expected that the assets will generate required revenue that approximates the allowable costs and returns approved by the regulatory authorities. However, such an approach to determining the fair value of a cost-based rate regulated asset may not be appropriate if it is expected that the rate-regulated entity will no longer be regulated, regulatory authorities are expected to change the allowable costs, or other types of rate action are expected to be imposed by regulatory authorities.

17.032 The fair value can be estimated using a market approach (e.g., sales comparison method, see Paragraph 17.041), an income approach (e.g., income capitalization method, see Paragraph 17.042), or a cost approach (e.g., replacement or reproduction cost new method, see Paragraph 17.043), or a combination of multiple approaches, depending on facts and circumstances.

17.033 Factors to consider when evaluating the appropriate valuation technique include: (a) the type of asset being measured; (b) identifying the principal (or most advantageous) market and market participants for the assets acquired; and (c) the appropriate valuation premise (stand-alone or in combination with other assets or assets and liabilities as a group), consistent with the acquired assets' highest and best use.

17.034 ASC Subtopic 820-10 includes the concept of highest and best use for a nonfinancial asset to determine the appropriate valuation premise to measure fair value for a single nonfinancial asset or group of nonfinancial assets. ASC Subtopic 820-10 identifies two premises of value: in combination with other assets or assets and liabilities

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as a group and stand-alone. For nonfinancial assets, either premise may produce the highest and best use. The premise selected provides maximum value to market participants.

ASC Paragraph 820-10-35-10A

A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

ASC Paragraph 820-10-35-10B

The highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financially feasible as follows:

a. A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).

b. A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property).

c. A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

ASC Paragraph 820-10-35-10C

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

ASC Paragraph 820-10-35-10D

To protect its competitive position, or for other reasons, a reporting entity may intend not to use an acquired nonfinancial asset actively, or it may intend not to use the asset according to its highest and best use. For example, that might be the case for an acquired intangible asset that the reporting entity plans to use defensively by preventing others from using it. Nevertheless, the reporting entity shall measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

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ASC Paragraph 820-10-35-10E

The highest and best use of a nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

a. The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).

1. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and the associated liabilities) would be available to market participants.

2. Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.

3. Assumptions about the highest and best use of a nonfinancial asset shall be consistent for all of the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.

17.035 In applying the guidance on highest and best use, an entity should determine the fair value for the asset in its current state. ASC Subtopic 820-10 states that the reporting unit's current use of the asset is considered the highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset. However, in determining the fair value, an entity should consider whether a market participant would acquire the asset with the intent to change its legal use. ASC Topic 805 states that in determining the highest and best use, the reporting entity determines whether the use is legally permissible, financially feasible, and physically possible. The reporting entity also should consider whether maximum value would be provided to market participants by using the asset on a stand-alone basis or in combination with other assets. See further discussion in Section J in KPMG Handbook, Fair Value Measurements - Questions and Answers.

17.036 In some situations, an entity may need to consider that a market participant could acquire a property with the intent to change the zoning restrictions. A market participant would do so if this was in its economic best interest. Although current zoning restrictions

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are an attribute of a property and are a matter of law that could significantly affect fair value, zoning restrictions are generally not permanent, and zoning changes are legally permissible. Zoning restrictions on the use of property can be, and often are, changed, and variances provided at the request of property owners (market participants) consider the possibility of a zoning change when pricing the asset at the measurement date. If the use was considered physically possible and legally permissible, the reporting entity would need to determine if the use was financially feasible. This analysis is consistent with ASC Subtopic 820-10's market participant view as well as with the guidance on accounting for costs of real estate projects in ASC Topic 970, *Real Estate—General,* which provides "The fair value of a (land) parcel is affected by its physical characteristics, its highest and best use, and the time and cost required for the buyer to make such use of the property considering access, development plans, *zoning restrictions,* and market absorption factors." (Emphasis added.)

17.037 When a fair value measurement of a differently zoned asset contemplates a change in the legal usage of the asset (e.g., zoning restrictions), the risks of the change and the cost a market participant would incur to transform the asset should be considered in the measurement.

17.038 When use of the asset in combination with other assets as a group is determined to be appropriate and its highest and best use, the fair value measurement of the asset should be based on the fair value that would be received in a sale or transfer of the group of assets.

17.039 This aggregation of assets for purposes of establishing the highest and best use premise, which could include multiple units of account, is the unit of measurement that should be used to measure the fair value for the individual units of account within the unit of measurement. ASC paragraph 820-10-35-10 states that assumptions regarding highest and best use should be consistent between the group of assets and the individual assets. Determining the fair value of individual units of account within a unit of measurement requires apportionment of the overall fair value measurement for the unit of measurement to the individual units of account. This is illustrated in Example 17.4.

Example 17.4: Apportionment of Unit of Measurement to the Individual Units of Account

ABC Corp. has two asset groups: Asset Group 1 and Asset Group 2. Each asset group represents an individual unit of account. If sold separately, ABC would receive $100 for Asset Group 1 and $100 for Asset Group 2. If sold together, ABC would receive $300 for the two asset groups. Given these facts, the highest and best use of Asset Groups 1 and 2 is to be sold in combination. Therefore, the unit of measurement is the aggregation of Asset Groups 1 and 2. Because ABC performed individual fair value measurements for Asset Group 1 and Asset Group 2, and determined the fair values for each asset group, one possible way of apportioning fair value to Asset Group 1 is by using the relative fair values. Based on this methodology, $150 of the overall unit of measurement's fair value would be apportioned to Asset Group 1 ($100, the individual fair value for Asset Group 1, divided by $200, the aggregated individual fair values for

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Asset Groups 1 and 2, multiplied by $300, the fair value measurement for the unit of measurement) and $150 would be apportioned to Asset Group 2.

Example 17.4a: Valuation of Assets That Are Subject to a Government Grant

ABC Corp. acquires DEF Corp. in a business combination. Two years before the acquisition, DEF received a grant from the local government to fund 33% of the cost of certain tangible fixed assets, subject to the condition that it must employ a minimum of 250 full-time employees at all times during the subsequent five years. DEF is required to repay the grant if it fails to meet this condition.

The assets subject to the grant had an original cost of $15 million, and the grant was $5 million. DEF accounted for the grant as a reduction of the cost of the assets, which have a weighted-average 10-year useful life. On the acquisition date, the assets have an aggregate net carrying amount of $8 million and an aggregate fair value of $11 million, based on market participant assumptions about their highest and best use. A contingent obligation to repay the $5 million grant exists if DEF does not continue to employ at least 250 full-time employees for three more years.

ABC should record the assets subject to the grant at their full fair value of $11 million on the acquisition date, i.e., on an unencumbered basis. The amounts recorded in the business combination are not affected by the fact that they were originally acquired subject to a grant or by the possible obligation to repay the grant. Rather, the contingent obligation to repay the grant should be evaluated as an assumed contingent liability (see Section 7).

17.040 In addition to determining the highest and best use that will impact the valuation premise, a valuation approach or combination of approaches should be used to determine fair value of property, plant, and equipment. The table below presents certain selected property, plant, and equipment and common valuation approaches to estimate their acquisition-date fair values when the premise of value is assumed to be in combination with other assets as a group.

Common Fair Value Measurement Concepts

	Market Approach	Income Approach	Cost Approach
Plant and equipment	Sales Comparison Method	Income Capitalization Method	Replacement Cost New Method
Real property			
Land	F	F	S
Buildings	F	F	F

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Personal property			
Machinery and equipment	O	S	F
Other			
Leasehold improvements	S	S	F
Construction-in-progress	S	S	F

Labeling Key

F	=	Applied Frequently
O	=	Applied Occasionally
S	=	Applied Seldom

Sales Comparison Method

17.041 The sales comparison method is frequently used to measure the fair value of real property (e.g., land and buildings) and occasionally used to measure the fair value of personal property (e.g., machinery and equipment).

17.041a The application of the sales comparison method to value real property identifies prices of recent transactions between market participants (purchasers/sellers) for comparable or similar properties. Once comparable or similar properties are identified, adjustments to the prices of those properties may be necessary to account for differences, including, but not limited to, real property rights conveyed, conditions of sale, market conditions, location, physical characteristics, use or zoning and others. The adjusted prices of the comparable properties are then analyzed and reconciled to conclude on an estimate of fair value of the acquired property. For example, if the comparable sales are observed on sales price per building square foot basis, then the adjusted price per square foot should be applied to the subject building's square footage.

17.041b Personal property (e.g., machinery and equipment, vehicles, office equipment, and other similar assets) with a secondary market can be valued with a market approach. Entities may use one of three sales comparison techniques to value personal property with a market approach.

- The direct match method estimates fair value by relying on a direct match of assets to assign a value. For this purpose, the asset is directly compared to identical equipment to conclude on fair value.
- The comparable match method assigns value to a subject asset based on an analysis of similar, but not identical assets, using a measure of utility as the basis of comparison. Rather than relying on identical equipment as an indication of fair value, similar equipment is compared to the subject asset.
- The percent of cost method establishes the ratio of the selling price to the current cost to buy a new version of a subject piece of equipment at the time

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of sale (i.e., current cost new). If sufficient data exists, similar types of equipment can be analyzed and percentage relationships can be developed based on age, selling price and cost.

Income Capitalization Method

17.042 The income capitalization method is used frequently to measure the acquisition-date fair value of real estate assets and seldom used to measure machinery and equipment in a business combination. There are two versions of the income capitalization method.

- The direct capitalization method involves estimating the fair value of the subject property based on a single year's net operating income (NOI) and capitalizing the NOI based on an appropriate capitalization rate (discount rate).[3] The NOI is the anticipated net income after vacancy and collection loss, and after deducting operating expenses from potential gross income. Capitalization rates are typically extracted from market data based on the ratio of a comparable property's single year NOI compared to its selling price. See Example 17.4b.
- The yield capitalization method involves projecting the NOI until the time of assumed sale by the property owner and estimating a terminal value on the assumed sale. The yield capitalization method is similar to a discounted cash flow model, where the future NOI and terminal value are discounted to their present values using an appropriate discount rate from the perspective of a market participant. The NOI in the terminal year is capitalized with an appropriate terminal capitalization rate to derive an estimated terminal value. The key steps as part of the yield capitalization method are: (1) estimating the future NOI and terminal value of the property; (2) identifying an appropriate terminal capitalization rate as part of estimating a terminal value; and (3) discounting the estimated NOI and terminal value to a single present value using an appropriate discount rate to estimate fair value.

Example 17.4b: Direct Capitalization Method

Inputs:

Market rent per square foot (psf/year)	$50	A
Total rentable square feet	× 24,150	B
Total annual rent	$1,207,500	C=A×B
	Projected annual	
Revenue	$1,207,500	
Operating expenses	487,859	
Net operating income (NOI)	$719,641	D

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Overall capitalization rate	7.25%	E
Direct capitalization value	**$9,926,083**	F=D/E
Value per square foot (rounded)	$411	G=F/B

Cost Approach

17.043 The cost approach is based on the premise of estimating a current cost of the subject property being appraised and then reducing the cost for all forms of depreciation and obsolescence. The cost approach can be used to measure the fair value of personal property (e.g., machinery and equipment) and other types of property (e.g., leasehold improvements, construction-in-progress) in a business combination when the premise of value is assumed to be in combination with other assets as a group. The cost approach involves estimating the replacement or reproduction cost new of the subject property.

- The replacement cost is the current cost to purchase a similar property having the nearest equivalent utility as the subject asset.
- The reproduction cost is the current cost of reproducing a new replica of the subject property using similar materials.

The decision to rely on replacement or reproduction cost for the cost approach depends on whether the replacement property is more desirable because it: (a) costs less to acquire; (b) costs less to operate; and/or (c) produces more revenue. If the replacement property with similar utility is more desirable than or superior to a new replica, the replacement cost should be used. In some instances, the replacement cost and reproduction cost may be the same if the subject property would be replaced with a replica. Once the replacement or reproduction cost new is estimated, the cost new is then adjusted for depreciable factors such as physical deterioration, functional obsolescence and economic obsolescence resulting in Replacement Cost New Less Depreciation (RCNLD).

17.043a Physical deterioration is the decrease in value that occurs as a result of wear and tear through use, exposure to the elements, and the passage of time. Depreciation factors are applied based on a variety of depreciation methods, such as age-life, declining balance, Iowa survivorship curves or other acceptable depreciation methods. The entity can also apply depreciation factors based on published depreciation rates from Marshall Valuation Services, BCRI or other publications, or internally built depreciation curves. The depreciation method is determined based on market research, discussions with plant personnel, observations from on-site inspections or other inputs, with the intention of applying a depreciation method that closely resembles depreciation experienced in the marketplace for similar types of assets. The subject property's expected normal useful life and effective age are considered when applying depreciation. Furthermore, the entity applies the depreciation method commensurate with the asset's expected normal useful life, which is typically based on discussions with plant personnel and market observations. Salvage values are also typically considered so that the subject property's replacement

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cost new is not depreciated below its salvage value if the subject property's age exceeds its expected useful life.

17.043b After deducting physical depreciation, the entity considers functional obsolescence, which is the loss in value or usefulness of the property caused by inefficiencies or inadequacies of the property itself, when compared to a more efficient or less costly property. Functional obsolescence should be considered when replacement assets are considered to have greater utility (i.e., through improved production processes or lower operating costs versus existing assets), the replacement property is less costly, or if there is over capacity inherent in the property.

17.043c Finally, the entity considers economic obsolescence. Economic obsolescence relates to a decrease in value due to adverse external factors, such as poor market demand for the product; industrial reorientation and unavailability of transportation; excessive governmental regulations; increased cost of raw materials, labor, or utilities; and other factors. Economic obsolescence is often estimated using an income approach or, in certain instances, measured based on inutility. Inutility exists when the operating level of a property or plant is significantly less than the rated or designed capacity and the condition is expected to exist for the foreseeable future.

Property, Plant, and Equipment to Be Used

17.044 Property, plant, and equipment to be used by the acquirer is measured at the acquisition-date fair value, taking into consideration the highest and best use from a market participant perspective, whether or not that use is consistent with the entity's intended use of the property. If no observable market exists for the acquired assets, an acquirer should use one or a combination of the valuation methods as previously discussed, to measure the fair value of the property, plant, and equipment.

Property, Plant, and Equipment to Be Sold (Held for Sale)

17.045 An acquired long-lived asset (disposal group) that will be sold is classified as held for sale at the acquisition date if the sale is probable and expected to qualify for recognition as a completed sale within one year, and the other criteria in ASC paragraph 360-10-45-9 are probable of being met within a short period (usually within three months) following the acquisition (unless already met at acquisition date). The acquirer should measure an acquired long-lived asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with ASC Section 360-10-35 (i.e., at fair value less cost to sell). ASC paragraph 805-20-30-22

17.046 Costs to sell, according to ASC Section 360-10-35, are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had it not decided to sell. Those costs include broker commissions, legal and title transfer fees, and closing costs that are incurred before legal title can be transferred. The costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is

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classified as held for sale. If the sale is expected to occur beyond one year as permitted in limited situations, the costs to sell should be discounted. ASC paragraph 360-10-35-38

Mining Assets

17.046a Mining assets are comprised of mineral properties and rights. The following guidance applies.

> **ASC Paragraph 930-805-30-1**
>
> An entity shall include value beyond proven and probable reserves in the value allocated to mining assets in a purchase price allocation to the extent that a market participant would include value beyond proven and probable reserves in determining the fair value of the asset.
>
> **ASC Paragraph 930-805-30-2**
>
> An entity shall include the effects of anticipated fluctuations in the future market price of minerals in determining the fair value of mining assets in a purchase price allocation in a manner that is consistent with the expectations of marketplace participants. Generally, an entity should consider all available information including current prices, historical averages, and forward pricing curves. Those marketplace assumptions typically should be consistent with the acquiring entity's operating plans with respect to developing and producing minerals. It generally would be inappropriate for an entity to use a single factor, such as the current price or a historical average, as a surrogate for estimating future prices without considering other information that a market participant would consider.

INTANGIBLE ASSETS

Valuation Analysis

17.047 If an intangible asset meets either the separability criterion or legal-contractual criterion under ASC Topic 805, the intangible asset is recognized and measured at its acquisition-date fair value, with limited exceptions (e.g., reacquired rights), typically through the use of a valuation technique, because an observable fair value for individual intangible assets usually is not available. Most intangible assets acquired in a business combination are intended to provide a direct or indirect return to the acquirer through an increase in revenue, lower costs, or other economic benefits. The valuation technique(s) should be those that best capture the value of those benefits.

17.048 Determining fair value of intangible assets can be measured using one or a combination of the three valuation approaches identified in ASC Subtopic 820-10, depending on facts and circumstances and the type of intangible assets being valued. Several techniques have been developed to estimate the fair value of specific intangible assets. This section discusses some of these methods under the three valuation approaches of the market approach, income approach, and cost approach.

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Market Approach

17.049 The market approach is used to value intangible assets based on recent sales of similar intangible assets when there are known and observable markets or market data for similar assets. Under the market approach, the value of an asset reflects the price at which comparable assets are sold in recent transactions and under similar circumstances. Use of the market approach requires comparable arm's length transactions for the individual intangible asset. If comparable transactions of similar assets are available, valuation ratios are calculated and applied to the intangible asset. However, in practice there are few comparable transactions involving comparable intangible assets within a reasonable time frame. As a result, the market approach is not commonly used to value intangible assets acquired in a business combination.

Income Approaches

Relief-From-Royalty Method

17.050 The relief-from-royalty method is a variation of an income approach that measures the fair value of an asset using a cost-savings concept. This is based on the notion that, if the entity did not own the asset, it would pay a royalty to a third party for the right to use that asset. Therefore, the value of the asset is the fair value of the cost savings of not paying a royalty to a third party. For example, this method is frequently used to value trade names, trademarks, developed technology, and in-process research and development. This is primarily due to the fact that there may be market observable royalty rates available.

17.051 The fair value of the asset is estimated based on the present value of the royalty payments that the acquirer saves by owning the asset, based on a market participant royalty rate. In many cases, the royalty rate is estimated based on market data for royalty arrangements involving similar transactions and assets. Because there may be limitations on the availability of observable data, the valuation professional should develop appropriate support for the royalty rate used.

Example 17.4c: Applying the Relief-from-Royalty Method

ABC Corp. (ABC) acquires DEF Corp. (DEF) and determines that it will use a Relief-from-Royalty (RfR) method to estimate the fair value of DEF's trade name as of the acquisition date. DEF is a domestic company and all of its assets are located in the U.S.

Key assumptions used in this valuation analysis include:

- Indefinite useful life because DEF has been operating under this trade name for more than a century, is well established and a market participant would continue to use the trade name
- Royalty rate of 2%
- Long Term Growth rate of 2.5%.

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Revenue

The projected revenue is based on the likely revenue generated from the intangible asset as of the valuation date and is generally tied to projections expected by a market participant. Because all sales are under the trade name, the revenues equal the total projected revenue for DEF.

Royalty Rate

The royalty rate is usually expressed as a percentage of the revenue generated through the use of the asset. As such, the hypothetical royalty used in the RfR method is calculated by multiplying the selected royalty rate by the future revenue related to the asset.

In many cases, the royalty rate is estimated based on market data for royalty arrangements involving similar transactions and assets with comparable rights and terms, and the royalty rate is adjusted to address differences. The entity should also consider qualitative factors, such as market recognition and awareness, history, longevity, and market size when selecting a royalty rate.

Discount Rate

The discount rate applied to the projected cash flows for an intangible asset must reflect the risk of the cash flows related to the asset. The weighted average cost of capital (WACC) of the business is generally used as a starting point, with upward or downward adjustments applied to reflect the risks of the intangible asset relative to the business.

Tax Amortization Benefit

In applying the RfR to value an intangible asset, the asset's value is equal to the present value of the after-tax cash flows inclusive of a tax amortization benefit. The tax amortization benefit reflects the ability of a market participant to adjust the basis of the intangible asset under a taxable transaction and deduct amortization over the 15-year life required for Section 197 tax purposes. The discount rate the entity uses in calculating the tax amortization benefit should be consistent with the discount rate used to discount other cash flows associated with the intangible asset.

Trade name valuation

($000s)	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
Projected revenue	$163,250	$173,861	$185,162	$197,198	$210,016	$215,266
Royalty rate	× 2%	× 2%	× 2%	× 2%	× 2%	× 2%
Royalty income	3,265	3,477	3,703	3,944	4,200	4,305
Taxes at 25%	816	869	926	986	1,050	1,076
After tax royalty income	2,449	2,608	2,777	2,958	3,150	3,229
Present Value factor at 13%	× 0.9407	× 0.8325	× 0.7367	× 0.6520	× 0.5770	× 5.4949
Present value	2,304	2,171	2,046	1,929	1,818	17,743

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Total present value	28,011
Tax amortization benefit [1]	3,622
Fair value	$31,633

[1] Based on a 15 year tax life and a tax rate of 25% (formula not shown).

Multi-Period Excess Earnings Method

17.052 The multi-period excess earnings method (MPEEM) is used to estimate the fair value of an intangible asset based on a residual cash flow notion. The principle behind this method is that the fair value of an intangible asset can be determined by estimating the cash flows that can be generated by the entire business or asset group and deducting the cash flows on all of the other assets that contribute to the cash flows (i.e., burdening the cash flows with contributory asset charges). The excess cash flows are ascribable to the intangible asset, and the fair value estimate is equal to the present value of those excess cash flows. For example, this method would be used for customer relationships and technology assets acquired in a business combination. See Example 17.4d.

17.053 Contributory asset charges (CACs) used in the MPEEM also are called capital charges or economic rents. Many implementation issues can arise when identifying and calculating CACs and in estimating rates of return associated with each contributory asset. The Appraisal Foundation issued guidance on:

- Considerations when selecting appropriate rates of *return on,* and in some cases *returns of,* identified contributory assets when applying the MPEEM;
- Reconciliation of the MPEEM result to the fair value of the asset grouping;
- Treatment of negative working capital and one-time acquisition accounting adjustments to working capital;
- Two potential calculations for determining fixed-asset CACs;
- Charges for elements of goodwill, other than assembled workforce;
- Simultaneous application of the MPEEM to multiple intangible assets that share the same benefit stream; and
- Comparison of the weighted-average cost of capital with the implied rate of return on a transaction and the weighted-average return on assets.

17.054 Return on and Return of. CACs reflect the usage of contributory operating assets, which may include working capital, fixed assets, and intangible assets. CACs compensate for an investment in a contributory operating asset by reflecting the rates of return on those assets that investors require. This represents the return on contributory operating assets, which will be reflected in the CACs.

17.055 CACs also may capture the recovery of contributory assets, which is the return of the contributory assets. Judgment is needed to determine whether returns of contributory

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operating assets should be included in CACs. For example, cash flows may already reflect reductions in the cash-flow stream for costs that are considered synonymous with returns of the contributory operating asset. When specific cash flows representing returns of the contributory operating assets are reflected in the cash-flow stream, they would be excluded from the CACs to avoid double-counting.

17.056 Reconciliation of Results of the MPEEM. Applying CACs under the MPEEM should neither enhance nor diminish the fair value of other identifiable assets and liabilities. Because CACs are viewed as an allocation of earnings to operating contributory assets, the MPEEM should calculate a specific intangible asset fair value in a manner that can be reconciled to the asset grouping fair value when the intangible asset's value is added to the other discrete operating asset and liability fair values.

17.057 Negative Working Capital. Unlike most other asset categories where CACs allocate the cash-flow stream to other assets, which reduces the fair value of the identifiable intangible asset, CACs for negative working capital represent an enhancement to the fair value of the identifiable intangible asset. The Appraisal Foundation's guidance expresses the view that negative working capital generated in the normal course of business reflects economic reality for some business models (e.g., negative operating cycle) and results in an enhancement of the value of the identifiable intangible by creating a business model where customers are willing to pre-pay for goods or services. However, reflecting negative working capital as an increase to the cash-flow stream would not be appropriate in situations where negative working capital represents an anomalous situation. Similarly, one-time business combination adjustments to working capital (e.g., inventory step-ups) do not represent long-term working capital operating levels and should be excluded from the initial and ongoing levels of working capital used to calculate CACs.

17.058 Calculating Fixed Asset CACs. The guidance describes two ways that may be appropriate for calculating CACs for fixed assets other than land. Both can take into consideration returns of and returns on the required level of fixed assets.

17.059 The *Average Annual Balance* calculation includes two separate charges. The return of charge corresponds to the annual economic depreciation for both the fair value of the contributory fixed assets and the estimated levels of future capital expenditures. It is also used as an input in the determination of the average annual balance of the fixed assets. The return on charge is based on the rate of return a market participant investing in such assets would require, which is applied to the average annual balance of the corresponding fixed assets.

17.060 The *Level Payment* calculation treats CACs as a series of level annual payments. It is conceptually similar to the calculation of an amortizing loan payment. Unlike the Average Annual Balance calculation, the Level Payment calculation presents CACs as one charge comprising both returns on and returns of the required level of fixed assets. Similar to the Average Annual Balance calculation, CACs estimated under the Level Payment calculation are based on the rate of return that reflects the market participant assessment of the investment's risk and is applied to the fair value of the contributory

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fixed assets and future capital expenditures. When used properly, the two calculations should yield comparable results.

17.061 CACs for Goodwill. In a business combination, assembled workforce is subsumed into goodwill rather than being recognized as a separate intangible asset. Nevertheless, the assembled workforce is typically an element of goodwill for which CACs are taken. Furthermore, in an acquisition of assets that is not a business combination, assembled workforce is sometimes recognized as an identifiable asset and is measured based on its fair value. Other than assembled workforce, goodwill-related CACs are expected to appear in MPEEM analyses infrequently, and when they are used, an unrecognized asset should be identified as contributing to the cash-flow stream.

17.061a Hypothetical CACs. The valuation analysis needs to consider and reflect charges for all assets that a market participant would require to provide the goods or services irrespective of whether these assets were acquired as part of the business combination. For example, an acquirer might not have acquired the target's trade name because the acquirer intends to use their own. In such situations, the MPEEM analysis needs to include a trade name charge even though the trade name was not acquired. A contributing asset could be: acquired as part of the transaction, already owned by the acquirer or purchased separately.[4]

17.061b Interrelation of CACs and certain expenses in the projected financial information. When asset charges in a customer relationship valuation include charges for finite-lived intangible assets, such as technology, it is important to avoid double counting R&D expenses in both the return "of" component of the CAC for developed technology and in the expenses in the projected financial information. Often, the CAC for developed technology is applied throughout the MPEEM forecast period based on the assumption that current technology will be replaced over time with a successor technology. Asset charges usually include both the return "on" as well as the return "of" component. There is the possibility of double counting because the projected financial information usually includes the cost associated with developing the successor technology. To avoid this, the MPEEM should add back the development expenses in R&D.[5]

Example 17.4d: Using MPEEM to Value Customer Relationships

ABC Corp. (ABC) acquires DEF Corp. (DEF) and determines that it will use the MPEEM to estimate the fair value of DEF's customer relationships as of the acquisition date. DEF is a U.S. company and all assets are located in the U.S. ABC developed a set of projected financial information for the entirety of the DEF business from a market participant perspective.

Key assumptions used in this valuation analysis include:

- An expected customer attrition rate of 10% per year (simplified linear)
- Growth in existing customer revenue of 4%

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- Marketing expenses related to attracting new customers estimated at 2% of revenue
- Development expenses for the next generation of the underlying technology of 4% of revenue.

Revenue

The MPEEM is based on forecasting revenue for the existing customer base and applying expected attrition rates. An entity then calculates the operating cash flows by determining the costs required to generate revenue from the existing customer base.

The revenue associated with the existing customers is developed by considering the growth anticipated from existing customers from both a volume and pricing perspective. Assumptions about revenue growth should be reasonable based on total revenue growth for the business and can be supported through historical and industry analysis. An entity applies an attrition rate to future revenue to reflect the potential loss of some existing customers over time.

Operating Expense Adjustments

As a starting point, cost of sales and operating expenses (as a percentage of sales) are generally based on the projections for the business in its entirety. The entity must consider what portion of the forecasted sales and marketing costs (included in the operating expenses) would be associated with obtaining new customers versus retaining existing customers. Only that portion attributable to the retention of customers should be retained in the costs relevant to the MPEEM. An analysis of historical data may be used to determine an appropriate percentage of sales and marketing costs that should be added back to cash flows.

Operating expenses should also be adjusted for other components of the cost structure that are not required to generate sales associated with the existing customer relationships. DEF, as an R&D focused business, continuously maintains and improves its technology base, as well as invests in developing new technology that eventually replaces its current technology base. The portion of the R&D budget attributable to the development of new technology is excluded from the customer analysis. Only the R&D expenses attributable to the maintenance of the current technology are included in the analysis. This avoids double counting the expense for new technology. The use of the technology is taken into account by applying an asset charge (see contributory asset charges below).

Market Participant Synergies

Synergies included in the overall projected financial information that would be considered by a market participant should be included in the customer relationship valuation to the extent that the existing customer bases would benefit from these synergies. These can include revenue as well as cost synergies.

Contributory Asset Charges

Contributory asset charges are derived from other assets that contribute to the overall value realized for a particular intangible asset. A contributory asset charge is based on the

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fair value of the contributory asset and a fair return on that asset. Generally, contributory asset charges are levied for working capital, tangible and identified intangible assets.

For DEF, the following assets contribute to the value realized by the customer relationship and are therefore contributory assets:

- Working capital
- Property, plant and equipment
- Land
- Trade name
- Technology
- Workforce

DEF's current technology base has a useful life of approximately 8 years. However, an eventual successor technology will be needed to support the customer relationship subsequently; therefore, the asset charge for technology is applied continuously.

Discount Rate

The discount rate applied to the projected cash flows for an intangible asset must reflect the risk of the cash flows related to the asset. The weighted average cost of capital (WACC) of the business is generally used as a starting point, with upward or downward adjustments applied to reflect the risks of the intangible asset relative to the business.

Tax Amortization Benefit

In applying the MPEEM to value an intangible asset, the asset's value is equal to the present value of the after-tax cash flows inclusive of a tax amortization benefit. The tax amortization benefit reflects the ability of a market participant to adjust the basis of the intangible asset under a taxable transaction and to deduct amortization over the 15-year life required for Section 197 tax purposes. The discount rate the entity uses in calculating the tax amortization benefit should be consistent with the discount rate used to discount other cash flows associated with the intangible asset.

Conclusion

Contributory charges are deducted from the after-tax cash flows and the cash flows are discounted to present value at a risk adjusted discount rate. A tax amortization benefit is then added to arrive at an estimate of the fair value.

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Customer relationship valuation

($000s)	Year 1	Year 2	Year 3	Year 4	Year 5	…[6]
Projected revenue	$150,000	$156,000	$162,240	$168,730	$175,498	
Retention probability [1]	× 100%	× 90%	× 80%	× 70%	× 60%	
Existing customer revenue	150,000	140,400	129,792	118,111	105,299	
EBITDA [2]	30,000	28,080	25,958	23,622	21,057	
Selling and marketing add-back [3]	3,000	2,808	2,596	2,362	2,106	
New technology R&D add-back [3]	6,000	5,616	5,192	4,724	4,211	
Adjusted EBITDA	39,000	36,504	33,746	30,708	27,374	
Depreciation [2]	3,000	2,808	2,596	2,362	2,106	
EBIT	36,000	33,696	31,150	28,346	25,268	
Taxes at 25% [4]	9,000	8,424	7,788	7,087	6,317	
Debt-free net income	27,000	25,272	23,362	21,259	18,951	
Contributory asset charges at 7.5% [5]	11,250	10,530	9,734	8,858	7,897	
Excess earnings	15,750	14,742	13,628	12,401	11,054	
Present value factor at 13%	× 0.9407	× 0.8325	× 0.7367	× 0.6520	× 0.5770	
Present value years 1 to 5	14,816	12,273	10,040	8,085	6,378	
Present value years 6 to 10[6]	13,207					
Total present value years 1 to 10	64,799					
Tax amortization benefit [7]	8,378					
Fair value	$73,177					

[1] Based on the attrition rate of 10%.
[2] Computed as a percentage of revenue based on the overall company PFI.
[3] Based on a percentage of revenue for the respective add-back.
[4] Taxes are computed based on EBIT.
[5] CAC are expressed as a percentage of revenue.
[6] Calculation for years 6 to 10 (not shown for simplicity).
[7] Based on a 15 year tax life and a tax rate of 25% (formula not shown).

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Applying the MPEEM to Multiple Assets within the Asset Grouping

17.062 There is diversity in practice in situations where two or more identifiable intangible assets share the same cash-flow stream and where it might be appropriate to measure each using the MPEEM (e.g., technology and customer-relationship intangibles). A question arises about whether it is appropriate to simultaneously apply cross charges between the identifiable intangible assets in the MPEEM computation. The guidance discourages the use of cross charges and proposes that only one identifiable intangible asset from the asset grouping should be valued using the MPEEM for a specific cash-flow stream. A potential way to resolve the problem is to split the cash-flow stream into more refined subsets of cash-flow streams. Alternatively, other valuation techniques might be used to value other intangible assets in the asset grouping rather than attempting to apply the MPEEM to multiple assets within the asset grouping. Alternative valuation models include the *relief from royalty, with and without, quadrant,* and *separation* methods.

Rates of Return on Contributory Assets

17.063 When an identifiable intangible asset is valued concurrent with a business valuation, leading practices include an analysis comparing the weighted-average cost of capital (WACC), implied rate of return (IRR) and weighted-average return on assets (WARA). A WARA analysis displays rates of return associated with each major asset class including the identifiable intangible asset that was valued using the MPEEM. The guidance observes that the selected rates of return on contributory assets should reflect the riskiness of those assets. Typically the risk profile of an entity's assets increases as one moves down its balance sheet (e.g., working capital generally is less risky than fixed assets, which generally are less risky than intangible assets). There also should be a correlation to how the assets are financed because, as the risk profile increases, the weighting shifts from debt to equity.

17.064 If the analysis shows significant differences among the WACC, IRR, and WARA, it may indicate a need to refine the existing analysis. The process may include altering preliminary rate of return estimates for the identifiable intangible asset or for some of the CACs. Additionally, if the asset grouping fair value assumes a nontaxable transaction structure, the WARA analysis may need to reflect a hypothetical adjustment as if the transaction were taxable, because the portfolio of assets may have been individually valued using a taxable-transaction premise.

Greenfield Method

17.064a The Greenfield Method is frequently used to value licenses (or other operating rights), particularly when the license's benefit significantly exceeds its cost. The underlying theory of the Greenfield Method is that a business is assembled around a pivotal asset (referred to as the *subject asset).* The subject asset's existence is the impetus for additional investments in complementary assets to create an operating entity. In other words, there would be no need to assemble the total asset complement without the subject asset. The license or operating rights driving the business are generally scarce, are often granted or regulated by a government, and are common in these industries:

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- Television
- Radio
- Wireless telecommunications
- Franchising
- Casino and gaming

17.064b Because the Greenfield Method isolates the cash flow attributable to the subject asset, it is considered a direct valuation method as described in ASC paragraph 805-20-S99-3. The Greenfield Method is often compared to the MPEEM, as both methods are used to value pivotal assets of a company. Unlike the MPEEM, however, the Greenfield Method deducts the costs associated with assembling a complementary asset base through explicit cash outflows to build or purchase the supporting assets. The MPEEM deducts economic rents – contributory asset charges – instead of deducting the costs to assemble the contributory asset base.

17.064c The Greenfield Method is often applied when:

- The license is critical to the business and generally considered indefinite in nature (e.g., where revocation rights are minimal);
- The industry has significant physical or legislative barriers to entry;
- There is a scarcity of licenses accessible to the industry (i.e., not situations where non-exclusive rights are routinely granted to all operators); or,
- The license allows possession of an underlying resource or asset and therefore denies its use to others.

Applying the Greenfield Method

17.064d The assumptions used in applying the Greenfield Method should reflect market participant expectations, industry standards, and trends in the respective markets as of the valuation date. Entities should consider technological advances throughout the forecast period to the extent they may affect the cash flows of market participants. Thus, the assumptions about returns, risks and growth patterns may be materially different from the actual, historical experience of the company that currently owns the asset.

17.064e Typically the Greenfield Method considers at least two distinct stages:

- The ramp-up period, encompassing the initial build-out of the business until mature margins and earnings are reached; and,
- Mature business operations or the terminal value.

17.064f Application of the Greenfield Method differs across industries because determining the fair value should be driven by the economics underlying the value of the subject asset. Generally, the Greenfield method requires a wide range of inputs and assumptions, including the length of the ramp-up period, mature earnings projections, capital expenditures and depreciation, working capital, tax rate, terminal value, discount

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rate, and tax amortization benefit. It may be challenging to gather all required data and make all relevant assumptions.

17.064g Ramp-Up Period. An entity should estimate the time period necessary to achieve a stable, mature business assuming the new business begins only with the subject asset. This ramp-up period should be based on industry norms for the subject asset and therefore may differ from the actual manner in which the business was formed and is currently operated. During this period, the projected earnings typically ramp up from zero or a negative figure to a mature level which in most cases is positive. The length of the ramp-up period may be influenced by various factors, such as the time to build out the required infrastructure (e.g., a wireless network in the case of a wireless spectrum license) or the time to acquire customers and reach a mature level of market share. Often a company would experience significant start-up expenses and inefficiencies resulting in substantial early period losses. Combined with the initial capital expenditures, the general expectation is that cash flows are negative in the initial years. The specifics associated with the ramp-up period may differ depending on the asset, industry, region, and other factors.

17.064h Mature business operations. The long-term estimate of cash flows for the subject asset should be based on market participant assumptions for market share, revenue and operating costs. The long-term outlook of the business owning the subject asset, however, is often used as a proxy. In that case, mature Greenfield Method cash flows converge with the projections of the existing business. Alternatively, there might be circumstances in which the existing business is not representative of a market participant long-term expected mature state. Examples can be existing businesses that have significant company-specific synergies with other assets or business units that are independent of the subject asset, or an existing business that does not fully utilize the potential of the subject asset (e.g., using an FCC license for strictly educational or religious broadcasting when it is available for full commercial use). As with the ramp-up period, the projection of the mature level of the business is subjective and thus requires consideration of industry benchmarks, market conditions, etc. to derive a market participant view. Depending on the industry, reliable market data may be difficult to obtain. Assumptions necessary to apply the Greenfield Method may be easier to support for industries where market studies of financial projections are available.

17.064i Terminal Value. Assets typically valued using the Greenfield Method generally have indefinite useful lives under ASC paragraph 350-30-35-4 and thus require a terminal value. Some of those assets may need to be renewed regularly. However, the example in paragraphs 350-30-55-11 through 55-13 indicates that if renewal is expected indefinitely with minimal legal, regulatory, economic or technological hurdles and there is a history of renewal for the asset, it would be deemed to have an indefinite useful life.

17.064j Tax Effects. To value the subject asset, an entity also must consider the relevant tax rate, tax losses created during the ramp-up period, and the depreciation of assets for tax purposes. During the initial ramp-up period, a business may generate significant losses. As the Greenfield Method theoretically analyzes the subject asset in isolation, an entity should assume that net operating losses generated by the subject asset are carried

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forward to offset earnings generated by that asset in future periods, rather than assuming that the net operating losses are used immediately to offset earnings from other unrelated assets in the business. Furthermore, only net operating losses generated by the subject asset should be considered in its valuation. Acquired or future net operating losses of the existing business are generally excluded from a Greenfield Method valuation.

17.064k To the extent that the subject asset qualifies as an amortizing intangible asset for tax purposes in the applicable jurisdiction, a tax amortization benefit is included in the valuation.

17.064l Discount Rate. Because the cash flows portray an entity using the subject asset, a WACC calculation for the hypothetical new business is typically used and is based on the long-term capital structure of a market participant and its associated cost of debt and equity. In practice, the WACC of the assembled business is often used as a starting point. Depending on the relative risk profile of the cash flows used, the discount rate in the analysis may differ from the WACC associated with the combined business operations of the company owning the subject asset, particularly if the market participant's view of the asset differs from its current use by the existing business; for example, because of company-specific factors or synergies. An entity should consider the start-up nature of the cash flows, the size of the operations, and the resulting riskiness of the cash flows when selecting the appropriate discount rate.

Incremental Cash Flow Method

17.065 Similar to the multi-period excess earnings method, the incremental cash flow method is used to estimate the fair value of an intangible asset based on a residual cash flow notion. This method measures the benefits (e.g., cash flows) derived from ownership of an acquired intangible asset as if it were in place, as compared to the acquirer's expected cash flows as if the intangible asset were not in place (i.e., with-and-without). The residual or net cash flows of the two models is ascribable to the intangible asset and, when discounted to its present value, provide an estimate of its fair value. The present value estimate should be determined using a discount rate that market participants would demand in light of the risks involved.

Cost Savings Method

17.066 The cost savings method values the asset by calculating the present value of the cost savings that an acquirer estimates would be obtained through owning an existing and functioning asset, provided that the cost savings would be available to market participants if they owned the intangible asset. These cost savings represent a measure of the benefits of ownership of the asset.

Cost Approach

17.067 The cost approach values the intangible asset based on the costs that would be incurred to re-create the intangible asset. Costs include directly attributable costs such as research and development. It is unusual for a cost approach to be used to value intangible assets. Intangible assets, especially those valued in combination with other assets or assets and liabilities as a group, typically possess value that transcends the estimated sum of the

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costs to re-create the asset. Therefore, there may be little or no relationship between cost and fair value. However, the use of a cost approach may be appropriate in limited circumstances, including the valuation of (1) assets that can be substituted effectively through replacement or reproduction over a relatively short period of time, or (2) specific IPR&D projects in which the stage of development, while substantive, is so early that reliable information about anticipated future benefits does not exist.

Intangible Assets Commonly Acquired in Business Combinations

17.068 The table and discussion below identify several intangible assets that are commonly acquired in business combinations, and some of the commonly used techniques for estimating the acquisition-date fair value of those assets. The list is not all-inclusive, and is presented for illustration purposes only.

Common Fair Value Measurement Concepts

	Valuation Approaches				
	Market	Income			Cost
Intangible Assets		Relief-From-Royalty Method	Multi-Period Excess Earnings Method	Incremental Cash Flow Method	
Marketing related					
Trademarks and trade names	O	F	S	O	S
Non-compete agreements	S	S	S	F	S
Customer related					
Customer relationships	S	S	F	O	S
Order/production backlog	S	S	F	O	S
Customer lists	O	S	O	S	F
Artistic-related					
Musical works	O	O	F	S	S
Technology based					
Patented and unpatented technology	S	F	O	O	F
In-process research and development	S	O	F	S	S

Labeling Key
F = Applied Frequently
O = Applied Occasionally
S = Applied Seldom

Trademarks and Trade Names

17.069 Trademarks and trade names (branding or brand) are used by entities to differentiate the source of a product and to distinguish it from competitors' similar products. Trademarks and trade names are frequently measured using the relief-from-royalty method. Key considerations when applying this technique when measuring trademarks and trade names include:

- Identifying the benefit stream attributed to the trademarks and trade names;
- Understanding the planned use for the trademarks and trade names by the acquirer and whether it is similar to the expected uses by market participants;

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- Selecting a royalty rate from market comparable agreements or previous agreements for the asset;
- Establishing a market participant tax rate;
- Determining whether a tax amortization benefit is appropriate; and
- Determining whether a terminal value is appropriate in the calculation.

Noncompete Agreements

17.070 Noncompete agreements are contracts that place restrictions on an entity or former owners of an entity and their ability to compete with the acquirer. The restrictions relate to specified markets and/or specified products or activities for a defined period of time. Noncompete agreements are often measured using the incremental cash flow method. Key considerations when applying this technique include:

- Identifying the benefit stream attributed to the noncompete agreement;
- Understanding of the period covered by the agreement;
- Estimating the probability of competition absent the agreement;
- Assessing the business impact of competition absent the noncompete agreement;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

Customer Relationships

17.071 Customer relationships acquired in a business combination may arise from contractual rights or through means other than contracts. For example, a customer relationship may exist 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. In many circumstances, intangible assets representing customer relationships are a significant element of the acquiree's fair value. Customer relationships are often measured using the multi-period excess earnings method. Key considerations when applying this technique include:

- Identifying one or multiple types of relationships to be measured at fair value;
- Identifying revenue or cash flow attributable to existing customer relationships (excluding order or production backlog, deferred revenue, and any separately recognized contract assets or contract liabilities after adoption of ASC Topic 606);
- Understanding revenue growth for existing customers;
- Estimating remaining contract lives or an attrition rate for existing customers;
- Removing sales and marketing expenses incurred by the entity to attract new customers;

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- Quantifying market participant synergies;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

Order/Production Backlog

17.072 Order or production backlog arises from unfulfilled contracts such as purchase or sales orders at the acquisition date. Order or production backlog is often measured using the multi-period excess earnings method because the benefit stream of the backlog may be distinct from the customer relationship intangible asset. Key considerations when applying this technique include:

- Identifying revenue or cash flow attributed to existing, but unfulfilled orders (excluding any separately recognized contract assets or contract liabilities after adoption of ASC Topic 606);
- Understanding the applicable costs related to the revenue or cash flow stream and adjusting to reflect market participant assumptions, if necessary;
- Determining the period over which the orders will be fulfilled;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

Customer Lists

17.073 A customer list consists of information about customers, such as their names and contact information. The list may be in the form of a database with other information, such as customer order histories and demographic information. A customer list is often measured using the cost savings method. Key considerations when applying this technique include:

- Identifying the costs incurred to collect, organize, and input the data into a storage system;
- Understanding the applicable costs related to development and maintenance of the software system used to store the data;
- Determining all other applicable costs related to the recreation of the customer list, including opportunity costs;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

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Musical Works and Rights

17.074 Musical works and rights such as musical compositions, represent works of art that may be income producing. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. Rights to musical works are seldom transacted on an individual basis. Instead, it is common for musical works, or the rights to market them, to be aggregated as a portfolio of income generating assets.

17.075 Because musical works and rights generate income, they may be measured under an income approach using a discounted cash flow method. Typically, this occurs when the portfolio constitutes a majority or all of the assets of the business. When musical works and rights exist among other income generating assets and the related cash flows cannot be separated, the portfolio of musical works and rights is frequently measured using the multi-period excess earnings method. Key considerations when valuing artist-related intangible assets include:

- Identifying revenue or cash flow attributed to the artist-related works and rights;
- Understanding the applicable costs related to the artist-related works and rights;
- Evaluating similarities and differences between the subject asset and the observed peer group;
- Determining the period over which the artist-related works and rights will be monetized;
- Calculating contributory asset charges, if appropriate;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

Patented and Unpatented Technology (Including Software)

17.076 Technology-related assets comprise a set of technical processes, intellectual property, and the institutional understanding within an organization with respect to various processes and products. Those assets can be classified as patented and unpatented technology. Generally, advanced technology is covered by a patent or similar legal protection.

17.077 Patented and unpatented technology is frequently measured using the relief-from-royalty method or cost savings method. Key considerations when applying these techniques include:

- Evaluating if the asset provides a return (e.g., generates revenues or cash flows), reduces expenses, or provides some other economic benefit;
- Understanding the planned use for the asset by the acquirer, and whether that planned use is similar to or different from potential use by market participants;

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- Identifying depreciable factors (e.g., erosion of value) and the remaining economic life;
- Quantifying costs incurred to develop the asset and required future costs;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

In-Process Research and Development

17.078 Research and development projects that are underway but not completed are referred to as in-process research and development (IPR&D). IPR&D acquired in a business combination satisfies the definition of an asset for recognition and measurement, because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from the IPR&D (see considerations in evaluating whether IPR&D qualifies as an asset in a business combination in Section 7).

17.079 The income approach is commonly used to value IPR&D assets. Techniques under the income approach include, but are not limited to, the multi-period excess earnings, relief-from-royalty, decision tree, and *split* methods. These methods are described in Chapter 1 of the AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities* (IPR&D Guide). Key considerations when applying the multi-period excess earnings method include:

- Selecting prospective financial information that best reflects the consideration transferred;
- Confirming the existence of assets acquired to be used in research and development activities, including IPR&D;
- Determining the cash flows related to the reliance on core or other technologies;
- Eliminating the effects of non-IPR&D activities from the prospective financial information;
- Capturing all expenses related to the IPR&D activity, including any third party royalty payments or future milestone obligations related to previous licenses of products employed in the IPR&D;
- Quantifying market participant synergies;
- Calculating contributory asset charges;
- Establishing a market participant tax rate; and
- Determining whether a tax amortization benefit is appropriate.

17.080 A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as defensive intangible assets or locked-up assets. Under ASC

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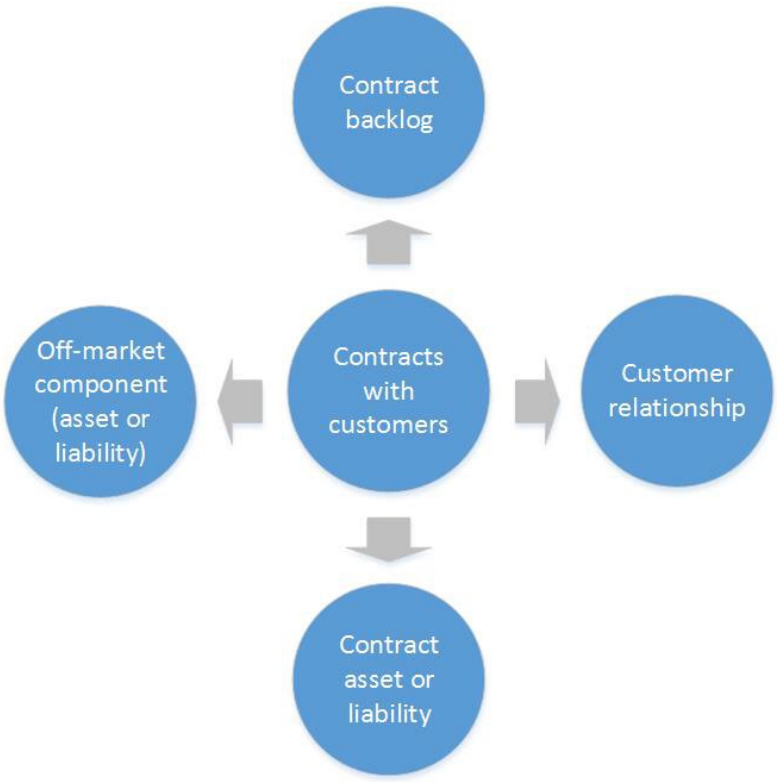
Topic 805, an acquirer recognizes and measures all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Subtopic 820-10. ASC Subtopic 350-30 provides guidance on how defensive intangible assets should be accounted for subsequent to their acquisition. When an IPR&D asset is acquired and intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. Refer to Section 12 for additional discussion of the accounting for defensive intangible assets.

CONTRACTS WITH CUSTOMERS

17.081 In a business combination, an acquirer must account for an acquiree's contracts with customers (revenue contracts) under ASC Topic 606. However, there may be multiple assets and/or liabilities arising from those contracts, some of which are measured at fair value in accordance with ASC Topic 805 and some of which are measured in accordance with ASC Topic 606. Contract assets and contract liabilities are exceptions to the recognition and measurement principles within ASC Topic 805. See Section 7 for additional details on the recognition and measurement principle exception.

17.082 An acquired contract with a customer may affect the following units of account:



Those units of account are commonly measured as follows.

- **Contract backlog.** If the contract is unique or not easily replaceable, then a backlog intangible asset is typically valued using an income approach (e.g., the multi-period excess earnings method). If the contract is easily replaceable,

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then backlog is typically valued using a cost approach via the avoided costs to acquire the contract. See Paragraphs 17.052 and 17.067 for additional discussion of the multi-period excess earnings method and the cost approach, respectively.

- **Off-market component.** This is an asset or liability to the extent that the terms of the contract are above or below what a market participant could achieve at the time of the acquisition. This unit of account is often valued using an income approach via the off-market differential as of the acquisition date. See Paragraphs 7.095 through 7.096 for additional discussion of accounting for contracts with favorable or unfavorable terms.
- **Contract asset or liability. These assets and liabilities are measured in accordance with ASC Topic 606 rather than fair value.** See Paragraphs beginning at 7.025d for a discussion of contract assets and contract liabilities.
- **Customer relationship.** The customer relationship intangible asset may be recognized separately from the contract and is often measured using an income approach (e.g., the multi-period excess earnings method or the distributor method). See Paragraphs 17.071 and 17.052 for additional discussion of valuing customer relationships and the multi-period excess earnings method, respectively.

17.083 These units of account can be incorporated into one valuation analysis (taking into account the different measurement basis of the contract asset or liability) or they may be estimated separately using various valuation techniques. It is important to understand the units of account to avoid double counting value. Regardless of the valuation approach applied, all cash flow components of a contract with a customer should be accounted for in the measurements of the different units of account above or in some cases another intangible asset. This is the case even when future cash flows are constrained under ASC Topic 606 because of either the variable consideration or royalty constraint, in which case the constrained cash flows would not be included in the measurement of the contract asset or contract liability, but would be included in determining the fair value of other intangible assets (e.g., customer-related intangible assets or acquired technology).

Example 17.5: Accounting for an Acquiree's Revenue Contract

Acquirer acquires Acquiree in a business combination on April 30, 20X9. Acquiree has a contract with a customer to perform a daily cleaning service at a customer's properties. The contract term runs from January 1, 20X9 to December 31, 20X9. The fee for the cleaning services is $1,000 per month, billable quarterly in arrears. The cleaning service is a performance obligation satisfied over time because the customer receives and consumes the benefits of Acquiree's performance as Acquiree performs. At the acquisition date, Acquiree had recognized revenue of $4,000 under the contract (using a time-based measure of progress) and a contract asset of $1,000. The first quarter receivable had been collected.

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Acquirer evaluates the accounting for the revenue contract under ASC Topic 606 as if Acquirer had originated the contract. The total transaction price for the contract is $12,000 and at the acquisition date Acquirer would have recognized revenue of $4,000 using a time-based measure of progress. At the acquisition date, the Acquirer records a contract asset of $1,000, which is the difference between the amount of revenue that Acquirer would have recognized ($4,000) and the amount it is unconditionally entitled to under the contract (the $3,000 already collected).

Assume that Acquirer records the following amounts for the contract asset and the remaining units of account at the acquisition date.

	Amount recognized
Contract asset (ASC Topic 606 value)	$1,000
Backlog intangible asset (fair value)	240
Favorable contract intangible asset (fair value)	160

At the acquisition date there is $8,000 of the ASC Topic 606 transaction price yet to be recognized ($12,000 less previously recognized revenue of $4,000) and Acquirer will recognize $1,000 of revenue per month as the performance obligation is satisfied. The contract asset of $1,000 recorded at the acquisition date will be reclassified to a receivable once its performance through June 30, 20X9 is complete.

Acquirer also amortizes the favorable contract intangible asset against revenue, resulting in a $20 per month ($160/8) reduction of revenue. Finally, Acquirer recognizes expense of $30 per month as the backlog intangible asset is amortized ($240/8). Alternatively, Acquirer could recognize the amortization of the backlog intangible asset as a reduction of revenue and no expense each month.

Acquirer records the following journal entries on May 31, 20X9 if the backlog intangible asset is amortized to expense:

	Debit	**Credit**
Contract asset	1,000	
Revenue		1,000

To recognize revenue in accordance with time-based measure of progress for May 20X9

Revenue	20	
Accumulated amortization on favorable contract intangible asset		20

To amortize the favorable contract intangible asset to revenue for May 20X9

Amortization expense	30	
Accumulated amortization on backlog intangible asset		30

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To recognize amortization of backlog intangible asset related to Acquiree's revenue contract for May 20X9

Acquirer records the following journal entries on June 30, 20X9:

	Debit	Credit
Accounts receivable	3,000	
Revenue		1,000

To recognize revenue in accordance with time-based measure of progress for June 20X9 and to record the accounts receivable from the customer and derecognize the associated contract asset.

Revenue	20	
Accumulated amortization on favorable contract intangible asset		20

To amortize the favorable contract intangible asset to revenue for June 20X9

Amortization expense	30	
Accumulated amortization on backlog intangible asset		30

To recognize amortization of backlog intangible asset related to Acquiree's revenue contract for June 20X9

The entries for July through December 20X9 would follow in a similar fashion, with the contract asset balances being adjusted to account for the difference between the amounts of revenue and billings, and with amortization of the favorable contract and backlog intangible assets recognized each period.

Acquirer separately determines the fair value of the customer relationship intangible asset and amortizes it to expense over its remaining useful life.

17.084 Paragraph not used.

LEASES (ACQUIREE IS LESSEE)

17.085 An acquiree's right of use asset is not measured at fair value. Rather, it is measured at an amount equal to the lease liability, adjusted for favorable or unfavorable terms. As discussed in the following paragraphs, the favorable or unfavorable component is measured at fair value. For additional guidance on recognizing and measuring assets and liabilities associated with acquired leases under ASC Topic 842, see chapter 11 of KPMG Handbook, Leases.

17.086 In a business combination, the acquirer would determine whether the terms of operating lease contracts acquired are favorable or unfavorable relative to market terms of comparable leases at the acquisition date. The fair value of an operating lease is the

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amount another entity of comparable credit standing would pay to assume the lease under its current terms, or the amount a market participant would pay to exit the lease.

17.087 Quoted market prices, if available, provide the most reliable and best evidence of fair value. In the absence of active markets with quoted market prices or other reliable information that indicate the value of the operating lease, the fair value of an operating lease is estimated using an income approach by identifying the present value of a rent differential (i.e., the difference between future cash flows under the contractual lease terms and current market rental rates). In addition, the original value of an acquired lease (e.g., the value associated with the avoidance of costs that would normally be incurred to execute a similar lease) should be considered in determining the fair value of the lease when the acquiree was the lessor under the operating lease.

17.088 If available, currently obtainable rental rates for similar assets, subject to similar terms, provide the best estimate of the market rental rate. If information about currently obtainable rental rates for similar assets is not available, circumstances to consider in estimating the market rental rate of the asset underlying an acquired operating lease include, but are not limited to:

- The general availability of the leased asset;
- Characteristics of the counterparty (such as creditworthiness of the lessee);
- The remaining lease term; and
- Renewal provisions and expectations.

17.089 When using the present value of a rent differential to estimate the fair value of an acquired lease, the acquirer should consider whether the rental rate that could be currently obtained in a market transaction for the underlying asset is a fair representation of the fair value rental rate. Some at the money leases, such as operating leases for airport gates, are sometimes bought or sold in exchange transactions. In those cases, there may be value to lease even if there is no rent differential.

17.090 The acquirer should consider whether an acquired operating lease may produce other identifiable intangible assets. For example, in certain real estate leases there may be an ongoing customer relationship with an anchor tenant associated with an acquired lease. A customer relationship that meets the recognition requirements of ASC Topic 805 should be recognized separately from the value of the lease and accounted for in a manner consistent with other separately identifiable intangible assets.

17.091 The present value of a rent differential of an acquired operating lease should be determined using a discount rate that is commensurate with the risks involved. Notwithstanding the fact that acquired operating leases may be valued using present value techniques, it is not appropriate to accrue interest on the value assigned to those leases subsequent to the acquisition date. Rather, the amount reflected in the acquisition accounting is amortized as an adjustment to lease expense if the acquiree is a lessee, or lease income if the acquiree is a lessor in periods subsequent to the acquisition date.

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17.092 When lease agreements contain variable terms, such as adjustments based on revenues or price changes, the acquirer should consider the terms of the lease relative to current market terms of comparable leases that were consummated near the date of acquisition to determine the fair value of the lease. If the annual lease payments of an operating lease are adjusted by the increase in an existing index or rate (such as the Consumer Price Index) plus 100 basis points, and the current market terms of comparable leases are based on the increase in the stipulated index plus 250 basis points, the 150 basis points difference in the application of the inflation index would be considered in determining the fair value of the lease.

17.093 – 17.095a Paragraphs not used.

LEASES (ACQUIREE IS LESSOR)

17.095b An acquirer recognizes an asset (liability) for favorable (unfavorable) terms in an acquiree lessor's **operating lease.** The favorable (unfavorable) asset (liability) is measured in the same manner described in Paragraphs 17.086-17.092.

17.095c For an acquiree lessor's **sales-type and direct financing leases**, the lease receivable is measured at the present value of the remaining lease payments and guaranteed residual value, and the unguaranteed residual asset is measured as the difference between the fair value of the underlying asset and the lease receivable. For additional guidance on recognizing and measuring assets and liabilities associated with acquired leases after adopting ASC Topic 842, see chapter 11 of KPMG Handbook, Leases.

INCOME PRODUCING REAL ESTATE IN THE REAL ESTATE INDUSTRY

17.096 Acquired income producing real estate should be valued as if the acquired property were vacant and include the value of used tenant improvements. The following discussion is intended to provide general guidance on applying this approach for real estate acquisitions. The identification, valuation, and amortization of tangible and intangible assets are determined based on the facts and circumstances of each acquisition and the process may vary from the approach described herein.

Step 1: Determine the *as-if vacant* fair value of the physical property acquired. Factors to consider in arriving at the value of a vacant building include current market lease terms, absorption rates, availability of comparable competing space, lease commissions and tenant improvements that would be incurred, historical occupancy and leasing history, quality of the building and its replacement value, and the future cash flows and valuation assumptions (including the capitalization rate and risk adjusted discount rate). Consideration should be given to existing tenant improvements in place in assessing how much, if any, tenant improvement allowance is needed to execute current market leases. In some cases, the client and/or lender may obtain a *dark value* appraisal, which should be considered as a means to determine *as-if vacant* fair value.

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Step 1a: Assign the as-if vacant fair value to land, building and improvements, and equipment based on each component of the asset's fair value utilizing a cost segregation study, appraisal, or comparable analysis.

Step 2: Determine the portion of the consideration transferred related to the value of above and below market in-place leases. Such amounts are determined on a lease-by-lease basis by computing the net present value of the difference between (i) the contractual amounts to be paid pursuant to the in-place lease and (ii) management's estimate of the fair market lease rate for the corresponding in-place lease measured over a period equal to the remaining term of the lease. Off-market renewal options, including those with off-market fixed or variable rates, should be considered in determining the value of the above and below market in-place leases. A favorable renewal option (i.e., unfavorable to the lessee) is generally ascribed no value, unless there are unusual circumstances that indicate the lessee is likely to exercise the option. Unfavorable renewal options (i.e., favorable to the lessee) that a market participant would reasonably expect the lessee to exercise generally should be included in the calculation of below market in-place lease values, regardless of whether the renewal periods are included in the lease term used for accounting purposes. Once the acquirer has calculated the value of the above and below market in-place leases, if that value is favorable (asset position) for some leases but unfavorable (liability position) for others, the acquirer should present the respective asset and liability amounts gross on its balance sheet as discussed above. Above market lease values generally would be amortized to rental income over the remaining term of those leases. Below market lease values would generally be amortized to rental income over the remaining lease term plus any renewal periods that were considered in the valuation of the below market lease liability.[6]

Step 3: Determine the portion of the consideration transferred related to the value of leases in-place at acquisition. In-place lease value should consider: (i) the value associated with avoiding the cost of originating the acquired in-place leases (i.e., the market cost to execute a similar lease, including leasing commission, legal, and other related costs); (ii) the value associated with the avoidance of tenant reimbursable operating costs estimated to be incurred during the assumed re-leasing period (i.e., real estate taxes, insurance, and other operating expenses); (iii) the value associated with lost rental revenue during the assumed re-leasing period; and (iv) the value associated with avoided tenant improvement costs or other inducements to secure a tenant lease. The value of in-place leases is amortized over the period that the in-place leases are expected to contribute to the future cash flows of the entity, based on entity-specific assumptions. In practice, this generally is viewed as the remaining term of the respective lease.

Step 4: Determine the unassigned amount by comparing the purchase price of the property to the sum of the amounts determined in steps 1-3. The unassigned amount represents a preliminary estimate of the value to be assigned to acquired customer relationships.

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Step 5: After considering alternative valuation techniques, evaluate the reasonableness of the amount assigned to the value of customer relationships in Step 4 to ensure that the value is representative of the customer relationships acquired. When evaluating the reasonableness of the value assigned to customer relationships, consider the nature and extent of the acquiree's existing business relationships with the tenants, growth prospects for developing new business with the tenants, and expectations of lease renewals. If the amount appears to be unreasonable, reassess whether all acquired assets assumed have been identified, recognized, and properly valued.

17.097 The value of the customer relationship intangible asset is amortized over the remaining initial term plus any renewal periods in the respective leases, but in no event should the amortization period be longer than the remaining depreciable life of the building.

Q&A 17.3: Purchase of a Real Estate Development Company

ABC Corp., a real estate development company, was acquired for $1 million. Assets consist primarily of cash and real estate (land to be developed, projects under development, and completed projects). In accordance with Topic 805, the acquirer has measured the identifiable assets acquired and liabilities assumed, except real estate, at their acquisition-date fair values. For the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed to equal the consideration transferred (assume no goodwill is involved), real estate is assigned a value of $1.8 million, which is assumed to be less than fair value.

Q. Is a value of $1.8 million assigned to real estate appropriate (again, assuming no goodwill is involved)?

A. No. Under ASC Topic 805, ABC should determine the acquisition-date fair value of the identifiable assets acquired and liabilities assumed. It would not be appropriate to value the real estate using a residual or *difference* method as described in this example. Fair value of land to be developed should be based on appraised values. Because ABC is a real estate developer, it may be appropriate for ABC to analogize to valuation of work-in-process and finished goods inventories in the valuation of projects under development and completed projects, respectively.

LIABILITIES

OVERVIEW

17.098 ASC Topic 805 requires that liabilities be measured at fair value determined in accordance with ASC Subtopic 820-10, reflecting the price that would be paid to transfer the liability in an orderly transaction between market participants at the date of acquisition. A fair value measurement of the liability should not include an adjustment related to a restriction that prevents transfer because the restriction is implicitly or

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explicitly captured in the other inputs to the fair value measurement (ASC subparagraph 820-10-35-18B). ASC paragraph 820-10-35-16 states that the transfer of a liability assumes that the liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. It is further assumed that the liability would not be settled with the counterparty or otherwise extinguished on the measurement date. Because the liability to the counterparty is presumed to be transferred rather than settled, the fair value measurement reflects the credit risk of the reporting entity and nonperformance risk is assumed to be the same before and after transfer.

17.099 Because liabilities are not typically transferred in active markets, estimating the fair value at the acquisition date involves the use of judgment. In ASC paragraph 820-10-35-16, the FASB noted that in the absence of a quoted price in an active market for an identical or similar liability at the measurement date, which would be unavailable because liabilities are not exchange-traded as liabilities, an entity should measure the fair value of the liability as follows:

- Using a valuation technique based on the quoted price of an investment in the identical liability traded as an asset;
- If the price of an identical liability traded as an asset is not available, use of a valuation technique that uses other observable inputs such as the quoted prices for investments in similar liabilities traded as assets; or
- If observable inputs are not available, use of another valuation technique under an income or market approach.

17.100 The following section identifies commonly used ways to measure the acquisition date fair value of certain liabilities acquired in business combinations.

TRADE ACCOUNTS AND NOTES PAYABLE

17.101 Trade accounts and notes payable assumed in a business combination are measured at fair value. Given the lack of observable markets or observable inputs for the transfer of trade accounts and notes payable, such liabilities are often measured using an income approach and discounted at the present value of the amounts to be paid, using an appropriate discount rate reflecting nonperformance risk inherent in the payable, using a market participant perspective.

17.102 Similar to trade accounts receivable, discounting for trade account payables may not be necessary when they are to be settled in a short period of time, provided that the difference between the present values and the gross amounts of the payables is not significant.

17.103 In September 2008, the VRG noted that some entities recognize components of working capital, including trade accounts receivable, at the acquiree's book value because the differences resulting from current interest rates are deemed to be insignificant. However, this is a non-GAAP policy and accordingly, entities should evaluate the potential significance of the policy and be able to support that applying the non-GAAP

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policy is immaterial to the entity's financial statements at the date of acquisition and in subsequent periods.

17.104 Paragraph not used.

LONG-TERM DEBT

17.105 Long-term debt, such as bonds and interest-bearing notes, are financial obligations that are not payable within 12 months. In a business combination, debt assumed is required to be measured at fair value at the date of acquisition. Quoted market prices, if available, generally provide the most reliable and best evidence of fair value. The use of quoted market prices for the debt traded as an identical asset can be used to measure fair value.

17.106 In the absence of quoted market prices for debt assumed (e.g., privately issued debt, quoted price of the instrument when traded as an asset), fair value is frequently determined using a market approach or income approach or, if appropriate, an entry price as a proxy for of the exit price of the liability (see Paragraph 16.040).

17.107 Debt issuance costs of the acquiree for debt issued prior to the business combination are generally recorded by the acquiree as a reduction of the liability and amortized over the debt term. Unamortized debt issuance costs of the acquiree are not recognized in a business combination because they do not meet the definition of an asset. Furthermore, debt issuance costs are not factored into the fair value measurement of the debt.

Market Approach

17.108 If quoted market prices are not available, an acquirer's best estimate of fair value may be based on the quoted market price of debt instruments traded as assets with similar characteristics, for example, quoted market prices of a similar debt instrument that is traded as an asset on a public exchange or dealer market, taking into consideration legal restrictions on the debt obligation. Similar market approaches are available when determining the fair value of debt assumed in a business combination, including a matrix pricing technique. Matrix pricing is a mathematical technique used to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

Income Approach

17.109 An acquirer's best estimate of the fair value of the debt obligation may be based on the present value of current market expectations of future cash flows using an appropriate discount rate. An appropriate discount rate is developed using observable inputs, if available, and should reflect current interest rates, credit assumptions, market liquidity, and other factors that market participants would incorporate in determining the price they expect to receive for the liability to be transferred to them.

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17.110 The discount rate should be based on the credit standing of the combined entity if the acquirer becomes directly obligated or guarantees the assumed debt. The credit standing of the combined entity may have characteristics of the creditworthiness of the acquirer prior to the business combination, or a blended credit standing of the acquirer and acquiree (e.g., for publicly traded debt, the market may react negatively to the increased leverage and combined credit profile of the acquirer as a result of the business combination). If the debt remains the obligation of the acquiree only, the appropriate discount rate may be the rate applicable to the acquiree's stand-alone creditworthiness at the date of acquisition. However, if market participants anticipate that the acquiree will benefit from synergies of the combined entity, then a more favorable discount rate may be appropriate. We believe using the acquirer's discount rate indicates that the acquirer has implicitly guaranteed the debt, whereas using the acquiree's discount rate could imply that the acquirer would tolerate a default scenario. For a strategic acquirer, we believe that using the acquiree's discount rate would be rare, because usually the acquirer would not permit debt default, which could lead to deconsolidating the subsidiary if it goes into bankruptcy and effectively negate the purpose of an acquisition. However, for a financial acquirer (e.g., a private equity firm), using the acquiree's discount rate might be more appropriate.

17.111 Factors to consider in determining the fair value of the debt assumed include:

(a) The remaining term to maturity of the debt assumed. If the debt assumed has a remaining term to maturity of five years, the market interest rate of the new debt with a five-year term to maturity should be considered in determining the appropriate interest rate to use in determining fair value.

(b) Conversion features of the debt, if any. If the debt is convertible into preferred or common stock, the market price of the preferred or common stock into which the debt is convertible should be considered in determining fair value.

(c) All other terms of the debt instrument, such as prepayment penalties, change-in-control provisions, call provisions, guarantees, and debt covenants.

(d) If the interest rate on the debt assumed in a business combination is dependent on the prime rate or another benchmark rate, but subject to a stated minimum and maximum rate condition at the date of acquisition.

Example 17.8: Determining the Fair Value of Debt Assumed in a Business Combination

ABC Corp. acquires DEF Corp. in a business combination. DEF operates in a newly deregulated industry, experienced operating losses, and expects negative cash flows beginning two years from now. ABC has an AA-credit rating and can borrow at 5%, while DEF has a BBB-credit rating and can borrow at 12%. Before the business combination, DEF's property, plant, and equipment were financed with senior unsecured debt. ABC intends to assume or guarantee the debt as part of the business combination. There are no prepayment rights as part of the debt obligation.

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Q. In determining the fair value of the debt assumed, how should ABC evaluate the senior unsecured debt?

A. Because ABC intends to assume or guarantee the senior unsecured debt, the debt should be evaluated based on the creditworthiness of the combined entity (e.g., if the debt is publicly traded, market participants may anticipate the enhanced credit standing of the debt at the date of acquisition based on the creditworthiness of the combined entity when pricing the debt).

However, if the debt remains the obligation of the acquiree, the effective interest rate would be based on the prior credit characteristics of the debt obligation based on DEF's BBB-credit standing if market participants expect that ABC will not guarantee the debt.

The fair value of the debt may be higher or lower than its face value resulting in the recognition of a debt premium or discount, and an effective interest rate that is lower or greater than the contractual rate.

17.112 In periods after the acquisition, the acquirer should amortize the difference between the fair value recorded on the acquisition date and the ultimate settlement amount using the interest method. If the interest rate used in the valuation of the debt assumed in a business combination is higher than the stated rate of the debt, a discount on debt should be recognized and amortized of the remaining period to maturity using the interest method. Similarly, if the interest rate used in the valuation of debt assumed in a business combination is lower than the stated rate on the debt, a premium on the debt should be recognized and amortized over the remaining period to maturity using the interest method. The recognition of a discount or premium on debt for financing reporting purposes may result in a deductible or taxable temporary difference under ASC Topic 740, unless the discount or premium on debt also is recognized for income tax reporting purposes.

ASSET RETIREMENT OBLIGATION

17.113 If a long-lived asset with an existing asset retirement obligation is acquired in a business combination, the acquirer should recognize the acquisition-date fair value of the obligation in accordance with ASC Subtopic 410-20, *Asset Retirement and Environmental Obligations - Asset Retirement Obligations.* The long-lived asset is valued on an unencumbered basis (i.e., without regard to the asset retirement obligation), and the related asset retirement obligation is recognized and measured separately. ASC Subtopic 410-20 applies to legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, or development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. ASC paragraphs 410-20-15-1 through 15-3

17.114 In determining the fair value of an asset retirement obligation, quoted market prices, if available, provide the most reliable and best evidence of fair value. In the absence of quoted market prices for the obligation, fair value is often determined using an income approach. ASC Subtopic 410-20 states that an expected present value technique

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will usually be the appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation.

DERIVATIVE INSTRUMENTS

17.115 In a business combination, the values assigned to derivative instruments, such as options and interest rate swaps, under ASC Topic 815, *Derivatives and Hedging,* should be based on the fair value of the instruments at the date of acquisition. The fair value of derivative assets should consider the effect of potential nonperformance of the derivative counterparty. In addition, ASC Subtopic 820-10 requires that the fair value of liabilities, including derivatives, also consider the impact of the entity's own nonperformance risk. Many derivative instruments (e.g., swaps and forwards) are affected by the risk of nonperformance of both the counterparty and the entity because the derivatives can be liabilities at some time during their lives and assets at other times (depending on market movements). For these derivatives, both the risk of counterparty credit risk and an entity's own nonperformance risk would be considered by a market participant in determining the fair value of these instruments regardless of whether they are currently in an asset or liability position.

REDEEMABLE PREFERRED STOCK

17.116 Although redeemable preferred stock may not meet the definition of a liability, it does represent a potential commitment to make future payments, and the acquirer should record the commitment at its fair value at the acquisition date.

Example 17.9: Redeemable Preferred Stock Held by Noncontrolling Interests

Q. How should an acquirer determine the fair value of redeemable preferred stock (RPS) that is held by noncontrolling interests?

A. A market approach or income approach is used most often to determine fair value of RPS. Under a market approach, quoted market prices, if available, are the best evidence of fair value. Where quoted market prices for the RPS are not available, the acquirer can use the income approach and estimate fair value as the present value of amounts to be paid using an appropriate discount rate. Where the acquirer does not collateralize or guarantee the RPS, the appropriate discount rate would be the rate that applies to the acquiree on a stand-alone basis if that is consistent with market participant assumptions. Qualified independent investment bankers may be needed to estimate the discount rate.

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Endnotes

[1] The gross amount (before reserve) represents the FIFO value.
[2] Deducting holding costs is explicitly mentioned in the guidance for tax purposes but was omitted in the historical (now superseded) guidance that was present in Statement 141. However, holding costs may have been considered as a component of costs of disposal. In any case, if inventory turnover rates are high, the opportunity cost of holding inventory is likely to be de minimis.
[3] Capitalization refers to determining the present value based on a single year cash flow assumed to continue into perpetuity.
[4] For further details on hypothetical CACs, see: (1) The Appraisal Foundation's Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group – Contributory Assets, The Identification of Contributory Assets and Calculation of Economic Rents section 2.1 and (2) AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities* (IPR&D Guide).
[5] For additional discussion of the R&D add-back, see AICPA Accounting and Valuation Guide, *Business Combinations* (Appendix C – C03).
[6] The useful life of above and below-market lease intangibles should be evaluated based on the guidance for intangible assets (ASC 350-30-35) and should not be based solely on whether the renewal periods are included in the lease term used for lease accounting purposes. Generally, this results in a useful life that incorporates the periods of expected cash flows used for valuation purposes.

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Section 18 - Determining the Fair Value of the Consideration Transferred in a Business Combination

Detailed Contents

Fair Value of the Consideration Transferred

- Overview
- Consideration in the Form of Equity Interests
  - Valuation Analysis
  - Shares of a Subsidiary Issued in a Business Combination
  - Issuing Shares of a Nonpublic or Closely Held Entity
  - Preferred Shares Issued in a Business Combination
  - Share-Based Payment Awards Included in the Consideration Transferred (Replacement Awards)
  - Debt Issued to Former Owners of Acquiree
  - Contingent Consideration
  - Example 18.1: Determining the Fair Value of Liability-Classified Contingent Consideration--Scenario 1
  - Example 18.2: Determining the Fair Value of Liability-Classified Contingent Consideration—Scenario 2
  - Example 18.3: Determining the Fair Value of Liability-Classified Contingent Consideration--Scenario 3

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FAIR VALUE OF THE CONSIDERATION TRANSFERRED

OVERVIEW

18.000 As discussed in Section 6, *Recognizing and Measuring the Consideration Transferred,* consideration transferred in a business combination may be in many forms including, for example, cash, noncash assets (e.g., a business or a subsidiary), debt issued to the former owners of the acquiree, equity interests issued (e.g., common or preferred equity instruments, options, warrants, member interests of mutual entities), replacement share-based payment awards, and contingent consideration. All consideration transferred, with the exception of replacement share-based payment awards, is measured at fair value at the acquisition date. Replacement share-based payment awards are measured in accordance with the fair value-based measurement principles of ASC Topic 718, *Compensation—Stock Compensation.*

18.001 Cash payments by an acquirer do not present measurement difficulties. However, the measurement of other forms of consideration can present varying degrees of difficulty and require judgment, so that it may be helpful to have an independent valuation performed in some situations. This Section includes discussion of certain elements of the consideration transferred in a business combination and the related measurement approaches for determining the fair value of those specific items. See Section 6 for additional accounting guidance related to the recognition and measurement of consideration transferred in a business combination.

CONSIDERATION IN THE FORM OF EQUITY INTERESTS

18.002 Equity interests issued as consideration in a business combination (other than replacement share-based payment awards) are measured at fair value at the acquisition date. Whenever available, the quoted price in an active market should be used to measure the fair value of equity securities issued to effect a business combination. If a quoted price in an active market is not available, other approaches will be needed.

Valuation Analysis

18.003 An AICPA Task Force developed a Practice Aid, *Accounting and Valuation Guidance: Valuation of Privately-Held-Company Equity Securities Issued as Compensation,* about valuing private entities. The Practice Aid was issued in 2013 to provide measurement guidance to be considered when valuing equity instruments of privately held entities. Although the Practice Aid is not authoritative, its guidance has been used as a resource by preparers, valuation professionals, and auditors in all industries.

18.004 While business combinations are outside its scope, the Practice Aid may contain some useful information (e.g., valuation techniques and best practices relevant to such valuations). Furthermore, Table 5-1 of the Practice Aid details some key differences

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between the valuations of a controlling interest versus a noncontrolling interest in an entity.

18.005 Paragraph not used.

18.006 The Practice Aid provides specific guidance and reporting requirements on valuations for financial reporting purposes. Key issues to consider when valuing equity securities of privately held entities include:

- **Fair Value Hierarchy.** The Practice Aid states that a valuation performed for the purpose of valuing privately held common stock issued as compensation should be based on the definition of fair value used in the employee share-based payment Topic (ASC Topic 718) and nonemployee share-based payment Subtopic (ASC Subtopic 505-50). This definition is different from the definition of fair value in ASC Subtopic 820-10 and is described in ASC Topic 805 as a fair value-based measure. Consistent with ASC Subtopic 820-10, the Practice Aid indicates that quoted prices in active markets are the best evidence of fair value. While quoted prices are not available for private entities, an entity may have had recent cash transactions for the issuance of shares that can be used to value a security. Use of such transactions would be contingent on (1) the transaction being for the same or similar shares as those being valued, and (2) the transaction being a current transaction between willing parties, that is, other than on a forced or liquidation basis, and not arising from the terms of a prior transaction (e.g., tranched equity offerings, the strike price of exercised share options would not be regarded as indicative of the fair value of the underlying shares or an investment by a strategic investor may not be representative of fair value for other shares).
- **Hierarchy of Valuation Alternatives.** The Practice Aid states that the reliability of a valuation report depends on the timing of the valuation (contemporaneous or retrospective) and the objectivity of the valuation professional (unrelated or related). It recommends that an entity engage an unrelated valuation professional to assist management in determining fair value if neither quoted prices in active markets nor arm's-length cash transactions are available. The Practice Aid further states that for purposes of valuing privately issued securities for which observable market prices of identical or similar securities are not available, the most reliable fair value estimate would be produced by a contemporaneous valuation.
- **Rules of Thumb Are Inappropriate.** An entity should not apply rules of thumb to value equity shares. For example, rules of thumb that value common shares at a specified discount to a recent round of financing with preferred shares or at a discount to an expected IPO price would be inappropriate.
- **Valuation of the Enterprise.** In valuing equity shares of privately held entities, the Practice Aid suggests a top-down analysis, whereby the value of the enterprise is determined and is allocated to debt and the different classes of equity.

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When valuing shares of privately held entities, generally the value of the entity as a whole should be established, and then used to value each class of the entity's outstanding shares. This top-down analysis should be based on an evaluation of the different rights of each class of shares, including their liquidation, redemption, or conversion rights. The Practice Aid includes extensive discussion on the nature of these rights.

- **Valuation Analyses to Establish Enterprise Value.** Absent quoted prices or comparable cash transactions, other valuation approaches must be applied to value shares issued by privately held entities. These include the income, market, or cost approaches. The selection of approach(es) depends, in part, on the nature of the entity and its stage of development.
  - In applying an income approach, the Practice Aid indicates that either a discount rate adjustment technique or an expected cash flow technique may be applied. Interest rates used under the traditional present value technique are usually significantly higher than those of similar public entities, calculated using the traditional Capital Asset Pricing Model.
  - When applying a market approach, consideration should be given to the comparability of the entities used in the market analysis and an understanding that the comparable transactions were on a fair value premise (e.g., not a forced sale) for like shares. Comparable pricing information may not be available for early stage entities. The Practice Aid discusses the use of the *backsolve* method, whereby transactions involving the entity's own securities are used to solve for the implied aggregate equity value of the entity.
  - A cost (asset-based) approach is generally less conceptually sound for valuing shares of privately held entities. However, an asset-based approach may be acceptable at an early stage of an entity's development when it is difficult to apply a market or income approach.
- **Valuation Analyses to Assign Enterprise Value to Different Classes of Equity.** The Practice Aid discusses several possible methods of assigning enterprise value to an entity's underlying shares. It refers to these methods as the Current-Value Method, the Option-Pricing Method, the Probability-Weighted Expected Return Method, and the Hybrid Method, and discusses circumstances when each method would be more or less appropriate and provides examples.
  - **The Current-Value Method** assigns value to preferred shares based on its current liquidation or immediate conversion values, whichever is greater. The Practice Aid states that a disadvantage of this method is that while it may be easier to understand, it is highly sensitive to the underlying assumptions. It also looks at the current best value for the preferred shares, without regard to possible future price movements. An entity should take care in using the current-value method because this

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method may undervalue the common shares when there is no plan to liquidate or sell the entity in the near future, because the common shares frequently derive much of their value from their disproportionate share of the future market value. This occurs frequently for entities emerging from bankruptcy, early-stage entities, and entities financed by private equity investors.

- **The Option-Pricing Method** treats the common and preferred shares as options on the entity's enterprise value. The Practice Aid states that a disadvantage of this method is that it may be complex to implement and that some of the assumptions to which it is highly sensitive, for example, the volatility or term, are difficult to objectively estimate. However, this method does capture the option-like characteristics of common shares for entities whose common shares are a small portion of the total capital structure.
- **The Probability-Weighted Expected Return Method** estimates the value of the common and preferred shares by considering possible scenarios for future enterprise value and realization of return by shareholders (e.g., IPO, sale to a strategic buyer, leveraged recapitalization, and continued operation). The return to the preferred and common shareholders is estimated under each scenario, as are associated probabilities. The Practice Aid acknowledges that this technique is difficult to implement and requires a number of assumptions about possible future outcomes, which are difficult to objectively estimate. This method is most appropriate when the time to a liquidity event is short.
- **Hybrid Methods** are discussed in the Practice Aid. In some situations, it may be appropriate to include a combination of the OPM and PWERM methods. The advantage of using both methods is that option-like payoffs associated with the various share classes are captured, while also considering future payoff scenarios.

- **Marketability Discounts.** Marketability discounts are often appropriate when valuing shares of privately held entities. The level of such discounts should be based on an evaluation of the shares' specific facts and circumstances (e.g., prospects for liquidity, restrictions on transferability[1], size, and timing of distributions). The use of rules of thumb or of average or median discounts reported in restricted shares studies is not appropriate.
- **Pre-IPO and IPO Value.** The Practice Aid acknowledges that differences would exist between pre-IPO and post-IPO values. The Practice Aid states that an IPO value eliminates many of the factors that give rise to a lack-of-marketability discount, by providing liquidity, reducing valuation uncertainties, and reducing ownership concentration.

  The Practice Aid indicates that significant differences between pre- and post-IPO values can exist. A valuation professional often accounts for the lack of

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marketability before an IPO by applying a marketability discount against the results of the valuation techniques (i.e., under the income, market, or asset-based approaches). Some of the difference in value between private and public entities may also be reflected in the discount rate used in the income approach. The Practice Aid indicates that the cost of capital for public entities may be lower, which would cause them to have a higher value than an otherwise comparable privately held entity. The quantification of such differences must be evaluated on a case-by-case basis, based on an entity's specific facts and circumstances.

- **Contents of a Valuation Report.** The Practice Aid includes detailed suggestions for the contents of a valuation report. It indicates that a valuation report prepared by a related valuation professional, including an internal report prepared by management, should contain the same level of information as that prepared by an external valuation professional.

  Summary reports are acceptable if issued as updates to a comprehensive report issued within the last year, when there has been no significant event or major financing that has occurred or is expected to occur.

Shares of a Subsidiary Issued in a Business Combination

18.007 Shares of a subsidiary issued in a business combination in exchange for shares of the acquiree should be valued as of the acquisition date based on the principles discussed in the previous paragraph. If the acquirer continues to maintain a controlling financial interest in the subsidiary after issuance, any difference between the fair value of the subsidiary shares issued and the carrying amount of the acquirer's respective interest in the subsidiary's net assets will be recognized as a capital transaction in equity in accordance with the noncontrolling interests guidance of ASC Subtopic 810-10, *Consolidation - Overall.* See Chapter 7 of KPMG Handbook, Consolidation, for additional guidance related to the accounting for noncontrolling interests.

Issuing Shares of a Nonpublic or Closely Held Entity

18.008 The acquisition of a public entity by a privately held entity provides an example of where the acquisition-date fair value of an acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests issued to effect a business combination. In those situations, consideration should be given to the fair value of the acquiree's equity interests in determining the fair value of the shares issued to effect the combination.

Preferred Shares Issued in a Business Combination

18.009 When preferred shares are issued in a business combination to the shareholders of the acquiree and there is no quoted market price available to determine the fair value of those shares, the characteristics of the preferred shares (e.g., dividend rate, conversion features, or redemption features) should be incorporated into the fair value of the

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preferred shares. 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. The approach to determining the fair value of such shares may be similar to that used to determine the fair value of debt securities.

18.010 The Practice Aid for privately held entities provides guidance and other considerations for determining the fair value of preferred shares. The guidance may be useful in measuring the fair value of preferred shares as part of the consideration transferred in a business combination.

18.011 See Section 6 for accounting guidance and other fair value consideration related to convertible preferred shares and other convertible instruments issued in a business combination.

Share-Based Payment Awards Included in the Consideration Transferred (Replacement Awards)

18.012 An acquirer may exchange its share-based payment awards (replacement awards) for awards held by grantees of the acquiree. If the acquirer is obligated to replace the awards, either all or a portion of the acquirer's replacement awards must be included in measuring the consideration transferred in a business combination. The measurement of replacement awards is a *fair-value-based* measure under ASC Topic 718, and is an exception to a fair value measurement principle under ASC Topic 805, *Business Combinations.*

18.013 See discussion of *Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Grantees of the Acquiree* in Section 11.

Debt Issued to Former Owners of Acquiree

18.014 An acquirer may issue debt to the former owners of the acquiree as part of the consideration transferred in a business combination. Quoted market prices, if available, generally provide the best evidence of fair value. In the absence of quoted market prices for the debt instrument (e.g., privately issued debt), fair value is frequently determined using a market approach or income approach.

Market Approach

18.015 If quoted market prices for an identical or similar liability are not available, an acquirer's best estimate of fair value may be based on the quoted market price of identical debt instruments traded as assets in active markets; for example, a quoted market price of an identical debt instrument traded as an asset on a public exchange or dealer market. If that price is not available, other observable inputs may be used, such as the quoted price in a market that is not active for the identical item held by another party as an asset. If prices for an identical liability traded as an asset are not available, there are other similar market approaches available when determining the fair value of the debt instrument, including a matrix pricing technique.

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Income Approach

18.016 An income approach measures the fair value of the debt instrument as the present value of the expected future cash flows using an appropriate discount rate. The discount rate should reflect what a market participant would demand to assume the risks of that liability including general interest rates, credit assumptions of the acquirer or combined entity depending on the facts and circumstances, market liquidity, and other risk factors. For examples of valuation techniques used under a market or income approach, see chapter F of KPMG Handbook, Fair Value Measurements - Questions and Answers.

Contingent Consideration

18.017 Contingent consideration includes, but is not limited to obligations to transfer additional consideration to the former owners of the acquiree if specified future events occur or conditions are met. Contingent consideration may include the issuance of additional securities or distribution of other consideration (e.g., cash) on resolution of contingencies based on, for example, post-combination earnings, post-combination security prices, regulatory approvals or other factors. All contingent consideration is measured at fair value on the acquisition date and included in the consideration transferred.

18.018 Contingent consideration issued in a business combination is classified at the acquisition date as either equity, or as an asset or a liability, based on the applicable GAAP. The accounting for contingent consideration after the transaction depends on whether the obligation for contingent consideration is classified as equity or as a liability (or in some cases, as an asset). See discussion of *Contingent Consideration* in Sections 6 and 12 for accounting guidance related to the classification and subsequent accounting, respectively, for contingent consideration.

18.019 Regardless of classification, estimating the fair value of contingent consideration can be challenging as the arrangements are often complex. ASC Subtopic 820-10 provides guidance for fair value measurements used in financial reporting, including contingent consideration. The guidance specifies that in cases where there is no quoted price for a liability or equity, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset. An entity should first consider observable market prices to measure the fair value of the identical item held by other parties as an asset. When observable prices are not available, an entity generally will apply an income approach or market approach from the perspective of the market participant holding the identical item as an asset.

> **ASC Paragraph 820-10-35-16B**
>
> When a quoted price for the transfer of an identical or a similar liability or instrument classified in a reporting entity's shareholders' equity is not available and the identical item is held by another party as an asset, a reporting entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date.

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ASC Paragraph 820-10-35-16BB

In such cases, a reporting entity shall measure the fair value of the liability or equity instrument as follows:

a. Using the quoted price in an active market for the identical item held by another party as an asset, if that price is available

b. If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset

c. If the observable prices in (a) and (b) are not available, using another valuation approach, such as:

1. An income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see [ASC] paragraph 820-10-55-3F).

2. A market approach (for example, using quoted prices for similar liabilities or instruments classified in shareholders' equity held by other parties as assets; see [ASC] paragraph 820-10-55-3A).

18.019a The income approach is generally appropriate for measuring the fair value of contingent consideration, given the forward-looking characteristics of contingent consideration arrangements and the lack of similarly traded assets or liabilities. There are two methodologies under the income approach to consider when determining the fair value of contingent consideration:

- **Scenario Based Method:** Similar to the Expected Present Value Technique (as discussed in ASC paragraphs 820-10-55-13 through 55-20), the Scenario Based Method (SBM) considers a range of potential outcomes and their assigned probabilities of occurrence. The expected cash flows attributable to contingent consideration are the sum of the probability-weighted outcomes for each of the scenarios. The outcomes are discounted to present value at an appropriate risk-adjusted discount rate.
- **Option Pricing Method:** An option pricing method (OPM), such as a risk-neutral Monte Carlo simulation, lattice model, or Black-Scholes-Merton option pricing model incorporate present value techniques and reflect both the time value and the intrinsic value of an option.

18.019b When determining whether a SBM or OPM is appropriate for contingent consideration one should consider whether:

- The goal is to incentivize the earnout recipients to significantly outperform baseline target metrics after the acquisition, or it is akin to a deferral of payment with easy-to-achieve target metrics (i.e., is the target metric substantive). See Example 18.3 for further details.

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- It is based on contingencies that are systematic (nondiversifiable risk)[2] or unsystematic (diversifiable risk)[3] or both.
- The payoff structure is linear or non-linear.
  - A linear payoff occurs when the contingent consideration payoff is a fixed percentage of the underlying metric (e.g., the contingent consideration payoff is 50% of revenue over the first three years after the acquisition).
  - A non-linear payoff occurs when the contingent consideration payoff is defined as a non-linear function on the underlying metric – frequently involving thresholds, caps, tiers, or catch-up features (e.g., if revenue is less than $2 million, the contingent consideration payoff is zero; however, if revenue is at least $2 million but not greater than $5 million, the contingent consideration payoff is 50% of the revenue in excess of $2 million, and if revenue is greater than $5 million, the contingent consideration payoff is $2.5 million plus 75% of the revenue in excess of $5 million).
- The payoff in one period is dependent on the payoff in an earlier period (i.e., path-dependent).

18.020 Considering the factors above, an SBM is well suited for (1) systematic financial-based metrics that are linear in nature and (2) unsystematic metrics such as technical milestones (e.g., based on FDA approval). In contrast, an OPM is well suited for non-linear payoffs based on systematic metrics/outcomes, which is similar to the structure of an option payment. However, an SBM would likely still be appropriate for a non-linear payoff when the target metric is not substantive because the threshold is so low that the payoff is approximately linear at the measurement date (see Example 18.3 for further details).

18.020a If the non-linear payoff is path dependent, a more complex simulation based OPM (e.g., Monte Carlo simulation) is generally used. Other OPMs (e.g., Black-Scholes-Merton) may be suitable when the payout is based on a single period or not dependent on the prior period.

18.020b Regardless of which method is selected the valuation should consider:

- The estimated expected future cash flows of the contingent consideration, which in the case of non-linear structures requires an understanding of the probability distribution of potential outcomes for the underlying metric; and
- A discount rate that reflects the risk inherent in the expected future cash flows of the contingent consideration. In general, the discount rate estimate should include allowances for:
  - The time value of money (risk-free rate);
  - The systematic risk inherent in the underlying metric or outcome;

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- The impact of the structure of the contingent consideration on the risk of the expected cash flows[4]; and
- Counterparty credit risk associated with the ability to make the future payments.

18.021 – 18.022 Paragraphs not used.

Example 18.1: Determining the Fair Value of Liability-Classified Contingent Consideration--Scenario 1

On January 1, 20X9, ABC Corp. acquires DEF Corp. in a business combination for $100 million. As part of the business combination, ABC and DEF's former owners enter into a contingent consideration arrangement. ABC agrees to pay additional cash consideration equal to 5% of the total revenue generated by DEF between the acquisition date and the first anniversary of the acquisition. According to DEF's most recent forecast, which reflects market participant expectations, revenue for the first year following the acquisition is projected as follows: a 60% probability of $125 million, a 20% probability of $100 million, and a 20% probability of $140 million.

In determining the fair value of the contingent consideration, ABC considers the expected revenue amounts and their associated probabilities[1], resulting in an expected payment of $6.15 million [($125 × 60% + $100 × 20% + $140 × 20%) * 5%]. Because ABC expects the payment one year from the acquisition date, it calculates the present value of the contingent consideration using an appropriate discount rate, which would not be a risk-free rate because the $6.15 million is not a certainty-equivalent amount, and the amount is included in the acquisition-date fair value of the consideration transferred. The contingency is liability-classified because it requires cash settlement and, as such, ABC must remeasure it to fair value each reporting period until the contingency is settled. ABC recognizes adjustments resulting from remeasurement in current earnings.

[1]This technique is known as the Expected Value Method and is described in ASC Section 820-10-55.

Example 18.2: Determining the Fair Value of Liability-Classified Contingent Consideration—Scenario 2

As part of a business combination on January 1, 20X7, ABC Corp. agrees to pay the former owners of XYZ Corp. additional consideration of $20 million after the acquisition date if a specific revenue target of XYZ is achieved for the second-year period ending December 31, 20X8. The revenue target is $100 million.

As part of evaluating the probability of achievement of the revenue target at the end of 20X8, ABC estimated the different outcomes, which reflect market participant expectations, using an expected cash flow technique, as follows[5]:

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	Revenue	Probability	Weighted Revenue
Low case	90,000	25.0%	22,500
Base case	110,000	50.0%	55,000
Stretch case	130,000	25.0%	32,500
		100.0%	110,000

ABC has calculated the expected revenue for the second-year ending on December 31, 20X8 as $110,000. ABC determined that the appropriate continuous and annualized risk-adjusted discount rate for revenue is 15%, the revenue annual volatility is 35%, and the continuous and annualized risk-free rate is 1.5%. The counterparty credit risk spread is 2%. Consistent with the midperiod convention, ABC assumes that the period to second-year expected revenue realization is 1.5 years and that the $20 million payment will be made on December 31, 20X8 (i.e., at 2.0 years).

ABC first calculates the expected present value of revenue as of January 1, 20X7 using the mid-period convention:

$87,837 = $110,000 × exp(-15% × 1.5)

ABC applies the Black-Scholes-Merton model to determine the fair value of the additional consideration as of January 1, 20X7 as follows:

Fair Value = Payment × exp(- Counterparty credit risk rate × Payment period)) × N(d2)

where counterparty credit risk rate is the sum of the risk-free rate and the counterparty credit risk spread and N() is the standard normal distribution function with

d2 = [ln($87,837/$100,000) + (1.5% - 0.5×35%^2) × 1.5] / [35% × 1.5^0.5] = -0.46

The fair value is calculated as:

Fair Value = $20 million × exp(- 3.5% × 2.0) × 32.12% = $6.0 million

The acquisition-date fair value of the contingent consideration is approximately $6.0 million, and is included in the consideration transferred. The contingency is liability-classified and, as such, is remeasured to fair value each reporting period until the contingency is settled. ABC recognizes adjustments resulting from remeasurement in current earnings.

Example 18.3: Determining the Fair Value of Liability-Classified Contingent Consideration--Scenario 3

As part of a business combination on January 1, 20X9, ABC Corp. agrees to pay the former owners of XYZ Corp. additional consideration of $5 million if revenue of XYZ for the year ending December 31, 20X9 is greater than $50 million. If this $50 million revenue threshold is not achieved, then no additional consideration is payable.

ABC estimates the expected revenue of XYZ for the year ending December 31, 20X9 to be $150 million, which is significantly above the $50 million revenue threshold. The

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main purpose for structuring the contingent consideration was to defer $5 million of consideration for one year, which is why the revenue threshold was set at such a low level.

In determining the fair value of the contingent consideration, ABC considers that the underlying metric (being future revenue) is systematic and, because of the $50 million threshold, the structure of the payoff is non-linear. For contingent consideration with a non-linear structure based on a systematic underlying metric, the Option Pricing Method would typically be most appropriate. However, given that the non-linear feature (i.e., the threshold) is not operative (i.e., the threshold is so low that the payoff is approximately linear) at the measurement date, ABC applies a Scenario Based Method.

Specifically, ABC first calculates the expected future payment to be $5 million (i.e., approximately 100% probability of achieving the threshold multiplied by the resulting payment of $5 million). ABC then discounts the expected payment at a credit-adjusted discount rate equal to the risk-free rate plus credit risk for one year. Since the likelihood of achieving the $5 million payment is assumed to be 100%, the contingent consideration mimics a vanilla debt instrument issued by ABC. ABC determines that the appropriate continuous annualized risk-free rate is 1.5% and the counterparty credit risk spread of ABC is 2%, considering the one-year term and subordinate nature of the obligation.

The fair value is calculated as:

Fair Value = 100% × $5 million × exp(- 3.5% × 1.0) = $4.8 million

The acquisition-date fair value of the contingent consideration is approximately $4.8 million, and is included in the consideration transferred. The contingency is liability-classified and, as such, is remeasured to fair value each reporting period until the contingency is settled.

ABC will continue to monitor the probability of achieving the threshold and, to the extent this deviates from 100% probability, will reassess whether a Scenario Based Method is still reasonable given the facts and circumstances at each future measurement date. If the probability of achieving the threshold falls below 100% (i.e., it is no longer reasonable to assume that the threshold will be achieved with certainty), then ABC will need to consider the risk of the underlying revenue and the impact of the non-linear structure on the value of the contingency, typically using an Option Pricing Method.

Endnotes

[1] Only in circumstances in which the restriction is a characteristic of the shares. See ASU 2022-03, Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restriction.
[2] Risks that cannot be fully removed through diversification (such as risks that are correlated with the market). Contingencies based on future revenue (or other financial metrics) are typically considered systematic.

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[3] Risks that can be diversified away. For example, an event whose outcome is not influenced by movements in the markets is a diversifiable risk; such risks are often illustrated by comparison to a coin flip. Contingencies based on regulatory or technical approvals are often considered unsystematic.

[4]For non-linear payoff structures involving a metric with systematic (non-diversifiable) risk, the OPM uses a risk-neutral framework to incorporate the impact of the non-linear structure on the risk of the contingent cash flows. In this case using an SBM, the discount rate would have to be adjusted to account for the impact of the non-linear payoff structure. However, the magnitude of the discount rate adjustment cannot be easily estimated. It is for this reason that OPM is recommended over SBM in this situation.

[5] For illustrative purposes, this example assumes three scenarios were considered by management. This is not meant to suggest that three is always the correct number of scenarios to consider.

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Section 19 - Determining the Fair Value of a Noncontrolling Interest in a Business Combination

Detailed Contents

Fair Value of the Noncontrolling Interest In a Partial Acquisition

- Overview
- Control Premium
- Valuation Analysis

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FAIR VALUE OF THE NONCONTROLLING INTEREST IN A PARTIAL ACQUISITION

OVERVIEW

19.000 As discussed in Section 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree,* in a partial acquisition, the acquirer measures the noncontrolling interest in the acquiree at its fair value at the date of acquisition.

19.001 Quoted market prices, if available, generally provide the best evidence of fair value of the noncontrolling interest. For example, in a partial acquisition of a public entity, an acquirer should measure the acquisition-date fair value of the noncontrolling interest on the basis of the quoted market price for the equity shares not held by the acquirer that continue to trade in an active market. However, in the absence of quoted market prices (e.g., a privately held entity), it may be necessary to use a valuation approach to determine the fair value of the noncontrolling interest.

19.002 As part of evaluating the best information available, the acquisition-date fair value of the consideration transferred by an acquirer is generally not indicative of the fair value of the noncontrolling interest. For example, the fair value of the acquirer's controlling interest in the acquiree and the noncontrolling interest on a *per-share* basis often differ. That is, a control premium is often part of the per-share fair value of the acquirer's controlling interest in the acquiree, which would not be reflected in the per share amount of any noncontrolling interest. ASC paragraph 805-20-30-8

CONTROL PREMIUM

19.003 A control premium[1] represents the fact that an acquirer is willing to pay more for equity securities that give it a controlling interest to take advantage of synergies and other benefits that flow from control over another entity. For example, the controlling interest may realize additional benefits from (i) improvements in cash flow, (ii) lower cost of capital for the combined entity or (iii) additional features of the controlling interest that are different from features of the noncontrolling interest. Alternatively, another investor may be unwilling to pay as much for a number of equity securities representing less than a controlling interest.

19.003a A control premium on the controlling interest therefore does not apply to the fair value of a noncontrolling interest, except in the rare circumstance it is demonstrated that the noncontrolling interests also will benefit from the market participant synergies and other benefits of the combined entity after the business combination on a pro rata basis. For example, synergies arising from a business combination might be in the form of increased sales or cost efficiencies at the acquired entity. In that scenario, while the acquirer might have paid an acquisition premium, all shareholders - both controlling and noncontrolling - would participate in the value of these synergies on a pro rata basis, thus there would not be a difference in the per share value between the majority or controlling

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interest and the noncontrolling interest. Conversely, if the synergies are realized only at the acquirer or another subsidiary of the acquirer, the noncontrolling shareholders of the acquired entity would not participate in the economic benefits realized from the synergies. In this scenario there would be a control premium applicable to the controlling interest and the noncontrolling interest would be valued at a discount from the controlling interest.

VALUATION ANALYSIS

19.004 In the absence of quoted market prices for determining the fair value of the noncontrolling interest, an acquirer uses other approaches to determine the fair value of the noncontrolling interest. However, when using appropriate valuation technique(s), it might be necessary to determine the acquisition-date fair value of the acquiree as a whole, and then identify the portion that relates to the noncontrolling interest. We generally would not expect an acquirer to determine the fair value of the noncontrolling interest by grossing up the value of the controlling interest (e.g., simply concluding the fair value of a 10% noncontrolling interest is $10 when the fair value of the controlling interest is $90), unless there is evidence that the noncontrolling interest participates in all benefits associated with control on a pro rata basis.

19.005 An AICPA Task Force developed a Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation,* on valuing private entities. See Section 18, *Determining the Fair Value of the Consideration Transferred in a Business Combination,* for additional discussion about the Practice Aid.

19.006 If the acquisition-date fair value of the acquiree as a whole is determined using one or a combination of the valuation approaches described, it may be reasonable to determine the fair value of the noncontrolling interest as the difference between the fair value of the acquiree less the fair value of the consideration transferred by the acquirer. Alternatively, an acquirer can use both market and income valuation approaches to directly measure the fair value of the noncontrolling interest.

Endnote

[1] Control premium may also be referred to as a Market Participant Acquisition Premium (MPAP). The MPAP is expressed through either enhanced cash flows or lower required rates of return. Refer to the Appraisal Foundation's Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums for additional information on determining a control premium.

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Section 20 - Determining the Fair Value of a Previously Held Equity Interest in a Business Combination

Detailed Contents

Fair Value of a Previously Held Equity Interest in an Acquiree in a Business Combination Achieved in Stages (Step Acquisitions)

Overview

Valuation Analysis

Control Premium

Example 20.1: Previously Held Equity Interest Valued on a Pro Rata Basis

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FAIR VALUE OF A PREVIOUSLY HELD EQUITY INTEREST IN AN ACQUIREE IN A BUSINESS COMBINATION ACHIEVED IN STAGES (STEP ACQUISITIONS)

OVERVIEW

20.000 As discussed in Section 9, *Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations,* in a business combination achieved in stages, the acquirer measures its previously held interest in the acquiree at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings at the acquisition date. The amount recognized in earnings includes changes in value previously recognized in other comprehensive income (e.g., when the previously held interest was classified as an available-for-sale security).

20.001 Quoted market prices, if available, provide the best evidence of fair value of a previously held interest in the acquiree. However, in the absence of quoted market prices (e.g., a privately held entity), the fair value may need to be determined using valuation approaches.

VALUATION ANALYSIS

20.002 Typically, techniques under the market approach or income approach provide the best evidence of fair value in the absence of quoted market prices. Section 19, *Determining the Fair Value of the Noncontrolling Interest in a Business Combination,* provides additional guidance in determining the fair value of equity securities in the absence of quoted market prices.

CONTROL PREMIUM

20.003 In September 2008, the FASB Valuation Resource Group (VRG) discussed whether the fair value measurement of a previously held interest should include a control premium. Although the VRG did not reach a conclusion at that meeting, an observer to the joint FASB/IASB business combination project team believes that the intent of the FASB was to exclude any control premium to determine the gain or loss on a previously held equity interest because that interest did not represent a controlling interest before the business combination. The measurement of the previously held equity interest in a business combination achieved in stages should not reflect a control premium, and the entire control premium should be attributed to the additional interest that was newly acquired to obtain control (i.e., any control premium in a step acquisition would be subsumed into goodwill). However, in limited circumstances it may be appropriate to incorporate a control premium when an entity can demonstrate that the previously held equity interest would benefit from the control transaction's proceeds on a pro rata basis. This might be the case when the previously held interest is subject to tag-along rights or drag-along rights, or other minority shareholders (other than the acquirer) would receive a pro rata share under the transaction structure. This is consistent with the FASB's

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conclusion in paragraph B382 of FASB Statement No. 141(R), *Business Combinations,* in which an acquirer overpays for its interest in an acquiree, and that overpayment is subsumed in goodwill, but does not result in a loss in earnings at the acquisition date.

Example 20.1: Previously Held Equity Interest Valued on a Pro Rata Basis

ABC Corp. is a minority investor in Target with 5 percent ownership of the common shares. Aside from ABC, Target has three shareholders that each hold a 5 percent interest with a fifth shareholder owning the remaining 80 percent.

ABC enters into an agreement with the other shareholders to buy the other shareholders' shares (totaling 95%) for $95. The agreement stipulates that each investor receives their proportionate share of the $95. This means the other three minority investors receive $5 each and the majority investor receives $80.

ABC values its previously held interest at $5 because those shares have the same value as the other shareholders.

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Section 21 - Not used

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Section 22 - Goodwill and Other Intangible Assets*

Detailed Contents

Goodwill and Other Intangible Assets

Scope of ASC Topics 805 and 350 Related to the Accounting for Goodwill and Other Intangible Assets

- ASC Topic 805
- ASC Topic 350
  - Accounting Guidance under Other Literature
- Initial Recognition of Intangible Assets
  - Internally Developed Goodwill and Other Intangible Assets

Variable Interest Entities

Excess Reorganization Value in Bankruptcy

Intangible Assets Acquired in a Business Combination (Including Goodwill)

Acquisition of Intangible Assets in Transactions That Do Not Constitute the Acquisition of a Business

Subsequent Accounting for Goodwill and Other Intangible Assets

- Finite versus Indefinite Life
- Determining and Evaluating the Useful Life of an Intangible Asset
  - Buyer-Specific Intent
  - Renewals or Extensions
  - Example 22.2: An Acquired Technology License That Renews Annually
  - Example 22.3: An Acquired Customer Relationship
  - Reacquired Rights
  - Other Examples of Determining the Useful Life of an Intangible Asset
  - Example 22.4: Intangible Assets--Amortizable and Nonamortizable
  - Example 22.5: Potential Indefinite-Lived Intangible Assets
- Amortizable Intangible Assets
  - Amortization Period and Method
    - Amortization Period
    - Amortization Method
  - Example 22.6: Amortization Methods
  - Residual Value
  - Reevaluation of Useful Life
  - Impairment of Amortizable Intangible Assets

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Nonamortizable Intangible Assets Other Than Goodwill
Indefinite-Lived Intangible Assets Are Not Amortized
Intangible Assets Acquired in a Business Combination That Are Used in Research and Development Activities
Impairment of Identifiable Indefinite-Lived Intangible Assets
Goodwill

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***** This section discusses the accounting for goodwill by public business entities and other entities that do not elect the Private Company Council (PCC) alternatives. The requirements under the PCC alternatives are discussed in Section 26, *Private Company and Not-for-Profit Accounting Alternatives.*

GOODWILL AND OTHER INTANGIBLE ASSETS

22.000 *Goodwill* is defined as follows:

> **ASC Master Glossary: Goodwill**
>
> An asset representing the future economic benefits arising from other assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that are not individually identified and separately recognized. …

22.001 *Intangible assets* are defined as:

> **ASC Master Glossary: Intangible Assets**
>
> Assets (not including financial assets) that lack physical substance. (The term *intangible assets* is used to refer to intangible assets other than goodwill).

22.002 While goodwill is, by definition, an intangible asset, the term *intangible assets,* as used in both ASC Topic 805, *Business Combinations* and ASC Topic 350, *Intangibles--Goodwill and Other,* generally excludes goodwill, which is discussed in those Topics separately from other intangible assets. These definitions also reflect the fact that intangible assets, as the term is used in ASC Topics 805 and 350, are individually recognized and measured, while goodwill is measured as the residual amount in the acquisition accounting (see Section 8, *Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase).*

SCOPE OF ASC TOPICS 805 AND 350 RELATED TO THE ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

22.003 The guidance in ASC Topics 805 and 350 for the initial recognition and measurement of, and subsequent accounting for, goodwill and other intangible assets is summarized below:

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		Initial Recognition and Measurement	Subsequent Accounting
Internally Developed Intangible Assets			
	Other Intangible Assets	ASC Topic 350 and other applicable GAAP (e.g., ASC Subtopic985-20)	ASC Topic 350 and ASC Section 360-10-35 and other applicable GAAP
Goodwill and Other Intangible Assets Acquired in a Business Combination			
	Goodwill	ASC Topic 805	ASC Topic 350
	Other Intangible Assets	ASC Topic 805	ASC Topic 350 and ASC Section 360-10-35 and other applicable GAAP
Other Intangible Assets Acquired in an Acquisition of Assets Not Constituting a Business			
	Other than IPR&D	ASC Topic 350	ASC Topic 350 and ASC Section 360-10-35 and other applicable GAAP
	IPR&D	ASC Topics 730 and 350	ASC Subtopic 730-10

ASC TOPIC 805

22.004 ASC Topic 805 addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. See discussion in Sections 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree,* 8, and 26, *Private Company and Not-for-Profit Accounting Alternatives.*

ASC TOPIC 350

22.005 ASC Topic 350 addresses the initial recognition and measurement of other intangible assets developed internally or acquired in an asset acquisition, and the

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subsequent accounting for goodwill and other intangible assets, regardless of how they were acquired.

ASC Paragraph 350-10-05-1

The *Intangibles--Goodwill and Other* Topic provides guidance on financial accounting and reporting related to goodwill and other intangible assets, including the subsequent measurement of goodwill and intangible assets. It does not include guidance on the accounting at acquisition for goodwill and other intangibles acquired in a business combination or an acquisition by a not-for-profit entity. It also does not include guidance on the accounting upon formation for goodwill and intangible assets recognized by a joint venture.

ASC Paragraph 350-20-05-1

[ASC] Subtopic [350-20] addresses financial accounting and reporting for goodwill subsequent to its acquisition and for the cost of internally developing goodwill.

ASC Paragraph 350-20-05-2

[ASC] Subtopic 805-30 provides guidance on recognition and initial measurement of goodwill in a business combination. [ASC] Subtopic 958-805 provides guidance on recognition and initial measurement of goodwill acquired in an acquisition by a not-for-profit entity. [ASC] Subtopic 805-60 provides guidance on the recognition and initial measurement of goodwill by a joint venture upon formation.

ASC Paragraph 350-20-15-2

The guidance in [ASC] Subtopic [350-20] applies to the following transactions and activities:

a. Goodwill that an entity recognizes in accordance with [ASC] Subtopic 805-30, [ASC] Subtopic 805-60, or [ASC] Subtopic 958-805 after it has been initially recognized and measured

b. The costs of internally developing goodwill and other unidentifiable intangible assets with indeterminate lives

c. Subparagraph Not Used

d. Amounts recognized as goodwill in applying the equity method of accounting and to the excess reorganization value recognized by entities that adopt fresh-start reporting in accordance with [ASC] Topic 852.

e. Subparagraph Not Used

ASC Paragraph 350-30-05-1

[ASC] Subtopic [350-30] addresses financial accounting and reporting for intangible assets (other than goodwill) acquired individually or with a group of other assets and for the cost of developing, maintaining, or restoring internally

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generated intangible assets. However, it does not discuss the recognition and initial measurement of intangible assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation. [ASC] Subtopic [350-30] also addresses financial accounting and reporting for intangible assets after their acquisition, including intangible assets acquired in a business combination, in an acquisition by a not-for-profit entity, or by a joint venture upon formation.

Accounting Guidance under Other Literature

22.006 ASC Topic 350 does not change the accounting for intangible assets prescribed in other accounting pronouncements identified in ASC paragraph 350-10-15-4. Thus, the accounting for intangible assets in the following pronouncements remains applicable:

(a) ASC Subtopic 730-10, *Research and Development - Overall.*

(b) ASC Topic 932, *Extractive Activities--Oil and Gas.*

(c) ASC Topic 928, *Entertainment--Music.*

(d) ASC Topic 950, *Financial Services--Title Plant.*

(e) ASC Topic 920, *Entertainment--Broadcasters.*

(f) ASC paragraphs 980-350-35-1 through 35-2 for rate-regulated activities.

(g) ASC Topic 985, *Software.*

(h) ASC Topic 740, *Income Taxes.*

(i) ASC Topic 860, *Transfers and Servicing.*

22.007 While not specifically cited in ASC Topic 350, it does not change the accounting for specific intangible assets provided by other authoritative GAAP such as ASC Topic 908, *Airlines;* ASC Subtopic 720-35, *Other Expenses - Advertising Costs;* ASC Subtopic 350-40, *Intangibles--Goodwill and Other - Internal-Use Software;* ASC Subtopic 720-15, *Other Expenses - Start-Up Costs;* and ASC Topic 926, *Entertainment--Films.*

INITIAL RECOGNITION OF INTANGIBLE ASSETS

Internally Developed Goodwill and Other Intangible Assets

ASC Paragraph 350-20-25-3

Costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as an expense when incurred.

22.008 ASC Topic 350 requires that the costs of internally developing, maintaining, or restoring intangible assets meeting the criterion in ASC paragraph 350-30-25-3 be recognized as expense as incurred.

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22.009 ASC paragraph 350-30-15-3, however, specifies that ASC Topic 350 also applies to costs of internally developing identifiable assets that an entity recognizes as assets. Accounting guidance for internally developed identifiable intangible assets that are recognized as assets by reporting entities generally is included in the pronouncements addressed in the above discussion, *Accounting Guidance under Other Literature.* However, if ASC Topic 350 includes additional requirements that go beyond, but are not inconsistent with the other pronouncements applied, such as additional disclosure requirements, the additional requirements of ASC Topic 350 are applicable to that intangible asset.

VARIABLE INTEREST ENTITIES

22.010 ASC Subtopic 810-10, *Consolidation - Overall,* requires an entity that becomes the primary beneficiary of a variable interest entity that does not constitute a business initially measures and recognizes the assets, except goodwill, and liabilities of the variable interest entity in accordance with the recognition and measurement principles of ASC Sections 805-20-25 and 805-20-30. However, the primary beneficiary should recognize a gain or loss for the difference between: (1) the fair value of any consideration transferred, the fair value of any noncontrolling interests, and the reported amount of any previously held interests; and (2) the net amount of the variable interest entity's identifiable assets and liabilities recognized and measured in accordance with ASC Sections 805-20-25 and 805-20-30. Consistent with ASC Topic 350, no goodwill should be recognized if the variable interest entity is not a business.

22.011 See Section 4, *Variable Interest Entities,* for additional discussion on accounting for variable interest entities.

EXCESS REORGANIZATION VALUE IN BANKRUPTCY

22.012 ASC Subtopic 852-10, *Reorganizations - Overall,* indicates that when applying fresh-start accounting upon emergence from bankruptcy, the reorganization value should be assigned to the entity's assets, liabilities and equity in conformity with the procedures specified by ASC Topic 805, including its provisions for initial recognition and measurement of intangible assets apart from goodwill. The excess reorganization value recognized by emerging entities that adopt fresh-start reporting under ASC Subtopic 852-10 is reported and accounted for in the same manner as goodwill arising in a business combination. See KPMG Handbook, Accounting for bankruptcies, for an in-depth discussion of the accounting for bankruptcies. Statement 142, par. B18

INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION (INCLUDING GOODWILL)

22.013 The initial recognition and measurement of goodwill and other intangible assets acquired in a business combination is discussed in the following Sections:

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- The initial recognition and measurement of goodwill arising from a business combination is discussed in Section 8, *Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase.*
- The initial recognition and measurement of other intangible assets acquired in a business combination is discussed in Section 7, *Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree.*

ACQUISITION OF INTANGIBLE ASSETS IN TRANSACTIONS THAT DO NOT CONSTITUTE THE ACQUISITION OF A BUSINESS

22.014 For guidance on accounting for intangible assets in an asset acquisition, see section 4.2 in KPMG Handbook, Asset acquisitions.

22.015 – 22.019 Paragraphs not used.

Example 22.1 Not used.

SUBSEQUENT ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

22.020 The accounting for other intangible assets subsequent to their acquisition is the same, regardless of whether they are acquired in a business combination or in an acquisition of assets, with the exception of reacquired rights acquired in a business combination (see discussion under *Reacquired Rights* below).

FINITE VERSUS INDEFINITE LIFE

22.021 The subsequent accounting for an intangible asset depends on whether its useful life is finite or indefinite. An intangible asset with a finite useful life is amortized, while an intangible asset with an indefinite useful life is not. An intangible asset has an indefinite life if there are no legal, regulatory, contractual, competitive, economic, or other factors limiting its life. *Useful life* is defined as the period over which an asset is expected to contribute directly or indirectly to future cash flows. An *indefinite useful life* is defined as extending beyond the foreseeable horizon, i.e., there is no foreseeable limit on the period of time over which the asset is expected to contribute to the cash flows of the reporting entity. ASC paragraph 350-30-35-4

22.022 Unless an intangible asset's life extends beyond the foreseeable horizon, an entity is required to assign it a useful life – even if a precise useful life for the asset cannot be determined. In such cases, the entity uses its best estimate of the intangible asset's useful life. For example, the useful life of a patent can typically be determined with precision because a patent has a clear expiration date under U.S. federal law and cannot be renewed. In contrast, the useful life of magazine subscriber relationships typically cannot be easily determined because an unknown number of subscribers will renew their current subscriptions. In the case of subscribers, the entity needs to estimate the period over which the underlying relationships will continue. This can be difficult and requires

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judgment based on the individual facts and circumstances; however, the SEC staff has stated that it would be extremely rare for any type of customer relationship intangible to have an indefinite life. As another example, airport slotting rights are also renewable when their contractual period expires. In contrast to the magazine subscriber relationships, an airline is likely to find it easier to determine that renewals will occur indefinitely – i.e., beyond the foreseeable horizon. This is because of longstanding industry practice of airlines being offered renewals to slotting rights given the critical nature of those rights to the airlines' operations. In that case, the slotting rights may be indefinite-lived intangible assets.

22.023 Some mature products and brand names might be considered to have indefinite lives. In contrast, a young brand or product typically has a finite useful life initially, but the passage of time and more evidence might lead to a conclusion that the life has changed to indefinite. For example, an acquired brand name that has been in the market for only a few years would likely not be considered to have an indefinite life, but after a longer history of stable cash flows, that conclusion might change. However, in our experience, it is uncommon for finite-lived intangible assets to become indefinite-lived intangible assets. Conversely, an indefinite-lived intangible asset may subsequently be determined to have a finite useful life. In this case, the intangible asset's carrying amount is first tested for impairment under ASC Subtopic 350-30 – i.e., a quantitative test is required unless the entity chooses to carry out (and passes) a qualitative assessment. Then the entity amortizes the remaining carrying amount over the new estimated useful life. Subsequently, the asset is tested for impairment under ASC Topic 360 at each reporting date if a triggering event has occurred. An entity reassesses the classification each reporting period, which is discussed further starting in Paragraph 22.036.

DETERMINING AND EVALUATING THE USEFUL LIFE OF AN INTANGIBLE ASSET

ASC Paragraph 350-30-35-1

The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life shall be amortized; an intangible asset with an indefinite useful life shall not be amortized.

ASC Paragraph 350-30-35-2

The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The useful life is not the period of time that it would take that entity to internally develop an intangible asset that would provide similar benefits. However, a reacquired right recognized as an intangible asset is amortized over the remaining contractual period of the contract in which the right was granted. If an entity subsequently reissues (sells) a reacquired right to a third party, the entity includes the related unamortized asset, if any, in determining the gain or loss on the reissuance.

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ASC Paragraph 350-30-35-3

The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular, the following factors with no one factor being more presumptive than the other:

a. The expected use of the asset by the entity.

b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate.

c. Any legal, regulatory, or contractual provisions that may limit the useful life. The cash flows and useful lives of intangible assets that are based on legal rights are constrained by the duration of those legal rights. Thus, the useful lives of such intangible assets cannot extend beyond the length of their legal rights and may be shorter.

d. The entity's own historical experience in renewing or extending similar arrangements, consistent with the intended use of the asset by the entity, regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of that experience, the entity shall consider the assumptions that market participants would use about renewal or extension consistent with the highest and best use of the asset by market participants, adjusted for entity-specific factors in this paragraph.

e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels).

f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

Further, if an income approach is used to measure the fair value of an intangible asset, in determining the useful life of the intangible asset for amortization purposes, an entity shall consider the period of expected cash flows used to measure the fair value of the intangible asset adjusted as appropriate for the entity-specific factors in this paragraph.

ASC Paragraph 350-30-35-4

If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term *indefinite* does not mean the same as infinite or indeterminate. The useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon - that is, there is no foreseeable limit on the period of time over which it is expected to contribute to

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the cash flows of the reporting entity. Such intangible assets might be airport route authorities, certain trademarks, and taxicab medallions.

ASC Paragraph 350-30-35-5

Examples 1 through 9B (see [ASC] paragraphs 350-30-55-2 through 55-28F) illustrate different intangible assets and how they should be accounted for in accordance with this Subtopic, including determining whether the useful life of an intangible asset is indefinite.

Buyer-Specific Intent

22.024 In determining the useful life of an intangible asset (or whether an intangible asset is indefinite lived), an entity should consider its intended use for the intangible asset (ASC paragraph 350-30-35-2). There can be a difference between the useful life of the asset and the period of cash flows used to measure the fair value of the asset based on assumptions market participants would use to price the asset.

22.025 Other factors that should be considered in determining the useful life of an intangible asset include:

- Relative stability of the cash flow forecast for the intangible asset;
- Relative stability of the cash flow history for the intangible asset;
- Period of time a product or concept has been in the market;
- Whether revenues are dependent on retaining key employees;
- Churn rate for customers;
- Mobility of customer and employee bases;
- Assumptions used to assess the asset for impairment; and
- Assumptions used to determine the fair value of the asset.

Renewals or Extensions

22.026 ASC paragraph 350-30-35-3(d) is intended to provide for greater consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. To achieve this, ASC paragraph 350-30-35-3(d) specifies that in developing assumptions about renewals or extensions used in determining the useful life of a recognized intangible asset, an entity should consider its own historical experience in renewing or extending similar arrangements (consistent with the entity's intended use of the asset), regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of such experience, an entity considers the assumptions that market participants would use about renewal or extension (consistent with the highest and best use of the asset by market participants), adjusted for the entity-specific factors in ASC paragraphs 350-30-35-1 through 5.

22.027 The following examples illustrate the application of ASC Subtopic 350-30.

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Example 22.2: An Acquired Technology License That Renews Annually

An exclusive, annually renewable technology license with a third party is acquired by an entity that has made significant progress in developing next-generation technology for digital video products. The acquiring entity believes that in two years, after it has completed developing its next-generation products, the acquired technology license will be obsolete because customers will convert to the acquiring entity's products. Market participants, however, are not as advanced in their development efforts and are not aware of the acquiring entity's proprietary development efforts. Thus, those market participants would expect the technology license to be obsolete in three years. The acquiring entity determines that the fair value of the technology license utilizing 3 years of cash flows is $10 million, consistent with the highest and best use of the asset by market participants.

In applying ASC paragraph 350-30-35-3(d), the acquiring entity considers its own historical experience in renewing or extending similar arrangements. In this case, the acquiring entity lacks historical experience in renewing or extending similar arrangements. Therefore, it considers the assumptions that a market participant would use consistent with the highest and best use of the technology license. However, because the acquiring entity expects to use the technology license until it becomes obsolete in two years, it adjusts the market participants' assumptions for the entity-specific factors in ASC paragraph 350-30-35-3(a), which requires consideration of the entity's expected use of the asset. As a result, the technology license will be amortized over a two-year period. The technology license will be reviewed for impairment under ASC Section 360-10-35.

Example 22.3: An Acquired Customer Relationship

An insurance company acquires 50 customer relationships operating under contracts that are renewable annually. The acquiring entity determines that the fair value of the customer relationship asset is $10 million, considering assumptions (including turnover rate) that a market participant would make consistent with the highest and best use of the asset by market participants. An income approach was used to determine the fair value of the acquired customer relationship asset.

In applying ASC paragraph 350-30-35-3(d), the acquiring entity considers its own historical experience in renewing or extending similar customer relationships. In this case, the acquiring entity concludes that its customer relationships are dissimilar to the acquired customer relationships and, therefore, the acquiring entity lacks historical experience in renewing or extending similar arrangements. Accordingly, the acquiring entity considers turnover assumptions that market participants would make about the renewal or extension of the acquired customer relationships or similar arrangements. Without evidence to the contrary, the acquiring entity expects that the acquired customer relationships will be renewed or extended at the same rate as a market participant would expect, and no other factors indicate a different useful life is appropriate. Thus, absent any other of the entity-specific factors in ASC paragraphs 350-30-35-1 through 35-5, in determining the useful life for amortization purposes, the acquiring entity considers the

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period of expected cash flows used to measure the fair value of the asset. The customer relationships will be reviewed for impairment under ASC Section 360-10-35.

22.028 In evaluating whether renewal or extension rights should be considered in determining the estimated useful life of an intangible asset, the acquirer should have both the intent and the ability to renew or extend the intangible asset. The acquirer's past practice of not renewing or extending comparable intangible assets may evidence a lack of the requisite intent or ability to do so. When evaluating an ability to renew or extend an intangible asset, a number of factors should be considered, including the acquiree's past practices, industry practices, the past practices of the party granting the intangible asset, and the nature of the party granting the right (e.g., governmental entities may be more likely to treat all parties equally which may limit the ability of the existing holder to renew an intangible asset).

Reacquired Rights

22.029 In some business combinations, an acquirer reacquires a right that it previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. For example, the acquirer may have previously granted the acquiree a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. ASC Topic 805 requires that a right reacquired in a business combination be measured on the basis of the remaining contractual term of the related contract, without regard to whether market participants would consider potential contractual renewals in determining its fair value. ASC Topic 805 also provides guidance on the subsequent accounting for a reacquired right, consistent with its initial measurement, requiring that it be amortized over the remaining contractual period of the contract in which the right was granted without regard to the criteria in ASC paragraphs 350-30-35-1 through 35-5. Refer to additional discussion about reacquired rights at Paragraph 11.015. ASC paragraphs 805-20-30-20 and 35-2

Other Examples of Determining the Useful Life of an Intangible Asset

22.030 The following examples illustrate the application of the criteria of ASC Section 350-30-35 in determining useful lives of intangible assets. Examples 1 through 9B are taken from ASC paragraphs 350-30-55-2 through 55-28F.

Example 22.4: Intangible Assets--Amortizable and Nonamortizable

1. An acquired customer list. A direct-mail marketing company acquired a customer list and expects that it will be able to derive benefit from the information on the acquired customer list for at least one year but for no more than three years.

The customer list will be amortized over 18 months, management's best estimate of its useful life, following the pattern in which the expected benefits will be consumed or otherwise used up. Although the acquiring company intends to add customer names and other information to the list in the future, the expected benefits of the acquired

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customer list relate only to the customers on that list at the date of acquisition (a closed-group notion). The customer list will be reviewed for impairment under ASC Section 360-10-35.

2. An acquired patent that expires in 15 years. The product protected by the patented technology is expected to be a source of cash flows for at least 15 years. The reporting entity has a commitment from a third party to purchase the patent in 5 years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in 5 years.

The patent will be amortized over its 5-year useful life to the reporting entity, following the pattern in which the expected benefits will be consumed or otherwise used up. The amount to be amortized is 40% of the patent's fair value at the acquisition date (residual value is 60%). The patent will be reviewed for impairment under ASC Section 360-10-35.

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

The copyright will be amortized over its 30-year estimated useful life, following the pattern in which the expected benefits will be consumed or otherwise used up and reviewed for impairment under ASC Section 360-10-35.

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

The broadcast license is deemed to have an indefinite useful life because cash flows are expected to continue indefinitely. Therefore, the license will not be amortized until its useful life is deemed to be no longer indefinite. The license will be tested for impairment in accordance with ASC paragraph 350-30-35-18 through 35-20.

5. For the broadcast license in Example 4. The FCC subsequently decides that it will no longer renew broadcast licenses, but rather will auction those licenses. At the time the FCC decision is made, the broadcast license has three years until it expires. The cash flows from that license are expected to continue until the license expires.

Because the broadcast license can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired license is tested for impairment in accordance with ASC paragraph 350-30-35-18 through 20. The license is then amortized over its remaining three-year useful life following the pattern in which the expected benefits will be

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consumed or otherwise used up. Because the license will be subject to amortization, in the future it will be reviewed for impairment under ASC Section 360-10-35.

6. An acquired airline route authority from the United States to the United Kingdom that expires in three years. The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals routinely are granted at a minimal cost and have historically been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service to the United Kingdom from its hub airports indefinitely and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Because the facts and circumstances support the acquiring entity's ability to continue providing air service to the United Kingdom from its U.S. hub airports indefinitely, the intangible asset related to the route authority is considered to have an indefinite useful life. Therefore, the route authority will not be amortized until its useful life is deemed to be no longer indefinite and will be tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-20.

7. An acquired trademark that is used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years. The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to continuously renew the trademark, and evidence supports its ability to do so. An analysis of product life cycle studies; market, competitive, and environmental trends; and brand extension opportunities provide evidence that the trademarked product will generate cash flows for the acquiring company for an indefinite period of time.

The trademark is deemed to have an indefinite useful life because it is expected to contribute to cash flows indefinitely. Therefore, the trademark will not be amortized until its useful life is no longer indefinite. The trademark will be tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-20.

8. A trademark that distinguished a leading consumer product that was acquired 10 years ago. When it was acquired, the trademark was considered to have an indefinite useful life because the product was expected to generate cash flows indefinitely. During the annual impairment testing of the intangible asset, the entity determines that unexpected competition has entered the market that will reduce future sales of the consumer product. Management estimates that cash flows generated by the product will be 20% less for the foreseeable future; however, management expects that the product will continue to generate cash flows indefinitely at those reduced amounts.

As a result of the projected decrease in future cash flows, the entity determines that the estimated fair value of the trademark is less than its carrying amount, and an impairment loss is recognized. Because the trademark is still deemed to have an

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indefinite useful life, it will continue to not be amortized and will instead be tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-20.

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

Because the useful life of the acquired trademark is no longer deemed to be indefinite, the trademark is tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-20. The carrying amount of the trademark after adjustment, if any, will then be amortized over its remaining four-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the trademark will now be subject to amortization, in the future it will be reviewed for impairment under ASC Section 360-10-35.

22.031 The franchise rights and investment management contract examples below describe possible circumstances in which an intangible asset may have an indefinite useful life. However, the analysis is highly dependent on the facts and circumstances, and judgment will be required.

Example 22.5: Potential Indefinite-Lived Intangible Assets

Example 1. An acquired company has a portfolio of owned or franchised fast food chain restaurants. The restaurants operate under a well-known brand name and the acquired company has historically been profitable. The restaurant brand name is expected to continue to generate positive cash flow for the acquirer beyond the foreseeable future. The fast food chain restaurants are in a mature, steady-growth stage of their life cycle. Therefore, the brand name may have an indefinite useful life. If so, the acquired brand name would not be amortized until its useful life is no longer deemed to be indefinite and would be tested for impairment on an annual basis in accordance with ASC Topic 350.

Example 2. An acquired investment advisory firm has an investment management contract with a registered mutual fund. The contract can be renewed annually by mutual agreement of both parties. The mutual fund and its advisor have had an ongoing relationship for the last five years and the contract has been renewed each year. Although the mutual fund can terminate the contract on short notice, the contract is not expected to be terminated any time in the foreseeable future.

Because the specific facts and circumstances support the company's ability to renew the contract indefinitely, the intangible asset related to the contractual relationship may

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have an indefinite useful life and if so would not be amortized but would be tested for impairment on an annual basis in accordance with ASC Topic 350.

AMORTIZABLE INTANGIBLE ASSETS

Amortization Period and Method

ASC Paragraph 350-30-35-6

A recognized intangible asset shall be amortized over its useful life to the reporting entity unless that life is determined to be indefinite. If an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset shall be amortized over the best estimate of its useful life. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used.

ASC Paragraph 350-30-35-7 (in part)

An intangible asset shall not be written down or off in the period of acquisition unless it becomes impaired during that period…

Amortization Period

22.032 An intangible asset is amortized over its useful life to the reporting entity, unless its life is determined to be indefinite. An intangible asset is not written down or off in the period of acquisition unless it becomes impaired during that period. IPR&D assets acquired in a business combination are measured and recognized at fair value regardless of their alternative future use rather than expensed at the acquisition date. ASC paragraphs 350-30-35-6 through 35-7

22.033 A business combination may result in the acquisition of assets that an entity does not intend to actively use but does intend to prevent others from using. Such assets are commonly referred to as *defensive intangible assets* or *locked-up assets.* Under ASC Topic 805, an acquirer recognizes and measures all intangible assets, including defensive intangible assets, at fair value determined in accordance with ASC Topic 820. ASC Subtopic 350-30 provides guidance as to how defensive intangible assets should be accounted for subsequent to their acquisition. Refer to Section 12, *Subsequent Measurement and Accounting,* for additional discussion of the accounting for defensive intangible assets.

Amortization Method

22.034 An amortizable intangible asset is amortized over its estimated useful life to its estimated residual value in accordance with the pattern of consumption of the economic benefits inherent in the intangible asset. Because we believe that the focus should be on using up the rights conveyed by the intangible asset, amortization in proportion to estimated revenues (or similar measure) generally would not be appropriate when it

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results in a back-ended amortization of the intangible asset. If a pattern of consumption cannot be reliably determined, the straight-line method should be used. The pattern in which economic benefits are consumed may be estimated using either a discounted or undiscounted cash flow basis. The difference in amortization between the two methods is illustrated below.

Example 22.6: Amortization Methods

Assume that the intangible asset has estimated undiscounted cash flows of $100. Assuming a 10% discount rate and a five-year life, the present value of the asset would be $75.8. The following table illustrates the pattern of amortization based on the pattern of discounted and undiscounted cash flows.

Year	1	2	3	4	5	Total
Net cash flows undiscounted	20.0	20.0	20.0	20.0	20.0	100.0
Discounted cash flows	18.2	16.5	15.0	13.7	12.4	75.8
Amortization – undiscounted	15.2	15.2	15.2	15.2	15.0	75.8
Amortization – discounted	18.2	16.5	15.0	13.7	12.4	75.8
Difference	(3.0)	(1.3)	0.2	1.5	2.6	0

Residual Value

ASC Topic 350-30-35-8

The amount of an intangible asset to be amortized shall be the amount initially assigned to that asset less any residual value. The residual value of an intangible asset shall be assumed to be zero unless at the end of its useful life to the entity the asset is expected to continue to have a useful life to another entity and either of the following conditions is met:

a. The reporting entity has a commitment from a third party to purchase the asset at the end of its useful life.

b. The residual value can be determined by reference to an exchange transaction in an existing market for that asset and that market is expected to exist at the end of the asset's useful life.

22.035 *Residual value* is the estimated fair value of an intangible asset at the end of its useful life less any disposal costs. ASC Topic 350 presumes that an intangible asset's residual value is zero, absent an expectation that the intangible asset will have a useful life to another entity after the acquirer finishes using it, and there is evidence to support the nonzero residual value. Evidence would include either a purchase commitment from a

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third party for the intangible asset or a market that exists currently that supports the estimated residual value and is expected to exist at the end of the intangible asset's useful life to the current holder. Reliable evidence of a purchase commitment from a third party would include the entity's right to put the intangible asset to the third party, but would not include call options held by the third party, rights of first refusal, or rights of first offer.

Reevaluation of Useful Life

> **ASC Paragraph 350-30-35-9**
>
> An entity shall evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively over that revised remaining useful life.
>
> **ASC Paragraph 350-30-35-10**
>
> An intangible asset that initially is deemed to have a finite useful life shall cease being amortized if it is subsequently determined to have an indefinite useful life, for example, due to a change in legal requirements. If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-20.

22.036 Useful lives of amortizable intangible assets are required to be reevaluated each reporting period, with any changes in estimated useful lives accounted for prospectively as a change in accounting estimate in accordance with ASC paragraph 250-10-45-17. The change in accounting estimate should be accounted for in the period of change if the change impacts that period only, or the period of change and future periods if the change affects both. Financial statements of prior periods should not be restated or retrospectively adjusted unless the change in estimate is a correction of an error. See discussion of *Adjustments to Provisional Amounts during the Measurement Period* in Section 10, *Measurement Period.*

22.037 An entity would stop amortizing an intangible asset prospectively that the entity subsequently determines has an indefinite useful life. When amortization ceases for an asset determined to have an indefinite life, the impairment test is carried out. Any resulting impairment loss is accounted for as a change in estimate, not as a change in accounting principle, and therefore would be presented in the same manner as other impairment losses. ASC paragraph 350-30-35-11

22.038 For purposes of evaluating the amortization period, ASC Topic 350 is silent as to whether the reference to reporting period is an annual period, an interim period, or both. We believe it is consistent with other requirements in ASC Topic 350 to interpret the reference to reporting period to mean annual reporting periods. Therefore, absent some

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triggering event (e.g., change in intended use), we believe that an entity should reevaluate the useful lives of intangible assets at least annually.

Impairment of Amortizable Intangible Assets

> **ASC Paragraph 350-30-35-14**
>
> An intangible asset that is subject to amortization shall be reviewed for impairment in accordance with the Impairment or Disposal of Long-Lived Asset Subsections of [ASC] Subtopic 360-10 by applying the recognition and measurement provisions in [ASC] paragraphs 360-10-35-17 through 35-35. In accordance with the Impairment or Disposal of Long-Lived Asset Subsections of [ASC] Subtopic 360-10, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

22.039 ASC Section 360-10-35 requires a long-lived asset (asset group), including amortizable intangible assets, to be tested for recoverability whenever events or changes in circumstances (indicators) indicate that its carrying amount may not be recoverable *(trigger-based testing)*. In that case, the entity must evaluate whether the carrying amount of the long-lived asset (asset group) is recoverable. If the carrying amount is not recoverable, the entity determines whether there is an impairment loss by reference to the fair value of the asset (asset group). Any impairment loss recognized under ASC Section 360-10-35 reduces the asset to its new cost basis. Reversal of a previously recognized impairment loss is prohibited. ASC paragraph 350-30-35-14

22.040 See KPMG Handbook, Impairment of nonfinancial assets, for in-depth discussion of the long-lived asset impairment model.

NONAMORTIZABLE INTANGIBLE ASSETS OTHER THAN GOODWILL

Indefinite-Lived Intangible Assets Are Not Amortized

> **ASC Paragraph 350-30-35-15**
>
> If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite.
>
> **ASC Paragraph 350-30-35-16**
>
> An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life.
>
> **ASC Paragraph 350-30-35-17**
>
> If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance

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with [ASC] paragraphs 350-30-35-18 through 35-19. That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

ASC Paragraph 350-30-35-17A

Intangible assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered *indefinite lived* until the completion or abandonment of the associated research and development efforts. During the period those assets are considered indefinite lived they shall not be amortized but shall be tested for impairment in accordance with [ASC] paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in this Section. Consistent with the guidance in [ASC] paragraph 360-10-35-49, intangible assets acquired in a business combination, acquired in an acquisition by a not-for-profit entity, or recognized by a joint venture upon formation that have been temporarily idled shall not be accounted for as if abandoned.

22.041 Intangible assets with indefinite useful lives are not amortized. However, an entity reevaluates its conclusion that an intangible asset has an indefinite useful life each reporting period. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the intangible asset should be tested for impairment in accordance with ASC paragraphs 350-30-35-18 through 35-19 and an impairment loss should be recognized to the extent the carrying amount of the asset exceeds its fair value. Thereafter, the intangible asset should be amortized prospectively, based on its remaining useful life.

Intangible Assets Acquired in a Business Combination That Are Used in Research and Development Activities

22.042 ASC Topic 805 specifies that assets acquired in a business combination that are IPR&D are considered indefinite-lived intangible assets until completion or abandonment of the related research and development efforts. Those assets are tested for impairment on an annual basis in accordance with ASC Topic 350 as described below. Once the research and development efforts are completed or abandoned, the entity determines whether the asset continues to be indefinite-lived or has become a finite-lived asset. If finite-lived, the useful lives of those intangible assets, if any, are estimated and the intangible asset is amortized over the useful life, consistent with ASC paragraphs 350-30-35-6 through 35-7.

22.043 When an IPR&D asset is intended to be used for defensive purposes, the accounting treatment will depend on what the acquired IPR&D asset is intended to defend. See Paragraph 12.018 for additional guidance.

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Impairment of Identifiable Indefinite-Lived Intangible Assets

22.044 A nonamortizable intangible asset is tested annually for impairment and more frequently if events or circumstances indicate that it is more likely than not that the asset is impaired. An impairment loss is incurred when the carrying amount of the asset is greater than its fair value; the excess is the impairment loss recognized. See KPMG Handbook, Impairment of nonfinancial assets, for further discussion of the impairment model.

GOODWILL

22.045 Goodwill is not amortized; rather, it is tested at least annually for impairment at a level referred to as a *reporting unit.* Goodwill must be tested between annual tests if an event occurs or circumstances change to indicate that it is more likely than not that an impairment loss has been incurred (i.e., a triggering event). Goodwill is considered impaired and a loss may be recognized when the carrying amount of a reporting unit with goodwill exceeds its fair value. See Section 26 for a discussion of a private company accounting alternative for evaluating goodwill triggering events.

22.046 – 22.047 Paragraphs not used.

22.048 A private company or not-for-profit entity can elect an accounting alternative to amortize goodwill on a straight-line basis over ten years, or less than ten years if it can demonstrate that a shorter useful life is more appropriate. An entity applying the alternative is permitted to continue to test goodwill for impairment at the reporting unit level or can test impairment prospectively at the entity level. See Section 26 for further details on this goodwill amortization alternative.

22.049 When an entity disposes of a portion of a reporting unit constituting a business, a relative fair value approach is used to assign a portion of reporting unit goodwill to the portion being disposed of and that goodwill is written off. When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained should be tested for impairment.

22.050 See KPMG Handbook, Impairment of nonfinancial assets, for in-depth discussion of the subsequent accounting for goodwill, including the goodwill impairment model, private company alternative and how to account for the disposition of all or a portion of a reporting unit.

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Section 23 - The Tax Effects of Business Combinations

See KPMG Handbook, Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations.

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Section 24 - The Tax Effects of Changes in Ownership Interests While Retaining Control

See KPMG Handbook, Accounting for Income Taxes, Section 6, The Tax Effects of Business Combinations.

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Section 25 - The Tax Effects of Asset Acquisitions

See KPMG Handbook, Accounting for Incomes Taxes, Section 10, Other Considerations.

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Section 26 - Private Company and Not-for-Profit Accounting Alternatives

Detailed Contents

Goodwill Accounting Alternatives

- Amortization Alternative
- Triggering Event Alternative

Identifiable Intangible Assets Accounting Alternative

- Customer-Related Intangible Assets
- Noncompete Agreements
- Transition

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26.000 ASC Subtopic 350-20, *Intangibles—Goodwill and Other—Goodwill,* provides a goodwill amortization alternative to all entities other than public business entities, not-for-profit entities, and employee benefit plans within the scope of Topics 960 through 965 (herein referred to as private companies). The amortization alternative allows an eligible entity to:

- amortize goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate);
- make an accounting policy election to test goodwill for impairment at either the entity or reporting unit level;
- test goodwill for impairment only when a triggering event occurs that indicates the fair value of an entity (or reporting unit) may be less than its carrying amount (i.e., an annual impairment test is not required); and
- measure goodwill impairment, if any, as the excess of the entity's (or reporting unit's) carrying amount over its fair value.

26.001 Subtopic 805-20, *Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest,* provides private companies and not-for-profit entities an alternative not to separately recognize and thereby subsume into goodwill any value attributable to (a) customer-related intangible assets that are not capable of being sold or licensed independently from the other business assets and (b) noncompete agreements when applying the acquisition method for a business combination, assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an equity method investee, and adopting fresh-start reporting when emerging from a Chapter 11 reorganization action. An entity that elects the alternative under ASC Subtopic 805-20 also must adopt the goodwill alternative to amortize goodwill. However, an entity that has adopted the alternative to amortize goodwill is not required to adopt the alternative for intangible assets and noncompetition agreements under ASC Subtopic 805-20.

26.001a ASC Subtopic 350-20 also provides private companies and not-for-profit entities an alternative to:

- identify and assess goodwill impairment triggering events only as of each reporting date (interim or annual); and
- perform any necessary goodwill impairment test using the financial information as of the reporting date (interim or annual).

See section 4.3.40 of KPMG Handbook, Impairment of nonfinancial assets for detailed discussion of this goodwill accounting alternative.

26.002 While an entity may initially elect these alternatives at any time after the issuance of the related standard without a preferability assessment, an entity should consider its expected future eligibility to qualify for the accounting alternative(s) before adopting. For example, an entity that is a private company now that becomes a public business entity in the future (e.g., because its financial statements will be included in an SEC filing by

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another entity, or it is itself filing a registration statement with the SEC) will need to recast historical financial statements to comply with the requirements applicable to a public business entity (i.e., as if the accounting alternative(s) had not been elected). The SEC staff may not accept an assertion that recasting historical financial statements would be impracticable, even though doing so may be difficult. Management of a private company therefore should carefully consider whether it might take the company public in the future before adopting the alternative accounting treatment for goodwill.

26.002a Before applying the accounting alternatives, an entity should evaluate if it is a public business entity that cannot apply those alternatives. For example, entities meet the definition of a public business entity if their financial statements are included in a registrant's SEC filing, such as when the entity is a significant acquiree under Rule 3-05 of Regulation S-X, a significant equity method investee under Rule 3-09 of Regulation S-X, or an equity method investee whose summarized financial information is included in a registrant's SEC filing under Rule 4-08(g) of Regulation S-X.

26.002b If an entity is considered a public business entity due only to the inclusion of its financial statements within another entity's SEC filing, the entity is considered a public business entity only for the SEC filing. For its stand-alone financial statements used for other purposes, the accounting alternatives can be elected. However, the definition of public business entity is different from the definition used for public entities for pro forma disclosures in Section 13 and close evaluation should be performed.

GOODWILL ACCOUNTING ALTERNATIVES

26.003 The Accounting Alternative Subsections of ASC Subtopic 350-20 provide private companies and not-for-profit entities with accounting alternatives for the measurement of goodwill after it is initially recognized.

AMORTIZATION ALTERNATIVE

26.004 A private company or not-for-profit entity that elects the goodwill amortization alternative amortizes goodwill on a straight-line basis over ten years, or less than ten years if it can demonstrate that a shorter useful life is more appropriate. An entity is not required to justify a 10-year amortization period for goodwill, even if the primary asset(s) acquired in the transaction is expected to generate cash flows for a period of less than 10 years.

26.005 Paragraph not used.

26.006 An entity applying the amortization alternative is permitted to continue to test goodwill for impairment at the reporting unit level or can test impairment prospectively at the entity level. An entity that makes a policy election to test goodwill for impairment at the entity level does not need to demonstrate this policy election is preferable.

26.006a See chapter 11 of KPMG Handbook, Impairment of nonfinancial assets for further discussion of the goodwill accounting alternative for amortizing goodwill.

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TRIGGERING EVENT ALTERNATIVE

26.007 A private company or not-for-profit entity that elects the triggering event alternative evaluates goodwill impairment triggering events only as of each reporting date (interim or annual) and performs any necessary goodwill impairment test using the financial information as of the reporting date (interim or annual). The accounting alternative can be applied regardless of whether a private company or not-for-profit entity has elected the goodwill amortization alternative. However, the triggering event alternative does not allow eligible entities that report on an interim basis to only evaluate goodwill triggering events as of the annual reporting date. Entities will need to carefully evaluate their reporting requirements (e.g., terms of lending arrangements) to determine whether their interim financial information is required to be in compliance with GAAP, which could be the case even if that information is less than a full set of GAAP compliant financial statements. See section 4.3.40 of KPMG Handbook, Impairment of nonfinancial assets for detailed discussion of the goodwill accounting alternative for impairment triggering event evaluation.

26.008 – **26.018** Paragraphs not used.

IDENTIFIABLE INTANGIBLE ASSETS ACCOUNTING ALTERNATIVE

SCOPE

ASC Paragraph 805-20-15-2

A private company or not-for-profit entity may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies when a private company or not-for-profit entity is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions:

a. Applying the acquisition method (as described in paragraph 805-10-05-4 for all entities and Subtopic 958-805 for additional guidance for not-for-profit entities)

b. Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with Topic 323 on investments—equity method and joint ventures

c. Adopting fresh-start reporting in accordance with Topic 852 on reorganizations

d. Accounting for the formation of a joint venture in accordance with Subtopic 805-60.

ASC Paragraph 805-20-15-3

An entity that elects the accounting alternative shall apply all of the related recognition requirements upon election. The accounting alternative, once elected,

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shall be applied to all future transactions that are identified in paragraph 805-20-15-2.

26.019 All the *in-scope* transactions identified in ASC paragraph 805-20-15-2 result in an entity applying a new basis of accounting generally consistent with the acquisition method. See Section 13 for discussion of *The Acquisition Method.* An entity that elects the intangible asset accounting alternative must also adopt the goodwill accounting alternative. However, an entity that has previously adopted the goodwill accounting alternative is not required to adopt the intangible asset accounting alternative.

26.020 An entity that elects the alternative for in-scope transactions does not need to justify that the use of the alternative is preferable as described in ASC paragraph 250-10-45-2. See additional discussion in the Transition section.

RECOGNITION

ASC Paragraph 805-20-25-30

An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. However, under the accounting alternative, an acquirer shall not recognize separately from goodwill the following intangible assets:

a. Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business

b. Noncompetition agreements.

CUSTOMER-RELATED INTANGIBLE ASSETS

26.021 Examples of customer-related intangible assets are discussed in ASC paragraphs 805-20-55-20 through 55-28 and include:

(a) Customer lists

(b) Order or production backlog

(c) Customer contracts and related customer relationships

(d) Noncontractual customer relationships

26.022 As discussed in ASC paragraphs 805-20-55-12 and 55-20 through 55-28, customer lists and noncontractual customer relationships do not arise from contractual or other legal rights, but may meet the separability criterion, and if so, are *identifiable.* Order production backlog and customer contracts and related customer relationships arise from contractual or other legal rights and therefore are identifiable without regard to separability (i.e., they also may be separable, but separability is not a necessary condition because they meet the contractual-legal criterion). See Section 7 for additional discussion of the separability criterion, contractual-legal criterion, and customer-related intangibles.

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26.023 ASC paragraph 805-20-25-31 provides examples of customer-related intangibles that may meet the criterion for separate recognition under the intangible asset accounting alternative including (but not limited to):

(a) Mortgage servicing rights

(b) Commodity supply contracts

(c) Core deposits

(d) Customer information (for example, names and contact information)

26.024 While the language in ASC paragraph 805-20-25-30(a) that identifies those customer relationship intangibles that may NOT be subsumed into goodwill (i.e., those that are "capable of being sold or licensed independently from other assets of a business") is different from the separability criterion discussed in ASC paragraph 805-20-55-3 (i.e., those that are "capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability"), we believe if a customer-related intangible asset meets the separability criterion, it may also meet the standard for separate recognition under the intangible asset accounting alternative (i.e., an entity will be unable to subsume it into goodwill). However, entities should consider all relevant facts and circumstances in determining whether a customer-related intangible does or does not meet the standard for separate recognition. The standard in evaluating the alternative (similar to the standard for evaluating the separability criterion) is whether a customer-related intangible asset is *capable* of being sold or licensed independently, whether or not the entity has an intention of selling the asset (see paragraph BC18 in the Basis for Conclusions to ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination*).

26.025 ASC paragraph 805-20-25-31 states that many of the examples of customer-related intangibles that require separate recognition also are contract-based intangible assets; however, we do not believe that all contract-based intangibles are, by definition, ineligible for the alternative (i.e., not all contract-based intangibles would necessarily require separate accounting). For example, some contract-based intangibles have contractual limitations on transfer, resulting in the holder being incapable of selling or licensing them independently. Accordingly, to determine whether an intangible (contract-based, or not) is eligible to be subsumed into goodwill, the entity will need to evaluate if it is capable of being sold or licensed independently from other assets of a business. An entity may not currently have a process in place to do that analysis on a contract-based intangible, because the intangible would require separate accounting (absent the intangible asset accounting alternative) even if it could not be sold because it meets the contractual-legal criterion. We believe entities primarily will focus on whether the asset is legally protected, separately transferable, and capable of providing discrete cash flows, which are the attributes that the PCC and Board believe users consider the most relevant in determining whether an intangible asset warrants separate accounting (see paragraph BC29 in the Basis for Conclusions to ASU 2014-18).

26.026 In evaluating whether a customer-related intangible is capable of being sold or licensed independently from other assets of a business, an entity should consider

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contractual limitations on transfer (in a similar way limitations are considered in the separability criterion analysis as discussed in ASC paragraph 805-20-55-4). The PCC and the Board note in the Basis for Conclusions to ASU 2014-18 that the examples of intangibles that require separate accounting represent relationships and information that can often be sold without input from the customer or their agreement to the transfer. Paragraph BC18 states that if the transfer depends on the decision of a customer, it would be clear that the entity is not capable of selling that customer-related intangible asset separately from the other assets of the business and therefore those intangible assets may be eligible for the accounting alternative.

> **ASC Paragraph 805-20-25-32**
>
> Contract assets, as used in Topic 606 on revenue from contracts with customers, are not considered to be customer-related intangible assets for purposes of applying this accounting alternative. Therefore, contract assets are not eligible to be subsumed into goodwill and shall be recognized separately.

26.027 Topic 606 defines a contract asset as:

> An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Contract assets are reclassified to receivables once an entity has an unconditional right to payment. Therefore, an acquired contract asset is recognized separately and does not qualify for the accounting alternative.

> **ASC Paragraph 805-20-25-33**
>
> A lease is not considered to be a customer-related intangible asset for purposes of applying this accounting alternative. Therefore, favorable and unfavorable leases are not eligible to be subsumed into goodwill and shall be recognized separately.

26.028 Although ASC paragraph 805-20-25-33 does not specifically address the value associated with leases in place at the acquisition date (in-place lease intangible assets) or customer relationships associated with a lease, we believe that because a lease is specifically identified as not being considered a customer-related intangible asset for the purpose of applying the alternative, none of the identifiable intangible assets associated with an acquired lease are eligible for the alternative and all would require separate recognition. See Section 7 for additional discussion of intangibles arising from acquired lease contracts.

26.029 While favorable lease contracts are not eligible for the alternative, paragraph BC20 in the Basis for Conclusions of ASU 2014-18 states that other favorable customer contracts are eligible to be subsumed into goodwill. However, an entity will need to evaluate whether the favorable contract is capable of being sold or licensed independently from other assets of a business, and, if so, it must be recognized separately from goodwill. Unfavorable customer contracts (or other intangible liabilities recognized as result of below-market terms) are not eligible for the alternative as they are not intangible

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assets (i.e., offsetting of customer-related intangible liabilities against customer-related assets is not permitted).

NONCOMPETE AGREEMENTS

26.030 Section 7 describes noncompete agreements as:

> Agreements that place restrictions on a person's or a business' ability to compete with another entity and, as such, meet the contractual-legal criterion for recognition as intangible assets. The restrictions generally relate to specified markets and/or specified products or activities for some period of time. These agreements may be entered into on a stand-alone basis, or may be embedded in another agreement, such as an acquisition agreement or an employment contract.

26.031 The PCC and the Board stated in the Basis for Conclusions to ASU 2014-18 that an entity is not required to assess whether a noncompete agreement is capable of being sold or licensed separately from the other assets of the business and that noncompete agreements would seldom, if ever, meet the criteria for recognition.

26.032 We understand (and the Basis for Conclusions acknowledges in paragraph BC19) that some entities consider noncompete agreements part of the business combination and some do not (i.e., they represent transactions separate from the business combination) because noncompete agreements are not specifically addressed in the business combinations guidance. The PCC and Board decided not to provide additional guidance on this issue. Entities that do not account for noncompete agreements in applying acquisition accounting will not be affected by the alternative.

26.033 See Section 7 for additional discussion of noncompete agreements.

> **ASC Paragraph 805-20-15-4**
>
> An entity that elects this accounting alternative must adopt the accounting alternative for amortizing goodwill in the Accounting Alternatives Subsections of [ASC] Topic 350-20 on intangibles—goodwill and other. If the accounting alternative for amortizing goodwill was not adopted previously, it should be adopted on a prospective basis as of the adoption of the accounting alternative in [ASC] Subtopic [805-20]. For example, upon adoption, existing goodwill should be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. However, an entity that elects the accounting alternative for amortizing goodwill is not required to adopt the accounting alternative in [ASC] Subtopic [805-20].

26.034 If the intangible asset accounting alternative is elected, an entity also is required to adopt the accounting alternative for amortizing goodwill, in which case goodwill resulting from a business combination is amortized on a straight-line basis over a period of 10 years. An entity also may amortize its goodwill over a shorter period if it can demonstrate that another useful life is more appropriate, which may be the case when goodwill consists of a significant amount of customer-related intangibles and/or noncompete agreements for which the intangible asset accounting alternative has been

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applied. See KPMG Handbook, Impairment of nonfinancial assets, for an additional discussion of the goodwill alternative.

TRANSITION

ASC Paragraph 805-20-65-2

The following represents the transition information related to Accounting Standards Updates No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination,* and No. 2019-06, *Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Assets to Not-for-Profit Entities,* referenced in [ASC] paragraph 805-20-15-1A:

a. Upon adoption of the Accounting Alternative Subsections of this Subtopic, that guidance shall be effective prospectively to the first transaction that is identified in [ASC] paragraph 805-20-15-2 after the adoption of the accounting alternative.

b. Customer-related intangible assets and noncompetition agreements that exist as of the beginning of the period of adoption shall continue to be subsequently measured in accordance with [ASC] Topic 350 on intangibles—goodwill and other. That is, existing customer-related intangible assets and noncompetition agreements should not be subsumed into goodwill upon adoption of the Accounting Alternative Subsections of this Subtopic.

c. Subparagraph superseded by Accounting Standards Update No. 2016-03.

d. A private company or not-for-profit entity that makes an accounting policy election to apply the guidance in the Accounting Alternative Subsections of this Subtopic for the first time need not justify that the use of the accounting alternative is preferable as described in [ASC] paragraph 250-10-45-2.

26.035 If elected, the identifiable asset accounting alternative is applied on the occurrence of the first in-scope transaction after the adoption of the accounting alternative and to all subsequent transactions thereafter and retrospective application is not permitted (only new customer-related intangible assets and noncompete agreements arising from transactions *after* the adoption date are eligible for the accounting alternative). An entity does not need to make a preferability assessment on the initial election of the intangible asset accounting alternative. See chapter 11 of KPMG Handbook, *Impairment of nonfinancial assets*, for transition guidance related to the goodwill alternative.

26.036 Based on discussions with the FASB staff, under the transition guidance we believe an entity has flexibility in defining its adoption period as its annual or an interim reporting period (including an interim period other than the first quarter) as long as the financial statements for that period have not yet been made available for issuance. Once an entity elects its adoption period, the beginning of that fiscal year will become the date

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on which goodwill amortization will begin for existing elements of goodwill (as discussed in Paragraph 26.015).

26.037 For example, assume a calendar year entity completed business combinations in September 2016 and October 2016 and issued September 30, 2016 interim financial statements. We believe the entity will have two options for initial adoption of the accounting alternatives. The first option would be for the entity to define its period of adoption as its annual 2016 reporting period, which is permitted because the annual 2016 financial statements have not yet been made available for issuance. Under that approach, the entity would apply the intangible asset accounting alternative to its entire annual period including both the September 2016 and October 2016 business combinations (because the September 2016 transaction was the first in-scope transaction in the annual period of adoption and the alternative is applied prospectively to all subsequent in-scope transactions). The entity also would amortize existing goodwill for the entire 2016 annual period (i.e., begin amortizing as of January 1, 2016).

26.038 A second option would be for the entity to define its period of adoption as the fourth quarter of 2016, which is permitted because the fourth quarter 2016 financial statements have not yet been made available for issuance. Under that approach, the entity would apply the intangible asset accounting alternative only to its October 2016 business combination. In this situation, the entity's annual 2016 financial statements would reflect the September 2016 business combination being accounted for without the intangible asset accounting alternative applied and the October 2016 business combination with the intangible asset accounting alternative applied. Although the period of adoption is the fourth quarter, goodwill amortization would begin at the beginning of the fiscal year (January 1, 2016) for goodwill that existed on that date. Goodwill amortization would begin in September 2016 for goodwill recognized in connection with the September 2016 business combination and in October 2016 for goodwill recognized in connection with the October 2016 business combination. Under that approach, the entity would not be able to apply the intangible asset accounting alternative to the September 2016 transaction because financial statements for that period (i.e., the third quarter of 2016) had already been available for issuance. The entity would most likely use this adoption option when it has already finalized (or nearly finalized) its acquisition accounting for the September 2016 business combination and does not want to incur the cost to revise its acquisition accounting for that transaction for the purposes of its annual financial statements.

26.039 We believe the intangible asset accounting alternative may only be adopted for transactions *occurring* during periods for which financial statements have not been issued (or made available for issuance). For example, assume an entity completed a business combination in December 2015 and issued the 2015 financial statements indicating the acquisition accounting was provisional. That entity would not be able to apply the intangible asset accounting alternative to that December 2015 transaction on the basis that the acquisition accounting was not finalized until 2016. The fact that acquisition accounting was provisional in the previously-issued financial statements is not a factor in determining that transaction's eligibility for the intangible asset accounting alternative because ASC paragraph 805-20-15-2 speaks specifically about applying the guidance in

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the period when it is required to recognize the fair value of intangible assets for an in-scope transaction (e.g., the acquisition date) rather than the period in which the accounting for that transaction is completed.

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Section 27 - Application of Pushdown Accounting

Detailed Contents

Background and Scope
Recognition
Example 27.1: Pushdown to Subsidiaries of an Acquired Entity
Determining Whether a Change-in-Control Event Has Occurred
Transaction Costs
Accounting for Goodwill
Treatment of Bargain Purchase Gains
Accounting for Acquisition-Related Liabilities
How to Apply Pushdown Accounting
Example 27.2: Acquisition of Less Than a Majority of Outstanding Stock
Example 27.3: Effect of a Call Option
Example 27.4: Applying Pushdown Accounting
Financial Statement Presentation
Example 27.5: Financial Statement Presentation
Accounting Policies
Presentation of Contingent Expenses of the Acquiree
Acquisition-Related Debt
Example 27.6: Joint and Several Obligation
Acquisition-Related Goodwill
Example 27.7: Goodwill Allocation
Acquiree with Foreign Entities
Acquisition Costs
Contingent Consideration
Electing Fair Value Option
Application of Pushdown Accounting at a Later Date
Example 27.8: Change in Accounting Principle
Example 27.9: Rolling Forward Subsequent Activity
Forgoing the Election to Apply Pushdown Accounting
Management Responsibilities for ICOFR

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Acquirer's Consolidated Financial Statements
Acquiree Separate Financial Statements
Change in Tax Basis
Call Report Considerations

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BACKGROUND AND SCOPE

27.000 *Pushdown accounting* refers to establishing a new basis of accounting in the separate (often described as 'stand-alone') financial statements of the acquired entity (or acquiree) after it is acquired. The acquisition adjustments recorded by the acquirer in a business combination under ASC Topic 805 are pushed down to the acquiree's separate financial statements.

27.000a An acquired entity is allowed, but not required, to apply pushdown accounting upon acquisition by a new controlling parent. The FASB provides specific guidance on how to account for goodwill, bargain purchase gains, and acquisition-related liabilities in the acquired entity's financial statements.

ASC Paragraph 805-50-25-4

An acquiree shall have the option to apply pushdown accounting in its separate financial statements when an acquirer—an entity or individual—obtains control of the acquiree. An acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

a. By transferring cash or other assets

b. By incurring liabilities

c. By issuing equity interests

d. By providing more than one type of consideration

e. Without transferring consideration, including by contract alone as discussed in paragraph 805-10-25-11.

ASC Paragraph 805-50-25-6

The option to apply pushdown accounting may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree. An acquiree shall make an election to apply pushdown accounting before the financial statements are issued (for a Securities and Exchange Commission (SEC) filer and a conduit bond obligor for conduit debt securities that are traded in a public market) or the financial statements are available to be issued (for all other entities) for the reporting period in which the change-in-control event occurred. If the acquiree elects the option to apply pushdown accounting, it must apply the accounting as of the acquisition date.

ASC Paragraph 805-50-25-8

Any subsidiary of an acquiree also is eligible to make an election to apply pushdown accounting to its separate financial statements in accordance with the guidance in paragraphs 805-50-25-4 through 25-7 irrespective of whether the acquiree elects to apply pushdown accounting.

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ASC Paragraph 805-50-25-9

The decision to apply pushdown accounting to a specific change-in control event if elected by an acquiree is irrevocable.

27.001 The election to apply pushdown accounting may be made by the acquired entity in the period in which there is a new controlling parent. However, once pushdown accounting is elected, it is irrevocable. The election to apply pushdown accounting can be made separately for each change-in-control event (e.g., acquisition by acquisition basis). Additionally, the acquired entity's subsidiaries can choose to apply pushdown accounting whether or not the acquired entity does.

27.002 Paragraph not used.

27.003 The pushdown accounting guidance in ASC Subtopic 805-50 applies to all entities and all transactions or other events that meet the definition of a business combination or an acquisition by a not-for-profit entity.

27.004 The acquirer does not need to apply acquisition accounting to enable the acquiree to elect pushdown accounting, although that may be one of the factors the acquiree considers when evaluating the benefits and costs. For example, if the acquirer was an investment company or individual, it may not be required to apply acquisition accounting. However, the acquiree would be able to elect to apply pushdown accounting if the acquirer is a new controlling parent.

27.005 Transactions including, but not limited to, the formation of a joint venture (except as described in ASC Subtopic 805-60), combinations of entities under common control, and certain other transactions that are identified in ASC paragraph 805-10-15-4 are excluded from the scope of the pushdown guidance because these transactions do not fall under the scope of business combinations accounting.

27.006 Additionally, we believe a subsidiary can elect to apply pushdown accounting in its separate financial statements when the parent entity emerges from bankruptcy and applies fresh-start reporting under ASC Topic 852, *Reorganizations.* This is the case even if the subsidiary did not file for bankruptcy.

27.006a Under ASC Subtopic 805-60, a joint venture accounts for its formation by applying a new basis of accounting at the joint venture level. In paragraph BC90 of the Basis for Conclusions of ASU 2023-05, Business Combinations – Joint Venture Formations: Recognition and measurement (ASC Subtopic 805-60), the FASB indicated a joint venture has similarities to an acquirer because the joint venture gains control of the net assets contributed to it as part of the formation transaction. Because there has been a change in control over the contributed net assets upon joint venture formation, we believe that a contributed subsidiary can also apply pushdown accounting in its separate financial statements. See Section 29 for guidance on accounting for the formation of a joint venture in the joint venture's financial statements.

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RECOGNITION

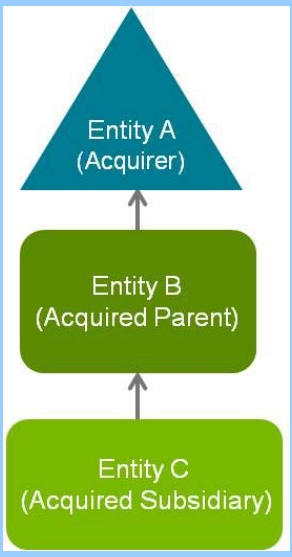
27.007 An acquired entity has the option to apply pushdown accounting in its separate financial statements upon acquisition by a new controlling parent. An acquirer might obtain control of an acquiree in a number of ways including:

- Transferring cash or other assets;
- Incurring liabilities;
- Issuing equity interests;
- Providing more than one type of consideration; and
- Without transferring consideration, including by contract alone as discussed in ASC Topic 805.

27.008 An acquired entity may make the election to apply pushdown accounting each time it is acquired by a new controlling parent. Once an entity elects to apply pushdown accounting to a specific change-in-control event, that decision is irrevocable.

27.009 A consolidated subsidiary of an acquired parent also has the option to apply pushdown accounting in its separate financial statements irrespective of whether the acquired parent applies pushdown accounting in its consolidated financial statements.

Example 27.1: Pushdown to Subsidiaries of an Acquired Entity



Entity A (Acquirer) acquires 80% of Entity B (acquired parent) and its wholly owned subsidiary Entity C (acquired subsidiary).

After considering the informational needs of its separate financial statement users, Entity B chooses not to apply pushdown accounting.

Entity C performs a similar evaluation as Entity B and elects to apply pushdown accounting. Its new basis is consistent with that established by Entity A even though Entity B did not apply pushdown accounting.

For purposes of Entity B's separate consolidated financial statements, Entity C's financial information would be based on Entity C's historical information (not pushdown information) even though Entity C applies pushdown accounting in its separate financial statements.

ASC Paragraph 805-50-25-5 (Before adoption of ASU 2025-03)[1]

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The guidance in the General Subsections of [ASC] Subtopic 810-10 on consolidation, related to determining the existence of a controlling financial interest shall be used to identify the acquirer. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in [ASC] paragraphs 805-10-55-11 through 55-15 shall be considered in identifying the acquirer. However, if the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree always is the acquirer. The determination of which party, if any is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of [ASC] Subtopic 810-10, not by applying the guidance in the General Subsections of that Subtopic related to a controlling financial interest or the guidance in [ASC] paragraphs 805-10-55-11 through 55-15.

ASC Paragraph 805-50-25-5 (After adoption of ASU 2025-03)

The guidance in the General Subsections of [ASC] Subtopic 810-10 on consolidation, related to determining the existence of a controlling financial interest shall be used to identify the acquirer. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in [ASC] paragraphs 805-10-55-11 through 55-15 shall be considered in identifying the acquirer. However, if the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree is the acquirer unless the business combination is effected primarily by exchanging equity interests. The determination of which party, if any is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of [ASC] Subtopic 810-10, not by applying the guidance in the General Subsections of that Subtopic related to a controlling financial interest or the guidance in [ASC] paragraphs 805-10-55-11 through 55-15. For a business combination that is effected primarily by exchanging equity interests in which a VIE is acquired, the factors in [ASC] paragraphs 805-10-55-12 through 55-15 shall be considered in determining which entity is the accounting acquirer.

27.010 ASC paragraph 805-50-25-5 uses the definition of control used in the consolidation guidance in ASC Subtopic 810-10. This Subtopic indicates that a controlling financial interest generally results from one entity obtaining, either directly or indirectly, more than 50% of the outstanding shares of another entity. In some instances, the power to control an entity may exist at a lesser percentage of ownership or from other means (e.g., through a contractual arrangement or as the primary beneficiary of a variable interest entity).

27.011 The EITF and FASB considered whether consolidated subsidiaries of an acquired parent that elected pushdown accounting must make the same election. The EITF and FASB ultimately concluded that each entity in the acquired consolidated group could decide whether to apply pushdown accounting in its separate financial statements because

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different entities within the group may have different financial statement users with different information needs.

DETERMINING WHETHER A CHANGE-IN-CONTROL EVENT HAS OCCURRED

27.012 Consolidation guidance generally is used to identify whether control has changed. In situations where a business combination has occurred but applying the guidance in ASC Subtopic 810-10 does not clearly indicate which of the combining entities is the acquirer, ASC paragraphs 805-10-55-11 through 55-15 should be considered to determine which entity is the acquirer (see Paragraphs 4.004 - 4.022). See SEC and Call Report Considerations for more information.

Initial Measurement

ASC Paragraph 805-50-30-10

If an acquiree elects the option in [ASC] Subtopic [805-50] to apply pushdown accounting, the acquiree shall reflect in its separate financial statements the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquiree by applying the guidance in other Subtopics of [ASC] Topic 805. If the acquirer did not establish a new basis of accounting for the individual asset and liabilities of the acquiree because it was not required to apply [ASC] Topic 805 (for example, if the acquirer was an individual or an investment company -- see [ASC] Topic 946 on investment companies), the acquiree shall reflect in its separate financial statements the new basis of accounting that would have been established by the acquirer had the acquirer applied the guidance in other Subtopics of [ASC] Topic 805.

ASC Paragraph 805-50-30-11

An acquiree shall recognize goodwill that arises because of the application of pushdown accounting in its separate financial statements. However, bargain purchase gains recognized by the acquirer, if any, shall not be recognized in the acquiree's income statement. The acquiree shall recognize the bargain purchase gains recognized by the acquirer as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree).

ASC Paragraph 805-50-30-12

An acquiree shall recognize in its separate financial statements any acquisition-related liability incurred by the acquirer only if the liability represents an obligation of the acquiree in accordance with other applicable Topics.

27.013 An entity that elects to apply pushdown accounting in its separate financial statements on a change-in-control event will reflect the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquired entity by applying ASC Topic 805. Additionally, if pushdown accounting is elected, an entity is required to disclose sufficient information to enable financial statement users to evaluate the nature and effect of pushdown accounting.

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27.014 If the acquirer does not apply ASC Topic 805 for the assets and liabilities of the acquiree (e.g., if the acquirer is an individual or an investment company), the acquiree may still elect pushdown accounting by applying the new basis in its separate financial statements consistent with what would have been the acquirer's basis if it had applied ASC Topic 805.

27.015 In applying pushdown accounting, the carrying amounts of the assets and liabilities in the financial statements of the acquired entity are adjusted to reflect the acquisition accounting adjustments recorded (or that would have been recorded) in the consolidated financial statements of the acquiring entity as of the date control was obtained. If pushdown accounting is applied, the separate financial statements of the acquired entity must reflect all of the acquisition adjustments; partial pushdown accounting is not permitted.

27.015a In addition, we believe that the measurement period for the acquiree's separate financial statements aligns with that of the acquirer. This means that any adjustments made by the acquirer to the provisional amounts recognized in the business combination will also be reflected in the acquiree's separate financial statements. Additionally, the acquiree's separate financial statements should include appropriate disclosures if the initial accounting for the business combination is incomplete.

TRANSACTION COSTS

27.016 Transaction costs incurred by the acquirer are not part of the new basis of the acquired entity. Therefore, the acquirer's transaction costs are not pushed down to the separate financial statements of the acquired entity.

ACCOUNTING FOR GOODWILL

27.017 If the acquiree elects to apply pushdown accounting, goodwill arising from the application of ASC Topic 805 is recorded in the separate financial statements of the acquiree. The amount of parent goodwill pushed down to the acquiree may be different from the amount of goodwill assigned to the parent's reporting units that include the acquiree, because the parent may assign some of the acquiree's goodwill to other parent reporting units that may benefit from the acquisition. See the section on Acquisition-Related Goodwill for more information.

TREATMENT OF BARGAIN PURCHASE GAINS

27.018 A bargain purchase gain, if any, recognized by the acquirer that results from the application of ASC Topic 805 is not recorded in the income statement of the acquiree when the acquiree elects to apply pushdown accounting. The acquiree recognizes a bargain purchase gain as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree) in its separate financial statements.

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ACCOUNTING FOR ACQUISITION-RELATED LIABILITIES

27.019 Acquisition-related liabilities, including debt incurred by an acquirer, is recognized in the separate financial statements of the acquired entity only if that entity is required to do so under other U.S. GAAP (e.g., if the entity is a named obligor or if it meets the requirements of joint and several liability arrangements).

27.020 When determining how to treat acquisition-related liabilities, the EITF and FASB considered the definition of a liability in FASB Concepts Statement No. 6 that states, "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."[2] Therefore, the EITF and FASB concluded that an acquired entity would recognize a liability incurred by the acquirer only if that obligation is the acquired entity's liability.

Subsequent Measurement

ASC Paragraph 805-50-35-2

An acquiree shall follow the subsequent measurement guidance in other Subtopics of [ASC] Topic 805 and other applicable Topics to subsequently measure and account for its assets, liabilities, and equity instruments, as applicable.

27.021 If an acquiree elects to apply pushdown accounting in its separate financial statements, in subsequent reporting periods it would follow the subsequent measurement guidance in ASC Topic 805. This topic addresses items such as reacquired rights, indemnification assets, and contingent consideration. Guidance on how to subsequently measure goodwill and other intangible assets is provided in ASC Topic 350.

Disclosures

ASC Paragraph 805-50-50-5

If an acquiree elects the option to apply pushdown accounting in its separate financial statements, it shall disclose information in the period in which pushdown accounting was applied (or in the current reporting period if the acquiree recognizes adjustments that relate to pushdown accounting) that enables users of financial statements to evaluate the effect of pushdown accounting. To meet this disclosure objective, the acquiree shall consider the disclosure requirements of other Subtopics of [ASC] Topic 805.

ASC Paragraph 805-50-50-6

Information to evaluate the effect of pushdown accounting may include the following:

a. The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.

b. The acquisition date.

c. The acquisition-date fair value of the total consideration transferred by the acquirer.

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d. The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial accounting for pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.

e. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible asserts that do not qualify for separate recognition, or other factors. In a bargain purchase (see [ASC] paragraphs 805-30-25-2 through 25-4), the amount of the bargain purchase recognized in additional paid-in capital (or net assets of a not-for-profit acquiree) and a description of the reasons why the transaction results in a gain.

f. Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete [see [ASC] paragraphs 805-10-25-13 through 25-14]).

The information in this paragraph is not an exhaustive list of disclosure requirements. The acquiree shall disclose whatever additional information is necessary to meet the disclosure objective set out in [ASC] paragraph 805-50-50-5.

27.022 An acquiree that elects to apply pushdown accounting in its separate financial statements must disclose, in the period in which pushdown accounting was applied (or in the reporting period in which a pushdown adjustment was recorded by the acquiree), sufficient information to enable financial statement users to evaluate the effect of applying pushdown accounting. Accordingly, the acquiree should consider the disclosures in other Subtopics of ASC Topic 805. ASC paragraph 805-50-50-6 indicates that these disclosures may include:

- The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.
- The acquisition date.
- The acquisition-date fair value of the total consideration transferred by the acquirer.
- The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.
- A qualitative description of the factors that make up the goodwill recognized, including expected synergies from combining operations of the acquiree, intangible assets that do not qualify for separate recognition, or other factors.

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In a bargain purchase, the amount recognized in additional paid-in-capital (or net assets of a not-for-profit acquiree) and a description of the reasons why the transaction resulted in a gain.

- Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous reporting periods (including those adjustments made as a result of the initial pushdown accounting being incomplete).

27.023 The disclosures listed above are not an all-inclusive list of the disclosure requirements. The acquiree is required to disclose enough information to meet the disclosure objectives of ASC Subtopic 805-50.

27.024 The EITF decided that when an entity elects pushdown accounting, it must make sufficient disclosures to enable financial statement users to evaluate the nature and effect of pushdown accounting. An acquired entity does not need to disclose information about its decision not to apply pushdown accounting.

27.025 The disclosure requirements for entities that apply pushdown accounting are generally consistent with the disclosure requirements for entities applying business combination accounting.

27.026 – 27.028 Paragraphs not used.

HOW TO APPLY PUSHDOWN ACCOUNTING

27.029 Under pushdown accounting, the carrying amounts of the assets and liabilities in the financial statements of the acquiree are adjusted to reflect the acquisition adjustments recorded in the consolidated financial statements of the acquiring entity as of the date control was obtained. The separate financial statements of the acquiree must reflect all of the acquisition adjustments; partial pushdown accounting is not permitted.

27.030 In pushdown accounting, the acquired entity is considered a new reporting entity for accounting purposes. The retained earnings of the acquiree are eliminated and the net effect of the pushdown adjustments is recognized as an adjustment to each of the affected capital accounts attributable to common shareholders. When the acquiring entity acquires 100% of the outstanding common stock of the acquiree, the equity (i.e., capital stock and additional paid-in capital) of the acquiree after the application of pushdown accounting will generally equal the purchase price. However, if the acquiree recognizes a portion of the parent's debt associated with the acquisition, either because it is jointly and severally liable or it is the legal obligor, the acquiree's equity would not equal the purchase price. Additionally, if the parent entity recorded a bargain purchase gain because the purchase price was less than the acquired entity's fair value, the equity of the acquiree, after the application of pushdown accounting, will equal the purchase price plus the bargain purchase gain. The bargain purchase gain is not recognized in the acquiree's separate financial statements.

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Example 27.2: Acquisition of Less Than a Majority of Outstanding Stock

Assume that upon the acquisition of 40% of the outstanding stock of an entity that is not a VIE the buyer obtains control over the entity as defined in ASC Topic 810. Control is generally obtained when one entity obtains, either directly or indirectly, more than 50% of the outstanding shares of another entity. In some instances the power to control an entity may exist at a lesser percentage of ownership.

Although the buyer acquires less than a majority of the outstanding stock, the entity may elect to apply pushdown accounting because the acquisition of 40% of the stock was a change-in-control event.

Example 27.3: Effect of a Call Option

In 20X4, Bank A acquires an interest of 48% of Bank B's common stock from a third party. Bank A also acquires a call option to purchase an additional 20% of Bank B's common stock from the third party in two years at the same price per share. Assume that Bank B is not a VIE and that the transaction does not give Bank A control over Bank B. Therefore, Bank B may not elect to apply pushdown accounting in 20X4 because there is no change-in-control event, because Bank A's 48% ownership and call option does not give it control over Bank B.

On exercise of the call option, Bank A's ownership will increase to 68% interest of the common stock. Assume that the exercise of the call option gives Bank A control over Bank B, which is still not a VIE. Therefore, at the time of that change-in-control event, Bank B may elect to apply pushdown accounting in its separate financial statements when Bank A becomes the new controlling parent through the exercise of the call.

Example 27.4: Applying Pushdown Accounting

ABC Corp. acquires all of the outstanding common stock of DEF Corp. for $1,000. ABC accounts for the acquisition as a business combination under ASC Topic 805. DEF elects to apply pushdown accounting in its separate financial statements.

As of the date of the acquisition, the book value of DEF's net assets is $650. DEF's equity accounts reflect common stock of $100, additional paid-in capital of $200, and retained earnings of $350.

The fair value of DEF's identifiable net assets acquired is $800. Therefore, $200 is allocated to goodwill ($1,000 purchase price less the $800 fair value of identifiable net assets).

DEF records the following entry to record the pushdown accounting adjustments.

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Identifiable net assets	$150	
Goodwill	200	
Retained earnings	350	
Additional paid-in capital		$700

DEF's financial statements before and after applying pushdown accounting as of the date of the acquisition reflect the following:

	Before Pushdown	After Pushdown
Identifiable net assets	$ 650	$ 800
Goodwill	—	200
Total net assets	$ 650	$1,000
Common stock	100	100
Additional paid-in capital	200	900
Retained earnings	350	—
Total equity	$ 650	$1,000

FINANCIAL STATEMENT PRESENTATION

27.031 The application of pushdown accounting represents a termination of one basis of accounting and the creation of a new basis. Therefore, the acquiree should not combine the periods prior to and subsequent to the date that pushdown accounting is applied. To emphasize the change in accounting basis, a vertical line generally separates the predecessor and successor financial statement periods if those periods are presented together. The financial statements would also clearly describe the basis of presentation as a result of applying pushdown accounting.

Example 27.5: Financial Statement Presentation

Parent acquires ABC Corp. on March 31, 20X5, and ABC applies pushdown accounting on that date. If ABC presents both the predecessor and successor periods in its financial statements, ABC's December 31, 20X5 statements of income, comprehensive income, cash flows, and changes in shareholder's equity would include a 3-month predecessor period and a 9-month successor period separated by a vertical line. The columns related to the two accounting entities would generally be labeled Predecessor and Successor or a similar designation. The notes to the financial statements would include relevant information for the predecessor and successor periods.

The following illustrates the format of columns for ABC's statement of income for the predecessor and successor periods:

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	Successor	Predecessor	
	April 1 – December 31, 20X5	January 1 - March 31, 20X5	Predecessor 20X4
Net income (loss)	$XX	$XX	$XX

ACCOUNTING POLICIES

27.031a ASC paragraph 805-50-35-2 states that an acquiree shall follow the subsequent measurement guidance in ASC Topic 805 and other applicable Topics to subsequently measure and account for its assets, liabilities and equity instruments, as applicable. In a business combination, an acquirer classifies and designates the identifiable assets acquired and liabilities assumed based on the acquirer's accounting policies as they exist on the date of acquisition. Accounting policies applicable to the acquired assets and assumed liabilities of the acquiree should be conformed to those of the acquirer after a business combination in the consolidated financial statements. Dissimilar operations, assets, or transactions may be a basis for different accounting policies.

27.031b We expect that in most scenarios the accounting policies would be the same in the consolidated financial statements of the acquirer and the separate financial statements of the acquiree. However, as the application of pushdown accounting represents a termination of one basis of accounting and creation of a new basis, in our view, the acquiree could use a different accounting policy in its separate financial statements on an on-going basis. In such scenarios, the subsidiary's policies would need to be conformed to those of the parent in the consolidated financial statements.

PRESENTATION OF CONTINGENT EXPENSES OF THE ACQUIREE

27.032 Acquirees often incur expenses related to the business combination. Certain expenses are contingent solely on the consummation of the business combination (e.g., investment banking fees paid by the acquiree or share-based awards that accelerate vesting if the issuer has a change-in-control event). When pushdown accounting is applied to acquiree financial statements, we believe that preparers have a policy election to present such expenses in either the predecessor period or *on-the-line,* as discussed below. These expenses should not be recognized in the successor period.

- Predecessor presentation - The expense is recognized in the predecessor period. There is no longer a risk that the consummation of the business combination will not occur and, therefore, any cost should be recognized at the closing of the predecessor period.
- On-the-line presentation - *On-the-line* refers to the vertical line that separates the predecessor period from the successor period and means that neither the predecessor nor the successor financial statements include the contingent fees as expenses. This presentation is analogous to the guidance in ASC

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paragraphs 805-20-55-50 and 55-51 that certain costs triggered by the consummation of the business combination should not be recognized until consummation occurs, and would not be recognized in the period preceding the business combination.

27.033 Whichever method is used should be applied consistently to all costs triggered solely by the consummation of a business combination. Additionally, preparers should disclose their policy, the facts and circumstances and amounts. See Paragraphs 27.045-27.047 for additional discussion on acquisition-related costs.

27.034 The SEC staff addressed the presentation of expenses incurred by the acquiree that are contingent on the closing of a business combination when pushdown accounting is applied.[3] The staff stated that registrants should determine whether each expense is most appropriately reflected in the predecessor period, successor period, or *on-the-line,* and disclose the amounts recorded in each period and the basis for determining the amounts included in each category.

27.034a We believe that the staff's reference to contingent expenses being recorded in the *successor* income statement refers to situations where the change-in-control event is not the sole event triggering the expense, such as double trigger awards as discussed in Example 11.12.

ACQUISITION-RELATED DEBT

27.035 Acquisition-related liabilities incurred by the acquirer are recognized by the acquiree in its separate financial statements if it is required to do so under U.S. GAAP. Acquisition-related liabilities include debt, which may be incurred by the acquirer to finance the acquisition of the acquiree or to finance the acquiree's operations. The SEC staff previously provided guidance about when the acquiring entity's debt, interest expense, and debt issuance costs should be pushed down to the acquiree in accordance with SAB Topic 5.J. However, that guidance was rescinded by SAB 115. Pushdown accounting, including pushdown of debt under SAB Topic 5.J, applied before the effective date of the new standard and SAB 115, is irrevocable.

Example 27.6: Joint and Several Obligation

ABC Corp. forms and contributes $100 to New Co. on April 1, 20X5. New Co. acquires a controlling financial interest in DEF Corp. on May 31, 20X5, for $200. New Co. borrows $100 from a bank to complete this acquisition. Because New Co. was formed to acquire DEF and has minimal operations, the bank requires that DEF be jointly and severally liable for repaying the loan.

Whether or not pushdown accounting is elected, generally DEF should record the debt and interest expense in its separate financial statements based on the guidance in ASC Subtopic 405-40 after considering whether each of the co-obligors are able to repay the debt. When DEF records the debt the offsetting entry is to additional paid-in capital.

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27.036 When the acquirer incurs acquisition-related debt that is not pushed down to the acquiree, the acquiree would record additional paid-in capital in its separate financial statements.

27.037 Debt and other liabilities may be required to be reflected in the acquiree's separate financial statements as a result of applying other U.S. GAAP even if the acquiree does not apply pushdown accounting. For example, to finance the acquisition, if the acquirer incurred debt with the acquiree being named as the legal obligor, that debt would need to be presented in the acquiree's financial statements even if the acquiree does not apply pushdown accounting. When debt is recognized in the acquiree's financial statements, we believe the debt issuance costs and related interest expense would also be recognized.

27.038 The SEC's criteria for when debt should be pushed down was rescinded by SAB 115 (see ASU 2015-08). If an acquired entity's assets or equity are pledged as collateral against the acquirer's debt, the acquiree is no longer required nor permitted to reflect that debt in its separate financial statements unless it is otherwise required to do so under U.S. GAAP. However, disclosures of such arrangements may be appropriate under other requirements.

ACQUISITION-RELATED GOODWILL

27.039 If pushdown accounting is applied, all goodwill related to the acquisition is pushed down to the acquiree and presented as goodwill in the acquiree's separate financial statements, even if some of the goodwill is allocated to the other reporting units in the acquirer's consolidated financial statements (see KPMG Handbook, Impairment of nonfinancial assets).

- If the acquiree is a public business entity, the goodwill is subject to an annual impairment test under ASC Subtopic 350-20 (see KPMG Handbook, Impairment of nonfinancial assets).
- Private company and not-for-profit acquirees may elect an alternative to amortize goodwill on a straight-line basis over 10 years or less if another useful life is more appropriate (see Paragraph 26.004). If the alternative is elected, the private company or not-for-profit entity also makes an accounting policy election to test goodwill at either the entity level or the reporting unit level and test for impairment only when a triggering event occurs.

27.040 While an impairment loss recognized in a subsidiary's separate financial statements may not necessarily be recognized in the parent's consolidated financial statements, it may represent a triggering event for the parent company.

27.041 The guidance in ASC Topic 350 requires that the parent assign all goodwill acquired in a business combination to one or more reporting units on the date of acquisition. Acquisition-related goodwill should be assigned to the reporting units of the acquirer that are expected to benefit from the synergies of the combination.

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27.042 The ways in which goodwill is allocated to the acquired entity and the parent's other reporting units may create differences between the amount of goodwill pushed down to the acquiree's separate financial statements (i.e., all of the goodwill from the transaction) and the goodwill allocated to the acquiree at the parent level. Effectively, some of the acquiree's goodwill might be allocated to other reporting units in the acquirer's consolidated financial statements.

Example 27.7: Goodwill Allocation

ABC Corp. acquires an 80% controlling financial interest in DEF Corp. on January 1, 20X4, for $200 and DEF elects to apply pushdown accounting. ABC recognizes goodwill of $40 as a result of applying ASC Topic 805. Under ASC Topic 350, ABC allocates goodwill to its reporting units (RU) as follows:

RU 1 - $5 (expects to benefit from the synergies of the combination);

RU 2 - $10 (expects to benefit from the synergies of the combination); and

RU 3 - $25 (includes all operations of DEF).

Notwithstanding this allocation by ABC to its reporting units, DEF will recognize goodwill of $40 in its separate financial statements.

When DEF performs its goodwill impairment test, it must follow ASC Topic 350 guidance to assign goodwill to its reporting units and test the $40 for impairment. An impairment loss from DEF as a result of impairment testing for its reporting units may not necessarily be recognized in the consolidated financial statements of ABC unless impairment testing performed at each of ABC's reporting units results in a similar impairment loss.

27.042a ASC paragraph 805-50-25-8 allows any subsidiary of an acquiree to elect pushdown accounting in its separate financial statements, even if its parent (the acquiree) does not apply pushdown accounting. When the acquiree has multiple subsidiaries, the entire amount of acquisition-related goodwill may not be attributable to the subsidiary applying pushdown accounting. In that case, the subsidiary will need to allocate a portion of the acquisition-related goodwill to its separate financial statements. We believe that the methodology for allocating acquisition-related goodwill to a subsidiary of an acquiree should be reasonable and supportable, which is consistent with the methodology for allocating goodwill to reporting units for impairment testing. For example, refer to the 'acquisition method' or the 'with-and-without method' described in Question 5.4.100 of KPMG Handbook, Impairment of nonfinancial assets.

27.043 If a private company or not-for-profit entity that has been acquired by a public business entity elects the alternative accounting available for goodwill, the acquiree's subsequent accounting for goodwill will be different from the acquirer. Because the alternative may only be elected by a private company or not-for-profit entity, the effect of this election would need to be reversed in the parent's consolidated financial statements.

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ACQUIREE WITH FOREIGN ENTITIES

27.044 We believe an acquiree with foreign entities applying pushdown accounting in its separate financial statements must follow the same guidance on foreign currency translation of goodwill and other acquisition accounting adjustments that applies to the acquirer. See Question 5.4.120 in KPMG Handbook, Impairment of nonfinancial assets, for further discussion.

ACQUISITION COSTS

27.045 The acquirer may incur acquisition costs in a business combination. These costs include:

- Finder's fees;
- Advisory, legal, accounting, valuation, and other professional or consulting fees;
- General administrative costs, including the cost of maintaining an internal acquisition department; and
- Registering and issuing debt and equity securities.

27.046 Acquisition-related costs incurred by the acquirer should be recorded as expenses by the acquirer in the periods in which the costs are incurred and the services are received, with the exception of the costs to issue debt or equity securities that are recognized under other guidance. Because acquisition costs are expensed by the acquirer when incurred and are not part of the new basis of the acquiree, they are not to be pushed down to the acquiree.

27.047 An acquirer may incur acquisition costs in a business combination and require the acquiree to reimburse them. Because the acquirer's acquisition costs are not an expense of the acquiree, the acquiree should record the reimbursement as a distribution to the acquirer (i.e., not as an expense).

CONTINGENT CONSIDERATION

27.048 Consideration transferred in a business combination may include contingent consideration. Contingent consideration could arise from an obligation by the acquirer to transfer additional cash, other assets or equity interests to the former owners of an acquiree as part of the exchange for control if specified future events occur or conditions are met. It may also include an acquirer's right to the return of previously transferred consideration if specified conditions are met. Under ASC Topic 805, the acquirer recognizes the acquisition-date fair value of the contingent consideration issued by the acquirer.

27.049 ASC Subtopic 805-50 does not provide guidance about whether the contingent consideration should be pushed down to the acquiree. We believe that a contingent consideration asset or liability should be pushed down to the acquiree only if the acquiree is legally obligated to pay or has the right to receive the contingent consideration. The

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contingent consideration would not be pushed down to the acquiree if it represents a legal right or obligation of the acquirer, not the acquiree. If that occurs and pushdown accounting is applied, the offset for the obligation that is not pushed down will be an increase to additional paid-in capital. If the contingent consideration is not a legal obligation of the acquiree, the acquiree would not report the fair value changes of the obligation in its separate financial statements.

27.050 The treatment of contingent consideration being pushed down to an acquired entity would be similar to the treatment of an acquirer's acquisition-related debt that is pushed down to an acquired entity's separate financial statements.

ELECTING FAIR VALUE OPTION

27.051 ASC Section 825-10-25 specifies that entities may elect to measure financial assets and liabilities at fair value, referred to as the fair value option (FVO) for financial instruments, and also specifies when the FVO may be elected.

> **ASC Paragraph 825-10-25-4**
>
> An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:
>
> a. The entity first recognizes the eligible item.
>
> b. The entity enters into an eligible firm commitment.
>
> c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting (for example, a transfer of assets from a subsidiary subject to [ASC] Subtopic 946-10 to another entity within the consolidated reporting entity not subject to that Subtopic).
>
> d. The accounting treatment for an investment in another entity changes because the investment becomes subject to the equity method of accounting.
>
> 1. Subparagraph superseded by Accounting Standards Update No. 2016-01.
>
> 2. Subparagraph superseded by Accounting Standards Update No. 2016-01.
>
> e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or accounting for securities in accordance with either Topic 321 on investments-equity securities or Topic 326 on measurement of credit losses.

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ASC Paragraph 825-10-25-5

Some of the events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option as discussed in [ASC] paragraph 825-10-25-4(e) are:

a. Business combinations, as defined in [ASC] Subtopic 805-10

b. Consolidation or deconsolidation of a subsidiary or VIE

c. Significant modifications of debt, as defined in [ASC] Subtopic 470-50.

27.052 An entity's election to apply pushdown accounting on a change-in-control event results in the entity's applying new basis in its accounting, using the principles in ASC Topic 805. As a consequence, an entity that elects pushdown accounting also may, at that same date, elect the FVO for any of its eligible financial instruments as prescribed in the Fair Value Option portion of ASC Section 825-10-25.

APPLICATION OF PUSHDOWN ACCOUNTING AT A LATER DATE

27.053 If the acquiree does not elect to apply pushdown accounting on a change-in-control event, it can elect to apply pushdown accounting in a subsequent reporting period subject to the requirements for a change in accounting principle. In accordance with ASC paragraph 250-10-45-2, an entity may change an accounting principle only if it justifies that the alternative accounting principle is preferable. The change in accounting principle would be applied retrospectively to the date pushdown accounting could have been elected (i.e., the change-in-control event date).

27.054 Although a change to elect pushdown accounting at a later date is subject to the change-in-accounting principles requirements, including a conclusion that the new accounting principle (to apply pushdown accounting) is preferable, an initial decision to apply pushdown accounting in the period of the change-in-control event is not subject to a preferability analysis. Once an entity elects to apply pushdown accounting to a specific change-in-control-event, that decision is irrevocable.

27.055 If pushdown accounting is applied at a later date, the acquiree would retrospectively adjust its financial statements to reflect the acquirer’s basis at the date control was obtained and roll forward for subsequent activity between the date control was obtained and the date pushdown accounting was elected. Retained earnings would be reset to zero at the acquisition date and reflect subsequent earnings or losses based on the new basis established in the pushdown from the acquisition date forward to when the election to apply pushdown accounting was made.

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Example 27.8: Change in Accounting Principle

ABC Corp. acquires a 90% controlling financial interest in DEF Corp. (subsidiary) on March 31, 20X5, and DEF does not elect to apply pushdown accounting in its separate financial statements. On December 31, 20X6, DEF elects to apply pushdown accounting. This election would be treated as a change in accounting principle (assuming pushdown accounting is deemed to be preferable). Under ASC Topic 250, DEF would apply the change retrospectively and revise its prior financial statements to reflect the application of pushdown accounting at the date it could have elected to apply it (March 31, 20X5, the date of the change-in-control event). The net assets to be pushed down are the parent's basis at March 31, 20X5, rolled forward for subsequent activity from March 31, 20X5, through December 31, 20X6.

Example 27.9: Rolling Forward Subsequent Activity

GHI Corp. acquires all the outstanding common stock of JKL Corp. for $1,000 on January 1, 20X5. GHI accounts for the acquisition as a business combination under ASC Topic 805. As of the date of the acquisition, the book value and fair value of JKL's identifiable net assets are $650 and $800, respectively. GHI records goodwill of $200 ($1,000 purchase price - $800 fair value of identifiable net assets).

JKL does not elect to apply pushdown accounting in its separate financial statements on the change-in-control event but elects to apply (and justifies as preferable) pushdown accounting on January 1, 20X6. Upon the election to apply pushdown accounting, the amount of net assets (including goodwill) to be pushed down ($800 + 200) is rolled forward for subsequent activity from January 1, 20X5 through January 1, 20X6.

Assume from January 1, 20X5 through January 1, 20X6, JKL has depreciation on an existing building of $40, acquires additional inventory of $200, collects $50 of receivables, and incurs debt of $80. The $40 of depreciation includes the additional depreciation based on the fair value of the assets at the acquisition date. Goodwill is tested annually for impairment rather than amortized; no impairment loss was recognized during the period. Upon the election to apply pushdown, JKL would record the following net assets. The corresponding adjustment would be reflected in JKL's equity.

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	Net assets to be pushed down at acquisition date (January 1, 20X5)	Subsequent Activity	Election to apply pushdown accounting (January 1, 20X6)
Property, plant, and equipment	400	(40)	360
Inventory	300	200	500
Receivables	300	(50)	250
Goodwill	200	0	200
Liabilities	(200)	(80)	(280)
Total net assets	$ 1,000	30	1,030

27.056 A U.S. registrant that adopts a change in accounting principle is required to file with the SEC a letter from its independent accountant indicating its view that the alternative principle is preferable. Those letters, called preferability letters, should describe why the accounting principle adopted is preferable to the prior accounting principle applied.

27.057 For U.S. SEC registrants, preferability letters must be included as Exhibit 18 in the first applicable filing under the Securities Exchange Act of 1934 (i.e., Form 10-Q or Form 10-K) following the accounting change. The letter need only be filed once. A preferability letter is required in Form 10-K only when the change in accounting principle occurred in the fourth quarter.

FORGOING THE ELECTION TO APPLY PUSHDOWN ACCOUNTING

27.058 An entity that has been acquired by a new controlling parent may decide not to apply pushdown accounting. This decision could be made for a number of reasons. If pushdown accounting is not applied by an entity acquired by a new controlling parent, practical difficulties could arise in subsequent periods due to the burden of managing and maintaining two sets of accounting records for the acquired entity. These difficulties could occur, for example, from having to perform two separate impairment analyses, maintaining two sets of records to track depreciation and amortization balances along with the corresponding tax balances, and recording different gains and losses when individual assets are sold. These difficulties could be further compounded if multiple reporting entities are acquired and they make different elections with respect to pushdown accounting. Entities should consider these practical difficulties during their decision-making process.

27.059 The EITF and FASB decided that when an entity elects pushdown accounting, certain disclosures will be required to enable financial statement users to evaluate the nature and effect of pushdown accounting. Furthermore, the EITF and FASB decided that

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an entity is not required to assess whether a change-in-control event has occurred at each reporting date.

MANAGEMENT RESPONSIBILITIES FOR ICOFR

ACQUIRER'S CONSOLIDATED FINANCIAL STATEMENTS

27.060 When the acquirer is an SEC registrant subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, it will need to design, implement, and assess the operating effectiveness of internal controls over financial reporting (ICOFR) related to the financial reporting implications the newly acquired entity may have on its consolidated financial statements. While the SEC permits the acquirer to exclude the internal controls that operate at the acquired business from management's report on ICOFR in the year of acquisition, the acquirer's management is still required to assess its own internal controls over the recognition, measurement, and disclosure implications of the acquisition. In the subsequent year, the acquirer's management will need to assess the design and operating effectiveness of the internal controls over the acquiree.

ACQUIREE SEPARATE FINANCIAL STATEMENTS

27.061 If the acquiree is required to assess the effectiveness of ICOFR either because it or its parent company is subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, its management will also need to ensure it has controls around the financial statement recognition, measurement, and disclosure implications resulting from the application of pushdown accounting. Examples could include internal controls around the accurate initial and subsequent recording of pushdown accounting journal entries, ensuring those balances are accurately reflected in the acquired entity's financial statements, appropriately recognizing acquisition-related liabilities, and having appropriate internal controls around new disclosure requirements.

CHANGE IN TAX BASIS

27.062 Deferred income taxes generally should be recognized for temporary differences related to the assets and liabilities included in both the consolidated and separate financial statements. The amounts of those temporary differences for the acquired entity's assets and liabilities may not be the same in the consolidated and separate financial statements because business combination accounting adjustments reflected in the consolidated financial statements may not have been pushed down to the acquired entity's separate financial statements.

27.063 When an acquisition is treated as a taxable transaction (resulting in a step-up in the basis of the assets and liabilities for tax purposes) and the acquired entity does not apply pushdown accounting in its separate financial statements, the step-up in basis of the financial statement carrying amount is not reflected in the acquired entity's financial statements. In this instance, the change in the temporary difference due to the change in tax basis is recognized as an adjustment to equity. Further, a valuation allowance

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recorded as of the acquisition date for the newly created deferred tax assets should also be recognized with an adjustment to equity. However, any subsequent change to the valuation allowance or change in the valuation allowance for existing deferred tax assets (including the write-off of existing deferred tax assets that the acquired entity can no longer realize as a result of the business combination) should be recognized as a component of income from continuing operations.

27.064 – 27.068 Paragraphs not used.

CALL REPORT CONSIDERATIONS

27.069 The Federal Financial Institution Examination Council (federal banking agencies) issued *Supplemental Instructions* for December 2014 Call Reports that address pushdown accounting. The federal banking agencies adopted Subtopic 805-50 for Call Report purposes. However, an entity's primary federal regulator may require or prohibit the use of pushdown accounting for Call Report purposes based on the regulator's evaluation of whether the election appears not to be supported by the facts and circumstances of the business combination.

Endnotes

[1] ASU 2025-03, *Determining the Acquirer in the Acquisition of a Variable Interest Entity*, amends the framework for identifying the accounting acquirer when the legal acquiree is a VIE. Under the amended framework, entities consider the general accounting acquirer factors in ASC 805 when the transaction is primarily effected by the exchange of equity interests. The ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2026. Early adoption is permitted.
[2] FASB Concepts Statement No. 8 amended FASB Concepts Statement No. 6. The revised definition of a liability is a present obligation of an entity to transfer an economic benefit.
[3] Carlton Tartar speech at the 2014 AICPA Conference on Current SEC and PCAOB developments, available at www.sec.gov.

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Section 28 - Combinations of Entities Under Common Control

Detailed Contents

Common Control

- Definition of *Common Control*
  - Example 28.1: Entities Controlled by Group of Shareholders
- Downstream Merger
- Combinations Between Entities or Businesses with a High Degree of Common Ownership
  - Example 28.2: Transfer or Exchange Between Entities with a High Degree of Common Ownership
- Financial Assets
- Inventory

Accounting and Reporting by the Receiving Entity

- Example 28.2b: Accounting by the Receiving Entity in a Combination of Entities under Common Control
- Example 28.2bb: Accounting for Distribution of Cash or Assumption of Liabilities
- Example 28.2c: Adjustment to Consideration Payable after Common Control Ends (Asset Acquisition)
- Change in Reporting Entity
  - Example 28.3: Change in Reporting Entity in a Common Control Step Acquisition
- Presentation of Prior Period Financial Statements
  - Example 28.4: Prior Period Financial Statements of Receiving Entity
- Conforming Accounting Methods
- Presentation of Historical Earnings per Share
- Accounting for A Change in Noncontrolling Interests from a Common Control Transaction
  - Example 28.4a: Acquisition of Noncontrolling Interest under Common Control
- Costs Related to Combinations of Entities Under Common Control
- Goodwill Impairment
  - Example 28.6: Two Methods of Goodwill Impairment

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Identifying the Predecessor Entity When Entities Are Not Under Common Control for All Comparative Periods

Example 28.7: Identifying the Predecessor Entity

Accounting and Reporting by the Transferring Entity

Financial Statement Presentation of Contributed Net Assets or Equity Interests

Recognition of Differences Between Amounts Contributed and Proceeds Received

Impairment Considerations

Example 28.8: Trigger for Impairment Evaluation

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28.000 ASC Topic 805 specifically excludes combinations between entities or businesses under common control from the scope of the business combinations guidance. Common control transactions do not meet the definition of a business combination because there has not been an *acquisition* by parties outside the continuing control group (i.e., no change-in-control event). Combinations between entities under common control involve exchanges or movements of net assets or equity interests between entities controlled (directly or indirectly) by the same parent, investor, or ownership group that has agreed to vote in concert.

28.001 ASC Subtopic 805-50 provides guidance about accounting for transactions between entities under common control, and may apply regardless of whether the net assets transferred meet the definition of a business (e.g., the transfer of an intangible asset between entities under common control). Even though the disclosure requirements apply specifically to the receiving entity, we believe the transferring entity should consider making similar disclosures.

Overview

ASC Paragraph 805-50-05-4

As noted in [ASC] paragraph 805-10-15-4(c), the guidance related to business combinations does not apply to combinations between entities or businesses under common control.

ASC Paragraph 805-50-05-5

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-of-interests method. The Transactions between Entities under Common Control Subsections provide guidance on preparing financial statements and related disclosures for the entity that receives the net assets.

Scope

ASC Paragraph 805-50-15-5

The guidance in the Transactions between Entities under Common Control Subsections applies to all entities.

ASC Paragraph 805-50-15-6

The guidance in the Transactions between Entities under Common Control Subsections applies to combinations between entities or businesses 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 transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

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c. A parent transfers its controlling 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 exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.

e. A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.

f. A limited liability company is formed by combining entities under common control.

g. Two or more not-for-profit entities (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

ASC Paragraph 805-50-15-6A

The guidance in the Transactions between Entities under Common Control Subsections does not apply to the initial measurement by a primary beneficiary of the assets, liabilities, and noncontrolling interests of a VIE if the primary beneficiary of a VIE and the VIE are under common control. Guidance for such a VIE is provided in [ASC] Section 810-10-30.

ASC Paragraph 805-50-15-6B

Mergers and acquisitions between or among two or more NFPs, all of which benefit a particular group of citizens, shall not be considered common control transactions solely because those entities benefit a particular group. The mission, operations, and historical sources of support of two or more NFPs may be closely linked to benefiting a particular group of citizens. However, that group neither owns nor controls the NFPs.

Recognition

ASC Paragraph 805-50-25-2

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 the date of transfer. See the Transactions between Entities under Common Control Subsection of [ASC] Section 805-50-45 for guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.

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Initial Measurement

ASC Paragraph 805-50-30-5

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 measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

ASC Paragraph 805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. [ASC] Section 250-10-45 provides guidance if retrospective application is impracticable.

Other Presentation Matters

ASC Paragraph 805-50-45-1

[ASC] Paragraph 805-50-25-2 establishes that the assets and liabilities transferred between entities under common control are to be initially recognized by the receiving entity at the transfer date. This Subsection provides guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.

ASC Paragraph 805-50-45-2

The financial statements of the receiving entity shall report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intra-entity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intra-entity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained

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earnings at the beginning of the periods presented shall be eliminated to the extent possible.

ASC Paragraph 805-50-45-3

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities need not be eliminated. However, [ASC] paragraph 805-50-50-2 requires disclosure.

ASC Paragraph 805-50-45-4

Similarly, the receiving entity shall present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

ASC Paragraph 805-50-45-5

Financial statements and financial information presented for prior years also shall be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries shall indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years shall only be adjusted for periods during which the entities were under common control.

Disclosure

ASC Paragraph 805-50-50-1

[ASC] Paragraphs 805-50-45-1 through 45-5 provide guidance on financial statement presentation in the period of transfer and for periods before the transfer of assets and liabilities between entities under common control. This Subsection addresses incremental disclosures related to such a transaction.

ASC Paragraph 805-50-50-2

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities is not required to be eliminated under the guidance in [ASC] paragraph 805-50-45-3 but shall be disclosed.

ASC Paragraph 805-50-50-3

The notes to financial statements of the receiving entity shall disclose the following for the period in which the transfer of assets and liabilities or exchange of equity interests occurred:

a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests.

b. The method of accounting for the transfer of net assets or exchange of equity interests.

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ASC Paragraph 805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with [ASC] Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

28.002-28.003 Paragraphs not used.

COMMON CONTROL

DEFINITION OF *COMMON CONTROL*

28.004 Only transactions in which all combining entities in the transaction are controlled by the common parent or a controlling ownership group that has agreed to vote in concert both before and after the combination qualify as combinations of entities under common control. As a general rule, ownership by one entity, directly or indirectly, of over 50% of the outstanding voting shares of another entity represents control. Control could also be achieved by means other than majority ownership of outstanding voting shares (e.g., contractual, agreement, or irrevocable assignment of ownership rights). Two or more entities may be deemed to be under common control when they are subject to control by the same parent, investor, or ownership group that has agreed to vote in concert. As used here, *control* has the same meaning as used in the FASB's guidance on consolidation (ASC 810-10). See Section 2 of this book for a discussion on the definition of control.

28.005 The term common control is not defined in ASC Topic 805. EITF Issue No. 02-5, "Definition of 'Common Control' in Relation to FASB Statement No. 141," discusses whether separate entities are under common control when there is common majority ownership by an individual, a family, or a group affiliated in some other manner. The EITF did not reach a consensus. However, during the discussion, the SEC Observer stated that the SEC staff believes common control exists in the following situations:

(a) An individual or enterprise holds more than 50% of the voting ownership interest of each entity.

(b) Immediate family members hold more than 50% of the voting ownership interest of each entity and there is no evidence that those family members will not vote their shares in concert. Immediate family members include a married couple and their children, but not the married couple's grandchildren. Situations in which entities are owned in varying combinations among living siblings and their children require careful consideration regarding the substance of the ownership and voting relationships in determining whether the related entities are under common control.

(c) A group of shareholders holds more than 50% of the voting ownership of each entity, and that group provides contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert.

28.006 While this SEC Observer comment was not carried forward into the Codification, our experience is that this observer comment generally holds in practice. Judgment is

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required to determine whether common control exists in situations other than those described above.

28.006a A private equity firm (PE firm) may decide to combine two of its portfolio companies (PortCos). The accounting for the combination (i.e., put-together transaction) will depend on whether the PortCos are considered to be under common control. When PortCos that are controlled by the same fund are combined, the combination is considered under common control. In some cases, a PE firm may sponsor and manage multiple funds but it does not have a controlling financial interest in the funds under ASC Topic 810 and no other single person or entity controls each of the funds. In that case, when PortCos controlled by different funds are combined, the transaction is not a common control transaction and is accounted for as a business combination even though the PE firm may manage and sponsor each fund. Careful analysis of the ownership structures of the funds is needed to determine if there is a single entity or individual (e.g., a founder) that may control each of the funds.

28.007 See KPMG Handbook, Consolidation, for discussion of means of control other than voting ownership interests, such as ownership of another variable interest, as consideration should be given to all of the facts and circumstances surrounding the relationships between the parties.

Example 28.1: Entities Controlled by Group of Shareholders

Five owners are subject to an owners' agreement that includes the necessary provisions to treat the five owners as a controlling ownership group. The five owners hold the following percentages of voting common stock in four combining enterprises.

Owner	Co W	Co X	Co Y	Co Z
A	0	5	65	0
B	15	0	15	60
C	15	35	0	15
D	15	30	10	10
E	0	10	10	0
Unaffiliated owners	55	20	0	15

Owners A, B, C, D, and E have agreed to a business combination in which those owners will exchange their interests in Co W, Co X, Co Y, and Co Z for interests in NEWCO. Co W, Co X, Co Y, and Co Z each constitute a business. The business combination should be treated as a combination of entities under common control.

NEWCO's consolidated financial statements for periods before the business combination would include the historical cost basis of Co X's, Co Y's, and Co Z's assets and liabilities for all prior periods in which the controlling ownership group held a controlling financial interest in the combining entities. The interests held by the unaffiliated owners in Co X and Co Z would be presented as noncontrolling interests

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in NEWCO's consolidated financial statements for all periods presented (see Chapter 7 of KPMG Handbook, Consolidation if the unaffiliated owners' interests in Co X and Co Z are acquired by NEWCO).

NEWCO's consolidated financial statements for all periods presented would reflect the historical cost basis of Co W on the equity method because the controlling ownership group did not hold a controlling financial interest in Co W during those periods.

DOWNSTREAM MERGER

28.008 A downstream merger is a type of common control transaction where a subsidiary (usually partially owned) exchanges its shares for the outstanding shares of its parent. After the transaction, the net assets are owned by the combined owners of the parent and the former owners of any noncontrolling interest in the subsidiary. Regardless of the form, a downstream merger is accounted for as if the parent acquired the subsidiary's shares.

28.008a The post-merger financial statements would be presented similar to a reverse acquisition with the former parent as the ongoing reporting entity and no change in basis of the consolidated group's net assets. The equity of the former parent is presented as the equity of the combined entity after giving effect to the acquisition of any noncontrolling interest. However, the former parent's capital share account would be adjusted to reflect the par value of the outstanding shares of the legal parent (i.e., former subsidiary). See the discussion of Reverse Acquisitions beginning at Paragraph 9.012.

COMBINATIONS BETWEEN ENTITIES OR BUSINESSES WITH A HIGH DEGREE OF COMMON OWNERSHIP

28.009 A transaction between entities with a high degree of common ownership, but that are not under common control, should be assessed to determine whether the transaction lacks substance. Paragraph 6 of FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations,* stated, "if the exchange lacks substance, it is not a purchase event and should be accounted for based on existing carrying amounts." Although FASB Technical Bulletin No. 85-5 was superseded by Statement 141(R), we believe this guidance remains relevant for transactions that lack economic substance.

28.010 The SEC staff has indicated that in a transfer or exchange between entities with a high degree of common ownership, they often compare the percentage owned by shareholders in the combined entity to the percentages owned in each of the combining entities before the transaction. When the percentages have changed (even by small amounts) or the owned interests are not in substance the same before and after the transaction, the SEC staff believes a substantive transaction has occurred and historical cost accounting is not appropriate.

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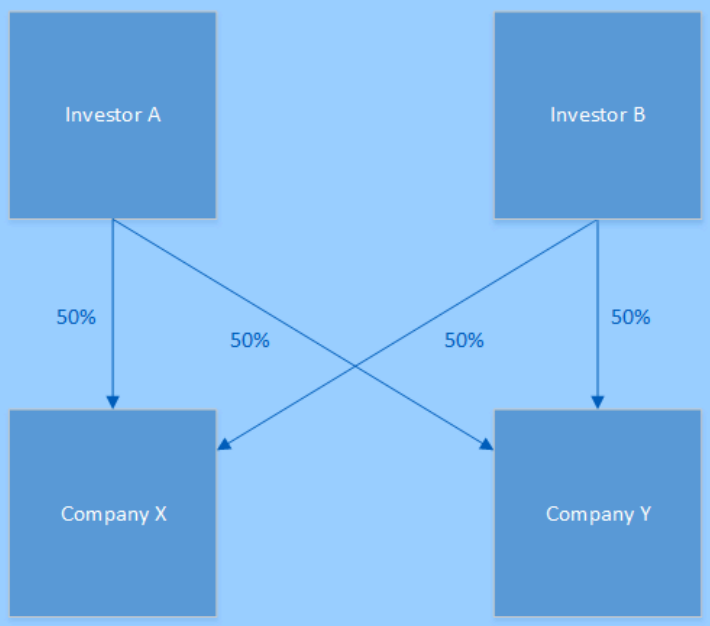
Example 28.2: Transfer or Exchange Between Entities with a High Degree of Common Ownership

Assume that Investor A and Investor B each own 50% of Company X and Company Y. Investor A and Investor B are unrelated and they have no agreement that would cause them collectively to be a controlling group over their investees. Company X acquires Company Y by exchanging new shares of Company X for all of the outstanding shares of Company Y previously held by Investor A and Investor B. After the transaction, each investor continues to own 50% of Company X and Company X owns 100% of Company Y.

Structure before the transaction

Ownership Interests	Company X	Company Y
Investor A	50%	50%
Investor B	50%	50%
	100%	100%



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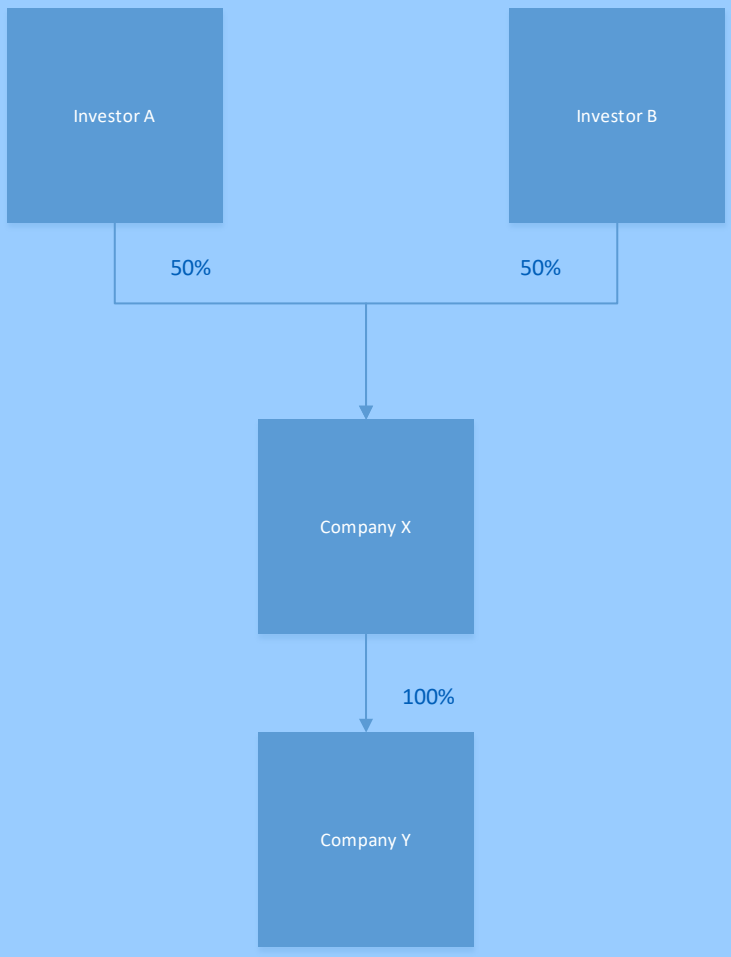
Structure after the transaction

Ownership Interests	**Company XY**
Investor A	50%
Investor B	50%
	100%



Should Company X account for the acquisition of Company Y as a business combination?

The percentage that each investor owns in the combined company is the same percentage they each owned before the transaction. Therefore, we believe the transfer of ownership is a *non-substantive exchange* and should be accounted for by Company X at carry over basis on an as-if pooling-of-interests basis. We note, however, that even small changes in the ownership percentages or other economic factors could result in the conclusion that a transaction has substance and should be accounted for as a business combination under ASC Topic 805.

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FINANCIAL ASSETS

28.011 Transfers of financial assets between subsidiaries of a common parent are accounted for under ASC paragraph 860-10-55-78. In addition, Question 3.2.30 in KPMG Handbook, Transfers and servicing of financial assets, discusses the accounting for transfers of financial assets from a parent to its consolidated subsidiary in that subsidiary's separate financial statements. For additional guidance on transfers of financial assets, see KPMG Handbook, Transfers and servicing of financial assets.

INVENTORY

28.012 When valuation is not in question and the transfer occurs in the ordinary course of business, it is generally acceptable for routine transfers of inventory between entities under common control to be accounted for as sales (including gain recognition by the transferor and a step-up in basis for the transferee).

28.013 Paragraph not used.

ACCOUNTING AND REPORTING BY THE RECEIVING ENTITY

28.014 Under ASC paragraph 805-50-30-5, assets and liabilities transferred or shares exchanged between entities under common control are accounted for at the historical cost of those entities' ultimate parent, in a manner similar to which a pooling-of-interests was accounted for under APB 16, *Business Combinations* (*as-if pooling-of-interests accounting).* If the carrying amount of the assets and liabilities transferred differs from the historical cost of the parent of the entities under common control, for example, because push-down accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

Example 28.2b: Accounting by the Receiving Entity in a Combination of Entities under Common Control

An investment fund (the Fund) has two portfolio companies (Company A and Company B) that the Fund is planning to combine as entities under common control by contributing the stock of Company A to Company B in preparation for an IPO. Company A was acquired by the Fund a number of years ago and pushdown accounting has never been applied to the separate financial statements of Company A. As an investment company, the Fund never completed acquisition accounting in its financial statements because the investment in Company A was accounted for at fair value after acquisition.

The consolidated financial statements of Company B will reflect the Fund's basis in Company A because ASC paragraph 805-50-30-5 requires that the financial statements of the receiving entity reflect the transferred assets and liabilities at the historical cost of the parent as though acquisition accounting had been applied from

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the date the Fund acquired Company A, with amounts adjusted for subsequent depreciation, amortization, accretion, impairment, etc. (essentially forcing pushdown accounting to be applied).

28.015 Any difference in the amount paid (or payable) by the transferee versus the historical cost of the assets (i.e., parent basis) transferred to the transferee is recorded as an adjustment to equity by the transferee/subsidiary and investment by the parent (i.e., as a capital contribution or distribution). A subsequent adjustment to the amount paid (or payable) to the transferor is also recorded in equity. We believe the subsequent adjustment should be recorded in equity even if common control no longer exists at the time of the subsequent adjustment to the amount paid (or payable), unless the reporting entity has adopted a new basis of accounting (e.g., as a result of applying pushdown accounting following a subsequent acquisition).

Example 28.2bb: Accounting for Distribution of Cash or Assumption of Liabilities

Parent Company owns 100% of the voting stock of Subsidiary A and 60% of the voting stock of Subsidiary X. Parent Company transfers its 60% interest in Subsidiary X to Subsidiary A for cash of $220. Parent Company's carrying amount of its investment in Subsidiary X is $200.

On receipt of Subsidiary X, Subsidiary A should record (1) its investment in Subsidiary X at $200 (Parent Company's carrying amount) and (2) a dividend to Parent Company of $20. Parent Company should record a net decrease in its investment in Subsidiary X of $200, an increase in its investment in Subsidiary A of $200, and a dividend from Subsidiary A of $20 for the difference between the cash received of $220 and the carrying amount of its investment in Subsidiary X of $200.

Example 28.2c: Adjustment to Consideration Payable after Common Control Ends (Asset Acquisition)

On June 30, 20X8, Subsidiary acquires from Parent a newly constructed power plant that is pending regulatory inspection in a common control transaction. Subsidiary records the asset at Parent's carrying amount ($30). Total consideration is $50, consisting of $45 of cash at the acquisition date and a $5 payment contingent on regulatory certification of the plant (expected to occur in October 20X8). The contingent payment is akin to a holdback and is considered highly certain to occur, and Subsidiary recognizes a liability of $5 at the date of transfer. As described in Paragraph 28.015, the difference between Parent's carrying amount of the asset and the amount paid (or payable) is recorded as an adjustment ($20 reduction) to equity.

On August 30, 20X8, Parent sells the stock of Subsidiary to an unrelated acquirer and common control ends. Subsidiary elects not to apply pushdown accounting in its

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stand-alone financial statements. At that time, the $5 consideration is still payable as certification has not yet occurred. In October 20X8, the regulator identifies deficiencies in the plant that Subsidiary must remediate before certification. As a result, Subsidiary negotiates with (its former) Parent to settle the outstanding payment at $3.

We believe Subsidiary should record the $2 adjustment to the liability in equity in its stand-alone financial statements, consistent with how it would have recorded the adjustment if common control still existed. That is, the net result is the same as if the consideration had been fixed at $48 at the time of the common control transaction.

If Subsidiary had elected to apply pushdown accounting, that would have created a new basis of accounting for both the asset and the liability, and Subsidiary would record the adjustment to the liability in its income statement.

If Parent and Subsidiary had not been under common control at the time of the transfer, the guidance on asset acquisitions would have applied. Subsidiary would have recorded the asset initially at its cost ($50, plus any acquisition-related costs), and the $2 adjustment would have reduced the carrying amount of the asset (see KPMG Handbook, Asset acquisitions, Section 3.5 and Section 4.8).

CHANGE IN REPORTING ENTITY

28.016 ASC paragraph 805-50-05-5 states that *some transfers* of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. ASC Topic 250, *Accounting Changes and Error Corrections,* defines a change in the reporting entity as financial statements that, in effect, are those of a different reporting entity and that the changes generally are limited to (1) presenting consolidated or combined financial statements in place of financial statements of individual entities, (2) changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and (3) changing the entities included in combined financial statements. If the equity interests or net assets transferred between entities under common control meet the definition of a business, we believe the transaction will generally result in a change in reporting entity that is accounted for by recognizing the net assets received at the carrying amount (or ultimate parent's historical cost if pushdown accounting was not applied) and retrospectively revising all comparative periods presented. This accounting is sometimes referred to as the *as-if pooling-of-interests* method.

28.016a If the equity interests or net assets transferred between entities under common control do not constitute the transfer of a business, including when a nonsubstantive holding company is added to an existing entity or consolidated group, we believe that a change in reporting entity generally has not occurred. Transfers of assets between entities under common control that do not result in a change in reporting entity are generally accounted for prospectively (i.e., comparative periods are not recast).

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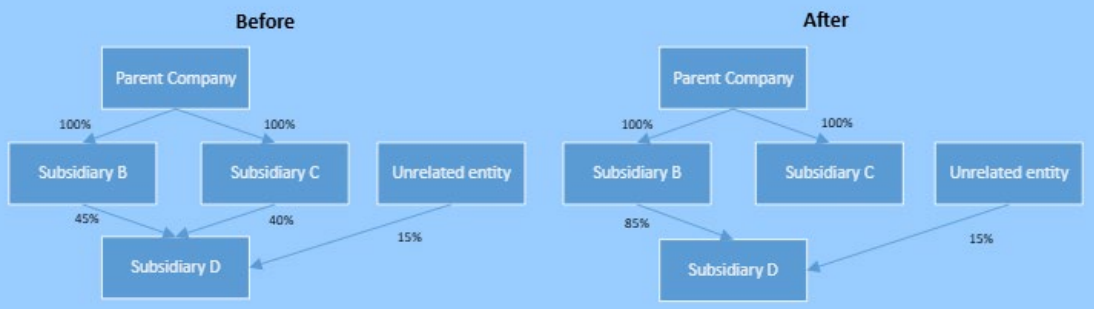
Example 28.3: Change in Reporting Entity in a Common Control Step Acquisition

Parent Company owns 100% of the voting stock of Subsidiary B and 100% of the voting stock of Subsidiary C. Subsidiary B and Subsidiary C own 45% and 40% of the voting stock of Subsidiary D, respectively. An unrelated entity owns the remaining 15% of Subsidiary D's voting stock. Subsidiary D meets the definition of a business.



Subsidiary C transfers its 40% ownership of Subsidiary D to Subsidiary B.

The Parent Company's noncontrolling interest in Subsidiary D is $150. Its carrying value of controlling financial interest in Subsidiary D is $850 (representing 85% of Subsidiary D's equity).

The transfer of Subsidiary C's equity interest in Subsidiary D to Subsidiary B is a common control transaction. This transaction does not affect the consolidated financial statements of Parent Company because its total ownership interest in Subsidiary D has not changed.

If Subsidiary B prepares stand-alone consolidated financial statements, the transfer of Subsidiary C's 40% interest in Subsidiary D is recorded by Subsidiary B at the parent's carrying amount of $400 ($850 × (40% / 85%) and would result in a change in reporting entity for Subsidiary B.

PRESENTATION OF PRIOR PERIOD FINANCIAL STATEMENTS

28.017 In as-if pooling-of-interests accounting, financial statements of the previously separate companies for periods before the combination are recast on a combined basis for all prior periods that the entities are under common control, assuming a change in reporting entity has occurred. ASC paragraph 805-50-45-5 specifies that the financial statements of previously separate entities are not combined for periods before the date that common control was established. When applying the guidance for a change in reporting entity, the financial statements should be presented for all periods as if the combination occurred at the inception of common control or as of the earliest period

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presented if the entities are under common control for all periods presented, unless it is impracticable to do so (see ASC paragraph 250-10-45-9).

Example 28.4: Prior Period Financial Statements of Receiving Entity

Company A has a controlling financial interest in Company B. On January 1, 20X2, Company A acquires a controlling financial interest in Company C. Company A merges Company C into Company B on January 1, 20X3 with Company B being the surviving subsidiary.

Company B's financial statements for periods before January 1, 20X2 (the date common control was established) are not recast. Rather, Company B's financial statements for periods before January 1, 20X2 continue to reflect only Company B's financial position and results of operations. The historical financial statements of Company C are combined with those of Company B as of January 1, 20X2.

CONFORMING ACCOUNTING METHODS

28.018 When applying the as-if pooling-of-interests method of accounting for combinations of entities under common control, the accounting principles used by the transferring entity may differ from those used by the receiving entity. In this circumstance, the carrying amounts of the transferred entity may be adjusted to the basis of accounting used by the receiving entity if the change is preferable under ASC Topic 250. Under ASC paragraph 805-50-30-6, a change in accounting to conform to the receiving entity's accounting policies that is determined to be preferable is applied retrospectively.

PRESENTATION OF HISTORICAL EARNINGS PER SHARE

28.019 In an as-if pooling for transactions among entities under common control, the entities' balance sheets, results of operations, and cash flows are added together and reported as if the entities had always been combined (starting with the earliest period that the entities are under common control). We believe that an entity generally should apply this same concept to EPS computations. An entity should retrospectively adjust prior period EPS to reflect the restated income or loss it would have reported in prior periods if the entities under common control had always been combined, similar to a stock split if shares are issued to stockholders of the contributing entity.

28.020 Generally, the numerator should equal the sum of the numerators of the combined entities and the denominator should reflect aggregate adjusted weighted average outstanding shares, based on equivalent shares of the combined entity. However, if either of the combined entities have potential common stock, the guidance in ASC paragraph 260-10-55-16 applies and the surviving entity should determine if the retroactive restatement of income from continuing operations causes potential common stock originally considered to be dilutive to become antidilutive (or vice versa).

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ACCOUNTING FOR A CHANGE IN NONCONTROLLING INTERESTS FROM A COMMON CONTROL TRANSACTION

28.020a Under ASC paragraphs 810-10-45-21A through 45-24, the accounting and reporting requirements for changes in noncontrolling interests in a subsidiary require that an increase in a parent's (including a common control group) ownership interest in a subsidiary is accounted for as an equity transaction. Additionally, a decrease in ownership of a subsidiary while maintaining control also is accounted for as an equity transaction unless a scope exception is provided.[1] Therefore, for these transactions, no gain or loss is recognized in income in the parent's financial statements. This also means that there is no change in the carrying amount of the subsidiary's assets or liabilities. This accounting treatment is consistent with the view that noncontrolling interest holders are a part of the ownership interest in the consolidated entity. Therefore, transactions involving the interests held by those noncontrolling owners should be reflected as equity transactions in the consolidated financial statements.

28.020b If the parent retains a controlling financial interest in a subsidiary, the transaction will be recorded as an equity transaction. Accordingly, the carrying amount of the noncontrolling interest is adjusted to reflect the change in ownership in a subsidiary as a result of the transaction.

Example 28.4a: Acquisition of Noncontrolling Interest under Common Control

Parent owns a controlling 100% interest in Subsidiary X and a controlling 75% interest in Subsidiary Y. ABC an unrelated third party owns the other 25% of Subsidiary Y. Both X and Y meet the definition of a business. The fair values and carrying amounts are as follows.

	Fair value	Carrying amount of net assets	Carrying amount of NCI
Subsidiary X	$ 125	$ 80	$ 0
Subsidiary Y	500	200	50
Total	$ 625	$ 280	$ 0

Parent and ABC enter into a reorganization executed in the following steps.

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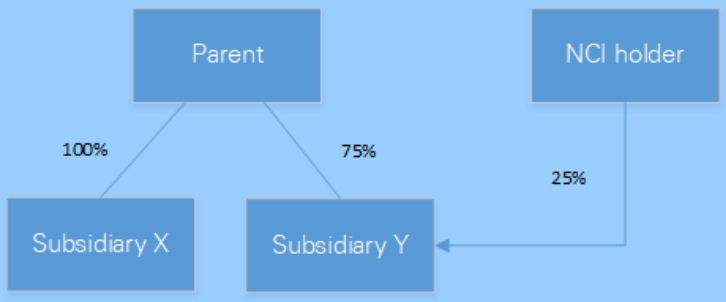
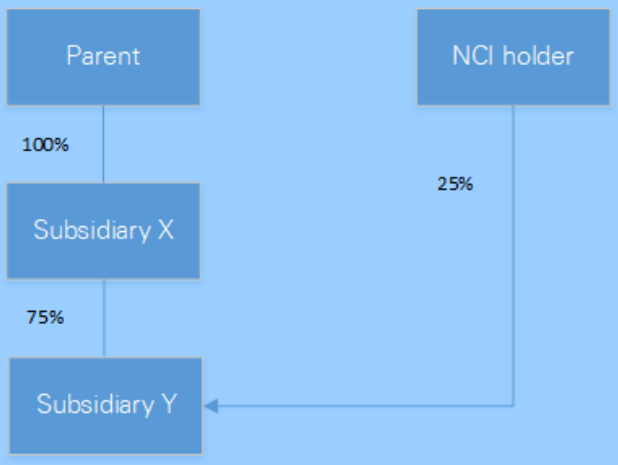
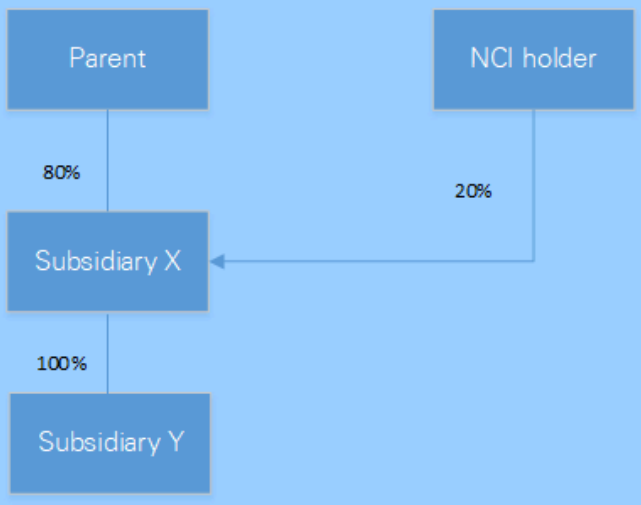
Before the transaction:



Step 1: Parent transfers its controlling interest in Subsidiary Y to Subsidiary X. The transfer of Subsidiary Y to X is a common control transaction.



Step 2: In conjunction with the transaction, the NCI holder of Subsidiary Y exchanges its 25% interest in Subsidiary Y for a 20% NCI in Subsidiary X.



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Parent's financial statements

Parent accounts for each step of the transaction as follows:

Step 1: The common control transaction does not affect the carrying amount of assets and liabilities in Parent's consolidated financial statements.

Step 2: The issuance of the 20% NCI in Subsidiary X in exchange for the outstanding 25% NCI in Subsidiary Y is accounted for as an equity transaction. Parent records the following journal entry:

NCI – Subsidiary Y	50	
Equity/APIC	6	
NCI – Subsidiary X		56 (20% of 280)

Subsidiary X financial statements

Subsidiary X accounts for each step in its separate financial statements as follows:

Step 1: Subsidiary X recasts its historical financial statements to include Subsidiary Y because Y is a business and a change in reporting entity occurred. In the recast financial statements, a 25% NCI in Subsidiary Y is reflected in the periods prior to the transaction and 25% of the income or loss of Y is attributed to the NCI holder.

Step 2: At the date of the transfer and exchange of the interest in Subsidiary Y for the 20% interest in Subsidiary X, Subsidiary X eliminates the NCI in its financial statements with an offsetting entry to APIC and no further income or loss is attributed to an NCI holder.

28.020c If a parent ceases to have a controlling financial interest in a subsidiary, then the parent is required to deconsolidate the subsidiary as of the date it loses control over that subsidiary. For more information on accounting for noncontrolling interests in consolidated financial statements, see Section 7 of this book. However, if a parent deconsolidates a subsidiary through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in ASC Topic 845 applies.

28.021 Paragraph not used.

Example 28.5 Example not used.

COSTS RELATED TO COMBINATIONS OF ENTITIES UNDER COMMON CONTROL

28.022 Although ASC Subtopic 805-50 is silent regarding the accounting for costs related to combinations of entities under common control, we believe these costs should be expensed in the period incurred, unless they relate to the issuance of debt or equity instruments, in which case they should be accounted for under other applicable guidance. This is consistent with the principle in a common control transaction that the net assets received by the entity should be recorded at historical costs (i.e., transferring entity basis).

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28.023 A combining entity that will be merged with entities under common control may have developed or may intend to develop a plan to integrate the businesses of the combining entities. That plan may include, among other things, terminating employees, disposing duplicative facilities, consolidating or relocating equipment and facilities, integrating information systems, or canceling lease contracts and executory contracts. A combining entity will recognize as liabilities only those costs that qualify for recognition if the requirements in ASC Topic 420 are met. For more information on the guidance in ASC Topic 420, see Section 7.

GOODWILL IMPAIRMENT

28.024 Goodwill presented in the financial statements of entities combined under common control should continue to be tested for impairment under ASC Topic 350. The authoritative literature does not provide explicit guidance to determine the reporting units or the process to test goodwill for impairment with respect to the comparative periods presented in the receiving entity's financial statements. In our experience, two methods have developed in practice.

28.025 The first method continues to use the historical reporting units for the combined entity, as if the combination under common control had not occurred until the date of the actual combination (Method A). This method alleviates the need for management to make hypothetical judgments about the operations and management of the combined entity for periods preceding the combination. However, this method requires management to evaluate the reporting structure of the combined entity after the combination. The guidance in ASC paragraph 350-20-35-45 should be followed to allocate goodwill to newly identified reporting units on reorganization of the reporting structure:

> **ASC Paragraph 350-20-35-45**
>
> When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in [ASC] paragraphs 350-20-35-39 through 35-40 shall be used to reassign assets and liabilities to the reporting units affected. However, goodwill shall be reassigned to the reporting units affected using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of (see [ASC] paragraphs 350-20-40-1 through 40-7).

28.026 Under the second method, reporting units are identified as if the combination occurred at the beginning of the earliest period presented (Method B). This method requires management to make assumptions about how the operations of the combined entity would have been managed in prior periods as if the entities had been combined in those periods. This is the case even if doing so is not consistent with how the separate operations were managed during those periods. A benefit of this approach is that it does not require a reorganization of the reporting structure at the date of the actual combination.

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Example 28.6: Two Methods of Goodwill Impairment

Method A

Company X was merged into Company Y in a combination of entities under common control on January 1, 20X4. Before the combination, Company X had one reporting unit (RU1X) and Company Y had two reporting units (RU1Y and RU2Y). After the combination, reporting unit RU1X was integrated with reporting units RU1Y and RU2Y. Company Y (the entity receiving the net assets of Company X) used Method A to determine its reporting units to test goodwill for impairment after the transaction.

For Company Y's financial statements for the year ended December 31, 20X4 and its comparative year ended December 31, 20X3, Company Y identified reporting units RU1X, RU1Y, and RU2Y to test goodwill impairment for the year ended December 31, 20X3 (period prior to combination). Because goodwill was tested for impairment (without impairment) at these three reporting units for the year ended December 31, 20X3, no impairment would be recognized for 20X3 in the recast 20X3 financial statements of Company Y. For the year ended December 31, 20X4, goodwill in reporting unit RU1X was assigned to reporting units RU1Y and RU2Y based on the relative fair values of the two portions of reporting unit RU1X prior to those portions being integrated with reporting units RU1Y and RU2Y, respectively.

Method B

Company X was merged into Company Y in a combination of entities under common control on January 1, 20X4. Before the combination, Company X had one reporting unit (RU1X) and Company Y had two reporting units (RU1Y and RU2Y). After the combination, reporting unit RU1X was integrated with reporting units RU1Y and RU2Y. Company Y (the entity receiving the net assets of Company X) used Method B to determine its reporting units to test goodwill for impairment after the transaction.

For Company Y's financial statements for the year ended December 31, 20X4 and its comparative year ended December 31, 20X3, Company Y identified reporting units RU1Y and RU2Y with RU1X integrated amongst RU1Y and RU2Y as if the operations of RU1X had always been integrated into those reporting units. In order to assess goodwill impairment, management will need to make assumptions about how those operations would have been managed before the common control transaction. Depending on the assumptions made, impairment at one or more reporting units could have been triggered in the historical period.

IDENTIFYING THE PREDECESSOR ENTITY WHEN ENTITIES ARE NOT UNDER COMMON CONTROL FOR ALL COMPARATIVE PERIODS

28.027 Identifying the predecessor entity is necessary when the entities included in the common control transaction were not under common control for all comparative periods

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presented. Under ASC paragraph 805-50-45-5, the financial statements of previously separate entities should not be combined for periods before the date that common control was established. In the post-combination financial statements, only the predecessor entity should be included in comparative periods preceding the date that common control existed. In addition, the predecessor is generally the receiving entity for accounting purposes.

28.027a In 2006, the SEC staff commented that the predecessor entity is typically the entity that was first controlled by the parent entity or control group. In our experience, this perspective provides a practical approach for identifying the predecessor entity and receiving entity and prevents the parent entity from using the legal form of the transaction to determine the financial reporting of the combined reporting entity.

Example 28.7: Identifying the Predecessor Entity

Parent Co. acquired Company Y and Company X on January 1, 20X1 and 20X2, respectively. Parent Co. transferred Company Y to Company X for cash consideration on December 31, 20X2.

Q. How should the combined financial statements of Company Y and Company X be presented for the two year period ended December 31, 20X2?

A. Because Company Y was controlled by Parent Co. before Company X, Company Y is the predecessor entity and the receiving entity for accounting purposes even though Company X is legally the receiving entity.

The financial statements of the combined entity for the two years ended December 31, 20X2 would include the following:

- Financial statements of Company Y for the year ended December 31, 20X1. Company X's financial statements are not included for the year ended December 31, 20X1 because common control of Company X did not exist for that period. However, since Company X is the issuer of the financial statements it may be appropriate to retroactively adjust the 20X1 capital accounts to reflect the legal capital of the legal parent by analogy to the guidance on reverse acquisitions (see discussion beginning at Paragraph 9.012).
- Financial statements of Company Y and Company X are presented on a consolidated basis for the year ended December 31, 20X2.
- Company X's net assets are recorded on January 1, 20X2 at Parent Co's basis because Company Y is the receiving entity.

28.028 If the entity first controlled by the parent is trivial or otherwise lacks substance, it may be appropriate to conclude that the first entity controlled is not the predecessor or receiving entity. In addition to the first entity controlled, relevant factors to consider include:

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- Relative size of the entities,
- Relative fair values of the entities
- Ongoing management structure, and
- Order in which the entities were acquired.

ACCOUNTING AND REPORTING BY THE TRANSFERRING ENTITY

28.029 ASC Subtopic 805-50 addresses the accounting by the receiving entity in combinations of entities under common control but does not provide guidance on the accounting by the transferring entity.

FINANCIAL STATEMENT PRESENTATION OF CONTRIBUTED NET ASSETS OR EQUITY INTERESTS

28.030 ASC Topic 805 is silent on the accounting by the entity that transfers the net assets or equity interests. Generally, we believe the transferring entity should report the transfer as a disposal pursuant to ASC Subtopic 360-10. Under ASC paragraph 360-10-40-4, "a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed" and should be accounted for as held and used until such date as provided under ASC paragraph 360-10-45-15. The transferring entity should continue to classify the asset or asset group as held and used until it is disposed (i.e., no presentation of discontinued operations prior to disposal). If the transferring entity distributes the asset or group to owners in a spin-off, that disposal shall then be reported in discontinued operations if it meets the conditions in ASC paragraphs 205-20-45-1A through 45-1C.

28.031 Generally, we do not believe it is appropriate to recast the transferring entity's historical financial statements to eliminate the transferred entity from its financial statements as if the subsidiary had never been owned by the transferring entity (i.e., retrospective adjustment of prior period financial statements, often referred to as the *de-pooling* method). However, in certain limited circumstances in which a common control transfer of the net assets or equity interests results in a change in reporting entity of the transferring entity, the transferring entity may consider the guidance in ASC paragraph 505-60-S99-1 (SAB Topic 5-Z.7).

28.032 ASC paragraph 505-60-S99-1 addresses whether a company, which disposes of a business in a spin-off transaction prior to filing an initial registration statement with the SEC, may characterize the transaction as a change in reporting entity and restate its financial statements as if the company never had an investment in the disposed of business. ASC paragraph 505-60-S99-1 provides criteria for considering if there has been a change in reporting entity by the transferring entity. While ASC paragraph 505-60-S99-1 does not specifically address transactions between entities under common control, the

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criteria may be used in limited circumstances to determine whether a change in reporting entity has occurred from the transferring entity's perspective.

28.033 It is important to note that all of the criteria in ASC paragraph 505-60-S99-1 must be met for the transferring entity to conclude that a change in reporting entity has occurred. This conclusion may be acceptable if the entities under common control:

- Are dissimilar businesses (*dissimilarity* is intended to mean substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by ASC Topic 280);
- Are managed and financed historically as if they were autonomous;
- Have no more than incidental common facilities and costs;
- Will be operated and financed autonomously after the transaction; and
- Will not have material financial commitments, guarantees, or contingent liabilities to each other after the transaction.

28.034 We believe careful consideration should be applied in determining whether a change in reporting entity of the transferring entity has truly occurred. If any of the criteria are not met, the presumption is retrospective adjustment of the prior period financial statements is ordinarily not appropriate.

RECOGNITION OF DIFFERENCES BETWEEN AMOUNTS CONTRIBUTED AND PROCEEDS RECEIVED

28.035 Because there has not been a change in basis for the control group, we do not believe a transferring entity should recognize a gain or loss upon transferring net assets or equity interests to an entity under common control. A difference between the carrying amount of net assets transferred and proceeds received, should be recognized by the transferring entity as an equity transaction (i.e., recognized as a contribution/distribution from/to shareholders). Recognizing the difference as an equity transaction is consistent with the guidance in ASC Subtopic 845-10 with respect to nonreciprocal transfers to owners.

> **ASC Paragraph 810-10-40-5**
>
> If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in [ASC Subtopic 845-10, *Accounting for Nonmonetary Transactions,*] applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in [ASC] paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent . . . .
>
> **ASC Paragraph 845-10-30-10**
>
> Accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff or other form of reorganization or liquidation or in a plan that is in

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substance the rescission of a prior business combination shall be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (see [ASC] paragraph 360-10-40-4) of the nonmonetary assets distributed. [ASC] Subtopic 505-60 provides additional guidance on the distribution of nonmonetary assets that constitute a business to owners of an entity in transactions commonly referred to as spinoffs. A pro rata distribution to owners of an entity of shares of a subsidiary or other investee entity that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spinoff. Other nonreciprocal transfers of nonmonetary assets to owners shall be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

28.036 Without authoritative literature specific to the transferring entity, we believe these paragraphs of ASC Section 845-10-30 provide appropriate guidance. Thus, the accounting effectively is a reorganization of the mutual parent company. This guidance is also consistent with the principles of ASC Subtopic 805-50, which specifies that the acquirer account for a combination of entities under common control at the ultimate parent's carrying amount but is silent with respect to the transferring entity's accounting.

IMPAIRMENT CONSIDERATIONS

28.037 The transferring entity should consider whether the planned transfer indicates that the assets to be transferred should be tested for recoverability. ASC paragraph 360-10-35-2 provides circumstances that trigger a recoverability analysis for assets to be held and used. Paragraph 360-10-35-21(f) states that one of those triggers is "a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life." We believe many have considered by analogy the guidance in ASC paragraph 360-10-40-4 for combinations of entities under common control.

ASC Paragraph 360-10-40-4

For purposes of [ASC] Subtopic [360-10], a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset (asset group) is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In such a case, an undiscounted cash flows recoverability test shall apply prior to the disposal date. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value. The provisions of this Section apply to nonmonetary

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exchanges that are not recorded at fair value under the provisions of [ASC] Topic 845.

To the extent that both the transferring and the receiving entities are part of the same consolidated group, paragraph 360-10-35-21(f) is not applicable for the purpose of preparing the parent entity's consolidated financial statements, as the transfer does not represent a disposal from the parent's perspective.

28.038 A loss on disposal is recorded if the fair value of the disposal group that constitutes a business is less than its carrying amount.

Example 28.8: Trigger for Impairment Evaluation

Background

An entity considers whether to dispose of a business through a transfer to an entity under common control and, while no final decision has been made, it believes it is more likely than not that the transfer will occur in the next 12 months.

Q. If an entity expects that it is more likely than not it will transfer a business to an entity under common control, is that a trigger for impairment evaluation?

A. Yes. ASC paragraph 360-10-35-21 provides the indicators that trigger a recoverability analysis for assets to be held and used. ASC paragraph 360-10-35-21(f) states that one of those triggers is "a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life."

ASC paragraph 360-10-40-4 indicates that if an asset to be held and used is tested for recoverability, the cash flows should be based on the remaining life of the asset, assuming the disposal transaction will not occur. That paragraph also states that "in addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value."

Endnote

[1] Conveyances of oil and gas mineral rights and transfers of goods or services to a customer in the scope of ASC Topic 606 are excluded from this guidance.

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Section 29 - Joint Venture Formations (Subtopic 805-60)

Detailed Contents

Overview

Scope

Example 29.1: Two Investors Establish Newco to Develop New Technology

Example 29.1a: Formation of Newco to Facilitate Sale of a Subsidiary

Scope Exceptions

Joint Venture Formation

Accounting for a Joint Venture Formation

Formation Date

Example 29.1b: Formation date not the legal formation date

Multiple Arrangements Accounted for as a Formation Transaction

Determining What is Part of the Joint Venture Formation

Recognizing and Measuring Identifiable Assets, Liabilities, and Any Noncontrolling Interest

Recognizing Goodwill or Excess Net Assets

Other Specific Guidance

Transfers of Financial Assets

Liability-Classified Contingent Payments

Share-Based Payments

Example 29.2: Joint Venture Replacement Share-Based Payment Employee Awards

Example 29.3: Joint Venture Replacement Share-Based Payment Employee Awards Are Liability-Classified

Example 29.4: Joint Venture Replacement Share-Based Payment Employee Awards Are Equity Classified

Disclosures

Private Company Alternatives

Measurement Period

Transition and Effective Date

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OVERVIEW

29.000 ASC Subtopic 805-60[1], *Joint Venture Formations*, provides guidance on accounting for the formation of a joint venture (JV) in the JV's separate financial statements. Specifically, ASC Subtopic 805-60 requires that a JV account for its formation by applying a new basis of accounting at the JV. The assets and liabilities contributed to the JV, including goodwill, if any, are generally measured at fair value on the formation date in accordance with Subtopic 805-20.

> **ASC Paragraph 805-60-05-2**
>
> Paragraph 805-60-25-2 requires that a joint venture account for its formation by applying a new basis of accounting. In accounting for the formation of a joint venture, none of the assets and/or businesses contributed to the joint venture are viewed as having survived the combination as independent entities. Rather, the formation is viewed as the transfer of the net assets to a new entity that assumes control over them. The history of that new reporting entity begins with the joint venture formation. A joint venture establishes a new basis of accounting upon formation by applying aspects of the acquisition method for business combinations, with adaptations that are unique to joint ventures as described in this Subtopic. Accounting for a joint venture formation includes the following steps:
>
> a. Determining the formation date
>
> b. Recognizing and measuring the identifiable assets, the liabilities, and any non-controlling interest in the net assets recognized by the joint venture
>
> c. Recognizing and measuring goodwill, if any, using the fair value of the joint venture as a whole immediately following formation.

SCOPE

29.001 ASC Subtopic 805-60 applies to the formation of the JV or corporate JV (both referred to as JV) and the accounting for those transactions in the JV's separate financial statements. To be in the scope of ASC Subtopic 805-60, the entity must meet the ASC Master Glossary definition of a JV or corporate JV.

> **ASC Master Glossary: Corporate Joint Venture**
>
> A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or

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relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

ASC Master Glossary: Joint Venture

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

29.002 Evaluating whether an entity meets the definition of a JV requires judgment and a careful evaluation of all of the characteristics in the definition, many of which are subjective in nature. While the owners of a JV typically jointly own and operate the entity, none of the owners (venturers) controls the JV in accordance with ASC Subtopic 810-10. Although joint control is essential, the SEC staff have objected to a conclusion that joint control is the only defining characteristic of a JV. Rather, each of the characteristics in the definition should be met for an entity to be a JV, including that the purpose of the entity is consistent with that of a JV. As discussed in Sections 1-3, the acquisition method in ASC Topic 805 should be applied to transactions where businesses are contributed to a jointly controlled entity that does not meet the definition of JV. ASC paragraph 805-10-S99-8 and SEC Speech: Christopher F. Rogers Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments

Example 29.1: Two Investors Establish Newco to Develop New Technology

Investor 1 and Investor 2 establish New JV to develop a new technology. To form New JV:

- Investor 1 contributes one of its subsidiaries, valued at $200 million, in exchange for a 50% equity interest and joint control of New JV.
- Investor 2 contributes $200 million in cash in exchange for a 50% equity interest and joint control of New JV. The contributed cash will be used for developing the new technology.

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Investor 1 and Investor 2 each appoint three members to New JV's six-member board of directors, and all board decisions require unanimous consent from all members.

This arrangement meets the definition of a JV. Both investors have contributed resources—one in the form of a business, the other in cash—in exchange for joint control of New JV. The purpose of New JV aligns with the definition of a JV because New JV is formed to develop new technology.

Example 29.1a: Formation of Newco to Facilitate Sale of a Subsidiary

Investor 1 and Investor 2 establish New JV. The purpose of New JV is to sell a portion of Investor 1's interest in Subsidiary S, which represents all of Investor 1's operations. Investor 1 and Investor 2 jointly control New JV. To form New JV:

- Investor 1 contributes Subsidiary S, valued at $200 million, in exchange for 100% of New JV's equity.
- Investor 2 pays $100 million in cash to Investor 1 in exchange for 50% of New JV's equity.

Investor 1 and Investor 2 each appoint three members to New JV's six-member board of directors, and all board decisions require unanimous consent from all members.

This arrangement does not meet the definition of a JV. While Investor 1 and Investor 2 share joint control of New JV, the objective of the arrangement is to sell 50% of Investor 1's interest in Subsidiary S rather than the creation of a JV. As such, the arrangement does not reflect the purpose typically associated with that of a JV.

SCOPE EXCEPTIONS

29.003 The guidance in ASC Subtopic 805-60 only applies to formation transactions. Any other transactions between the JV and its owners are accounted for under other US GAAP. In addition, ASC Subtopic 805-60 scopes out other types of transactions that are addressed under other US GAAP, such as transactions between entities under common control, proportionately consolidated ventures and collaborative arrangements.

ASC Paragraph 805-60-15-4

The guidance in this Subtopic does not apply to any of the following:

a. Transactions between a joint venture and its owners other than the formation of a joint venture

b. Formations of entities determined to be not-for-profit entities in accordance with Topic 958

c. Combinations between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)

d. Entities in the construction or extractive industries that may be proportionately

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consolidated by any of their investor-venturers in accordance with paragraph 810-10-45-14

e. Collaborative arrangements within the scope of Topic 808, except for any part of the arrangement that is conducted in a separate legal entity that meets the definition of a joint venture.

JOINT VENTURE FORMATION

29.004 Because ASC Subtopic 805-60 does not apply to transactions between a JV and its owners subsequent to JV formation, it is important to distinguish formation transactions from subsequent transactions with the venturers. While ASC Subtopic 805-60 does not define a formation transaction, it states that an entity determines whether a transaction or event is a JV formation by applying the:

- definition of a JV (see the Scope section) and
- guidance on determining the formation date (see Formation Date section).

ASC paragraph 805-60-25-1

29.005 The venturers may enter into multiple arrangements that are required to be combined into a single JV formation transaction. In that case, all of the arrangements would be accounted for as a single formation transaction as of the formation date. See Multiple Arrangements Accounted for as a Formation Transaction for additional discussion. ASC paragraph 805-60-25-3 and 25-4

29.006 The formation of a JV is not necessarily the creation of a new legal entity. While a JV formation often includes a newly formed entity, we believe that a newly formed entity is not required to have a JV formation. For example, an existing subsidiary could become a JV from a transaction or event that makes it meet the definition of a JV (e.g., a contribution of a business or net assets from a new investor and change in governance). Paragraph BC34 of the Basis for Conclusions of ASU 2023-05

ACCOUNTING FOR A JOINT VENTURE FORMATION

29.007 A JV formation is considered the creation of a new reporting entity (not necessarily the creation of a new legal entity) that triggers a new basis of accounting. Therefore, the net assets of the JV are measured at fair value on the formation date. ASC Subtopic 805-60 requires the JV to use the business combinations (i.e., the acquisition method) guidance in ASC Subtopic 805-20 to measure the net assets of the JV. Similar to the acquisition method, accounting for a JV formation includes the following steps:

- Determining the formation date
- Recognizing and measuring the identifiable assets, liabilities, and any noncontrolling interest

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- Recognizing and measuring goodwill (or excess net assets), if any, using the fair value of the JV as a whole immediately following formation.

ASC paragraph 805-60-25-2

However, accounting for a JV does not include identification of an acquirer because the JV receives the controlling interest in the net assets.

29.008 ASC Subtopic 805-60 does not affect the venturer's accounting for its interest in the entity. The venturer would generally measure its investment received from contributing net assets at fair value and account for it using equity method accounting. See KPMG Handbook, Equity Method of Accounting for a discussion of venturer accounting. Although both the venturer and the JV use fair value measurements, the venturer may still have an equity method basis difference when the JV applies ASC Subtopic 805-60. This is because the measurement of the JV's net assets based on 100% of its equity interest would include any control premium, while the venturer's investment generally would not.

FORMATION DATE

29.009 The formation date is the date the entity initially meets the definition of a JV, which is not necessarily the same as the legal entity's formation date. Similar to the acquisition date under the acquisition method, the formation date of a JV is the measurement date for the formation transaction.

Example 29.1b: Formation date not the legal formation date

Investor 1 forms a new legal entity (Entity X) on January 1. On June 1, Investor 1 and 2 each contribute businesses to Entity X and amend the governing documents such that Entity X meets the definition of a joint venture. June 1 is the formation date.

29.010 The entire formation transaction, including all contributions received or that are receivable as of the formation date, is measured at the formation date even when there are multiple arrangements combined into a single formation transaction. In contrast, transactions that are considered separate from the JV formation, such as additional contributions that are not part of the formation transaction, are accounted for separately under other GAAP and may have different measurement dates. ASC Subtopic 805-60 has guidance on when to combine multiple arrangements into a single formation transaction and when transactions are separate from the formation transaction. ASC paragraph 805-60-25-3

Multiple Arrangements Accounted for as a Formation Transaction

29.011 ASC Subtopic 805-60's guidance on combining multiple transactions is consistent with the guidance in ASC paragraph 810-10-40-6 on combining multiple disposal transactions. The guidance states:

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ASC Paragraph 805-60-25-4

Multiple arrangements may establish the formation of a joint venture and constitute the joint venture formation transaction. Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the multiple arrangements as a single transaction that establishes the formation, a joint venture shall consider the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the joint venture should account for the multiple arrangements as a single transaction that established the formation of the joint venture:

a. The multiple arrangements are entered into at the same time or in contemplation of one another.

b. The multiple arrangements form a single transaction designed to achieve an overall commercial effect.

c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

d. One arrangement considered on its own is not economically justified, but the multiple arrangements are economically justified when considered together.

29.012 The determination of which arrangements to include in the formation transaction may require significant judgment and analysis of the facts and circumstances of each arrangement. If multiple arrangements are accounted for as a single transaction, then the formation date is the measurement date for all arrangements that are part of the formation transaction.

29.013 In some circumstances, the assets and liabilities of individual arrangements may not be received by the JV as of the formation date. Therefore, the specific assets and liabilities from those arrangements may not be recognized on the formation date. Those items would be recognized when they meet the recognition criteria in ASC Subtopic 805-20 (see Section 7 for discussion of the recognition guidance). ASC paragraph 805-60-25-3

Determining What is Part of the Joint Venture Formation

29.014 Certain transactions should be accounted for separate from the JV formation. Specifically, ASC Subtopic 805-60 indicates that payments between a JV and its venturers should be evaluated under the business combinations guidance for identifying a separate transaction. If separate from the formation transaction, the separate transaction is accounted for under other US GAAP. However, a JV cannot apply the guidance in ASC Topic 805 on separate transactions relating to pre-existing relationships or acquisitions costs because the JV is a new reporting entity whose history begins on the formation date (i.e., there can be no pre-existing relationships). ASC paragraph 805-60-25-7 and Paragraph BC57 of the Basis for Conclusions of ASU 2023-05

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29.015 ASC Subtopic 805-60 also requires an entity to allocate share-based payment awards granted to employees of the JV between pre-formation and post-formation compensation cost. The following table summarizes the guidance JVs should use to evaluate these separate transactions.

	Applicable guidance	For further details, see	Source
Payments between a JV and its venturers may be separate from the formation transaction	ASC paragraphs 805-10-55-24 through 55-26	Paragraphs 11.017 through 11.023	ASC paragraph 805-60-25-6
Share-based payment awards are allocated between pre-formation vesting and post-formation compensation cost	ASC paragraphs 805-30-30-9 through 30-13	Paragraphs 29.2026	ASC paragraph 805-60-25-8

RECOGNIZING AND MEASURING IDENTIFIABLE ASSETS, LIABILITIES, AND ANY NONCONTROLLING INTEREST

29.016 At the formation date, the JV establishes a new basis of accounting for its identifiable assets and liabilities and any noncontrolling interest. The JV's assets and liabilities are recognized and measured in accordance with the business combinations guidance in ASC Subtopic 805-20 regardless of whether the JV constitutes a business in accordance with ASC Subtopic 805-10 (see Section 2 on the definition of a business). This means that the JV measures the identifiable assets and liabilities at fair value with the same exceptions used for business combinations, such as employee benefits, income taxes and leases. See Section 7 for a full discussion of recognizing and measuring identifiable assets, liabilities and noncontrolling interest. ASC paragraphs 805-60-25-10 through 25-11 and 30-1

29.017 ASC Subtopic 805-60 provides specific guidance related to transfers of financial assets, contingent payments and share-based payments. See Other Specific Guidance for additional discussion.

29.018 After formation, the JV subsequently measures and accounts for its assets and liabilities in accordance with the guidance on business combinations. That is, the JV would apply any specialized accounting for an acquirer required under the business combinations guidance (see Section 12) or follow other applicable GAAP for those assets and liabilities not specifically discussed in ASC paragraph 805-10-35-1. ASC paragraph 805-60-35-1

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RECOGNIZING GOODWILL OR EXCESS NET ASSETS

29.019 The JV recognizes goodwill at the formation date by measuring the excess of:

- the JV's formation-date fair value, which is the fair value of 100% of the JV's equity immediately following formation, including any noncontrolling interest in the JV, over
- the net of the formation-date amounts of the identifiable assets and liabilities recognized by the JV.

ASC paragraphs 805-60-30-2

29.020 If the JV does not meet the definition of a business at the formation date, the JV would still recognize goodwill if the fair value of its equity exceeds the net formation-date amounts of the assets, liabilities and noncontrolling interest. However, the FASB indicated that the presence of more than an insignificant amount of goodwill is expected to be unusual when the assets contributed are not a business. ASC paragraph 805-60-25-13

29.021 If the amount of the net assets recognized by the JV exceeds the fair value of the JV's equity, the excess net asset amount (i.e., bargain gain) is recorded as an equity adjustment. ASC paragraph 805-60-30-3

29.022 Before the JV recognizes goodwill or a bargain gain, the JV should ensure that it has identified all of the contributed identifiable net assets and that all available information as of the formation date has been considered when measuring the fair value of those identifiable net assets and the joint venture as a whole. Paragraph BC48 of the Basis for Conclusions of ASU 2023-05

OTHER SPECIFIC GUIDANCE

Transfers of Financial Assets

29.023 If a venturer transfers financial assets that are within the scope of ASC Subtopic 860-10 to the JV, then the JV determines whether to recognize the transferred financial assets by applying the guidance in ASC Subtopic 860-10. ASC paragraph 805-60-25-15

Liability-Classified Contingent Payments

29.024 A JV accounts for contingent payments to its owners as a contingent liability or asset under ASC Subtopic 805-20 (see Paragraphs 7.154 through 7.158a). That is, the contingency is measured at fair value if the fair value is determinable at the formation date. However, if the fair value is not determinable, then the recognition and measurement criteria in ASC Topic 450 are applied (i.e., probable and reasonably estimable). ASC paragraphs 805-60-30-6

29.025 The contingent consideration guidance for business combinations in ASC Subtopic 805-30 does not apply for JV formations. Because the accounting for contingent

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consideration in a business combination requires measurement at fair value, the accounting for contingent payments in a JV formation may be different than those in a business combination. ASC paragraph 805-60-30-6 and Paragraph BC62 of the Basis for Conclusions of ASU 2023-05

Share-Based Payments

29.026 When a JV issues share-based payment replacement awards to grantees, it applies the guidance in ASC paragraphs 805-30-30-9 through 30-13 to allocate the fair-value-based measure (i.e., measured under ASC Topic 718) of the awards between pre-formation vesting and post-formation compensation cost. See Paragraphs 11.025 through 11.060 for discussion of this guidance. However, the value of these awards does not affect the total amount of equity or goodwill recognized upon formation; instead, it is recognized as a reallocation of additional paid-in capital. ASC paragraphs 805-60-25-8 and 30-7

Example 29.2: Joint Venture Replacement Share-Based Payment Employee Awards

New JV is a newly formed corporation with no assets or liabilities. On January 1, 20X0, New JV receives contributions of:

- Business A (controlling financial interest of 90 percent voting interest) from Venturer 1 and
- Business B (100 percent voting interest) from Venturer 2

In exchange, New JV issues 50 common shares to each Venturer 1 and Venturer 2. New JV has no other classes of equity or any other equity instruments outstanding before receiving the contributions.

New JV determines that it first met the definition of a JV on January 1, 20X0, which is its formation date.

Before consideration of any liabilities for share-based payments, New JV determines the following formation-date fair values:

	Formation-date Fair Values (in millions)
JV as a whole, including a noncontrolling interest (10 percent voting interest) in Business A that is owned by an outside entity	$100
Identifiable assets	$120
Liabilities	$ 40
Noncontrolling interest in Business A	$ 5

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On formation, New JV issues replacement awards for share-based payment awards of Business A.

	Original award	Replacement award
Total service period	4 years	3 years
Remaining service period	2 years	1 year
Fair-value-based measure at formation date	$20 million	$20 million

Because the employees will need to render an additional year of service post-formation, only a portion of the contributed business's awards is attributable to pre-formation vesting. For simplicity, assume that New JV estimates that there will be no forfeitures of the replacement share-based payment awards.

The portion attributable to pre-formation vesting equals the fair-value-based measure of the contributed business's award ($20 million) multiplied by the ratio of the pre-formation vesting period (2 years) to the **greater of** the total service period (3 years) and the original service period of the contributed business's award (4 years). Therefore, $10 million ($20 million × 2 ÷ 4 years) is attributable to pre-formation vesting and New JV's additional paid-in capital upon formation. The remaining $10 million is attributable to post-formation vesting and recognized as compensation cost in New JV's post-formation financial statements in accordance with Topic 718 on stock compensation.

New JV applies the guidance in Topic 718 to determine whether the share-based payments should be classified as liabilities or equity.

ASC paragraphs 805-60-55-2 through 55-6

Example 29.3: Joint Venture Replacement Share-Based Payment Employee Awards Are Liability-Classified

Assume the same facts as Example 29.2. If New JV determines that the replacement share-based payment awards are classified as liabilities, then total liabilities will equal $50 million ($40 million + $10 million). For simplicity, when taking the share-based payment liabilities into account, the fair value of New JV as a whole is $90 million ($100 million – $10 million), including the $5 million noncontrolling interest in the net assets recognized by the joint venture.

New JV calculates goodwill as follows (in millions).

Fair value of New JV as a whole (including $5 noncontrolling interest)	$ 90
Less: Net fair value of identifiable assets and liabilities recognized ($120 assets − $50 liabilities)	(70)
Goodwill recognized by New JV at formation date	$ 20

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New JV calculates additional paid-in capital as follows (in millions).

Net assets recognized by New JV, excluding share-based payment liabilities ($120 identifiable assets – $40 liabilities + $20 goodwill)	$ 100
Less: The fair value of noncontrolling interest in business contributed to New Venture	(5)
Less: The fair value of pre-formation vesting replacement share-based payments classified as a liability	(10)
Additional paid-in capital recognized by New Venture at the formation date	$ 85

New Venture records the following entry at the formation date (in millions).

	Debit	Credit
Identifiable assets recognized	$ 120	
Goodwill	20	
Liabilities recognized		$40
Noncontrolling interest		5
Share-based payment liability (pre-formation vesting)		10
Additional paid-in capital		85

ASC paragraphs 805-60-55-7 through 55-10

Example 29.4: Joint Venture Replacement Share-Based Payment Employee Awards Are Equity Classified

Assume the same facts as Example 29.2. If New JV determines that the replacement share-based payment awards are classified as equity, then total liabilities will equal $40 million and the fair value of New Venture as a whole is $100 million, including the $5 million noncontrolling interest in the net assets recognized by the joint venture.

New JV calculates goodwill as follows (in millions).

Fair value of New JV as a whole (including $5 noncontrolling interest)	$ 100
Less: Net fair value of identifiable assets and liabilities recognized ($120 assets − $40 liabilities)	(80)
Goodwill recognized by New JV at formation date	$ 20

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New JV calculates additional paid-in capital, excluding additional paid-in capital attributable to share-based payments, as follows (in millions).

Net assets recognized by New JV, excluding share-based payment liabilities ($120 identifiable assets – $40 liabilities + $20 goodwill)	$ 100
Less: The fair value of noncontrolling interest in business contributed to New Venture	(5)
Less: The fair value of pre-formation vesting replacement share-based payments classified as equity	(10)
Additional paid-in capital recognized by New JV at the formation date (excluding additional paid-in capital attributable to pre-formation vesting share-based payments)	$ 85

New JV records the following entry at the formation date (in millions).

	Debit	Credit
Identifiable assets recognized	$ 120	
Goodwill	20	
Liabilities recognized		$40
Noncontrolling interest		5
Additional paid-in capital – share-based payments (pre-formation vesting)		10
Additional paid-in capital		85

ASC paragraphs 805-60-55-11 through 55-14

DISCLOSURES

29.027 ASC Subtopic 805-60 requires a JV to disclose information enabling financial statement users to understand the nature and financial effect of the JV formation in the period in which the formation date occurs.

ASC Paragraph 805-60-50-2

In the period of formation, a joint venture shall disclose the following:

a. The formation date

b. A description of the purpose for which the joint venture was formed (for example, to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities)

c. The formation-date fair value of the joint venture as a whole

d. A description of the assets and liabilities recognized by the joint venture at the formation date

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e. The amounts recognized by the joint venture for each major class of assets and liabilities as a result of accounting for its formation, either presented on the face of financial statements or disclosed in the notes to financial statements (see paragraph 805-60-45-1)

f. A qualitative description of the factors that make up any goodwill recognized, such as expected synergies from combining operations of the contributed assets or businesses, intangible assets that do not qualify for separate recognition, or other factors.

PRIVATE COMPANY ALTERNATIVES

29.028 A JV that is a private company may apply the accounting alternatives for:

- Subsequent measurement of goodwill (i.e., the amortization alternative and the triggering date alternative); and
- Separate recognition of certain identifiable intangible assets. Electing this accounting alternative requires also electing the goodwill amortization alternative (i.e., amortizing goodwill on a straight-line basis over 10 years, or fewer than 10 years if a shorter useful life is demonstrably more appropriate).

See Section 26 for detailed discussion of private company alternatives.

MEASUREMENT PERIOD

29.029 ASC paragraphs 805-60-25-14 allows a JV to apply the measurement period guidance in ASC Section 805-10-25. See Section 10 for additional information about applying the measurement period guidance. If the accounting for the JV formation is incomplete and the formation date amounts have been recognized provisionally, the JV would disclose:

- The reasons why the initial accounting is incomplete; and
- The specific assets, liabilities, noncontrolling interests, or the formation-date fair value of the JV as a whole for which the initial accounting is incomplete.

ASC paragraph 805-60-50-3(a) and (b)

29.030 In addition, in subsequent periods, the JV would disclose the nature and amount of any measurement period adjustments recognized during the reporting period, including separately the amount of adjustment to current-period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts was recognized as of the formation date. ASC paragraph 805-60-50-3(c)

TRANSITION AND EFFECTIVE DATE

29.031 ASC Subtopic 805-60, Joint Venture Formations, is applied prospectively to all JV formations on or after January 1, 2025. Early adoption is permitted in any interim or

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annual period for which financial statements have not yet been issued (or made available for issuance). ASC paragraph 805-60-65-1

29.032 A JV with a formation date before the initial application date (i.e., the date the JV first applies ASC Subtopic 805-60) may apply the guidance retrospectively if the JV has sufficient information. When applying retrospective application, the initial application date is considered the beginning of the earliest comparative period presented. A JV that elects to apply the guidance retrospectively:

1. Recognizes the cumulative effect of initially applying ASC Subtopic 805-60 as an adjustment to the opening balance of retained earnings (or other appropriate components of equity in the statement of financial position) at the initial application date.
2. Applies any relevant guidance other than ASC Subtopic 806-60 (for example, for measuring identifiable assets, liabilities, and any noncontrolling interest in accordance with ASC Subtopic 805-20) as the guidance existed at the formation date (i.e., without considering the subsequent adoption of relevant ASUs). Provides the transition disclosures required by ASC paragraphs 250-10-50-1 through 50-3 in the period of the initial application date.

   ASC paragraph 805-60-65-1

Endnote

[1] ASU 2023-05, *Joint Venture Formations, Recognition and Initial Measurement*, was issued in August of 2023 and introduced ASC Subtopic 805-60, *Joint Venture Formations*. See transition and effective date discussion at Paragraph 29.031. See Paragraph 1.012a for discussion of joint venture formations before the adoption of ASU 2023-05.

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