

This topic is not covered in this book.

Topic 410: Asset Retirement and Environmental Obligations

Topic 410, *Asset Retirement and Environmental Obligations*, contains four subtopics:

10 Overall

20 Asset Retirement Obligations

30 Environmental Obligations

980 Regulated Operations [See the corresponding topic in Chapter 9 for coverage of this shared subtopic]

General Discussion

ASC 410-20 specifies the accounting and reporting requirements for liabilities related to the retirement of tangible long-lived assets and the related asset retirement cost. Examples of assets covered by ASC 410-20 include assets related to nuclear power plants, mining and landfill operations, offshore oil platforms and oil fields. Also, lease agreements often contain requirements that the lessee return the leased property to its original state as of the inception of the lease. If the lessee made leasehold improvements, then the lessee should record an asset retirement obligation, as discussed below. ASC 410-20 applies to all enterprises that have legal obligations related to the retirement of long-lived assets of a tangible nature that are a result of the development, acquisition, or construction of long-lived tangible assets, and/or the normal operations of the assets. Legal obligation related to the retirement is defined in a broad manner by the ASC and includes an obligation that an entity must settle because of an existing law, an enacted law, a statute, an ordinance, an oral contract, a written contract, or a contract under the doctrine of promissory estoppel. The doctrine of promissory estoppel states that an obligation related to asset retirement may exist even though no consideration was provided for the promise to reclaim the property, because the entity making the promise should have expected the entity receiving the promise to rely on the promise.

ASC 410-20 does not apply to an obligation that is created solely from a plan to dispose of a tangible long-lived asset under the provisions of ASC 360 or to an obligation created from using the asset improperly. In addition, ASC 410-20 does not apply to certain types of lessee obligations. Lessee obligations generally should be accounted for using the provisions of ASC 840. However, if a lessee obligation meets the requirements of a legal obligation for retirement as discussed above, and the lease obligation does not meet the definition of minimum lease payments or contingent rental payments using the provisions of ASC 840, then the provisions of ASC 410-20 would apply. In addition, if the lease obligation of the lessor meets the requirements of ASC 840, the obligation should be accounted for using the provisions of ASC 410-20 instead of ASC 840.

Once an entity determines that a retirement obligation for tangible long-lived assets should be reported, a liability for the asset retirement obligation is to be reported at an amount equal to fair value of the liability in the accounting period that the liability is incurred, if it is reasonable to determine fair value.

When it is not reasonable to determine fair value in the accounting period incurred, the liability should be reported in the accounting period when it is first possible to reasonably determine the fair value of the liability (ASC 410-20-25-4). FASB Statement of Financial Accounting Concepts (SFAC) No. 6 addresses liability recognition and ASC 410-20 addresses fair value measurements.

ASC 410-20-25-6 provides additional information about fair value measurement and states that the fair value of the asset retirement obligation generally can be estimated when any of the following conditions exist:

- Information indicates that the obligation's fair value is embodied in the purchase price of the asset;
- An active market is available for the transfer of the obligation; or
- Information is available that allows for the application of a present value model that incorporates uncertainty and timing into the fair value estimate.

Generally, it is assumed that information is available for application of present value techniques when others have specified the method and timing of the settlement of the asset retirement obligation such as by contract, law, or regulation and information is available to estimate the date of settlement or range of dates, method of settlement, or potential methods of settlement and the probabilities related to dates and methods of settlement. When an entity has a conditional asset retirement obligation (the timing and/or method of settlement are dependent upon some future event), the liability should be reported when the fair value of the obligation can reasonably be estimated. ASC 410-20-55, paragraphs 47 through 62, provide several examples illustrating when an entity is able to estimate the fair value of the asset retirement obligation.

Once the asset retirement liability has been computed, the related long-lived asset should be increased by an amount equal to the amount of the liability in the same accounting period that the liability is reported.

ASC 820 provides guidance on the determination of fair value. Fair value is the amount that would be received on the measurement date from the sale of property or the amount paid to transfer a liability between sellers and buyers (market participants) in an orderly transaction. In addition, it is assumed that the sellers and buyers are unrelated parties on the measurement date. One way to determine fair value is to use quoted market prices. In many cases, however, quoted market prices are not available and an enterprise must estimate fair value. Fair value may be estimated using future cash flows on a present-value basis. One present-value method is referred to as the expected-present-value concept. The expected present value concept uses multiple cash flows situations to reflect the possible cash flow outcomes for a specific asset retirement obligation and a credit-adjusted risk-free interest rate. The traditional present value concept uses a single set of cash flows and an interest rate equal to the risk of the situation. ASC 410-20-30-1 states that the expected present value concept may be the only one that would be appropriate for asset retirement liabilities because of the uncertainties related to both timing and amount of future cash flows.

When estimating cash flows to determine fair value of the retirement liability, the enterprise should normally use the same assumptions that the market place would use if the information is available without significant effort or cost to the entity. If the market place information is not available, the enterprise should use its own assumptions that are reasonable and can be supported when computing cash flow information. In addition, when discounting cash flows using the expected cash flow approach, the entity should use a credit-adjusted risk-free discount rate that reflects the entity's credit standing.

An asset retirement liability may be incurred in more than one accounting period because the obligation is created over more than one time period, such as in the case of nuclear power plants or landfills. If the obligation is incurred over more than one accounting period, each liability incurred is accounted for as a separate liability layer and each layer is measured at fair value (ASC 410-20-35-1).

Once an asset retirement liability is recorded, increases and decreases in the liability may occur in subsequent accounting periods. The changes in the liability account generally occur for two reasons: (1) increases in the liability from passage of time, and (2) increases and decreases in the liability account from changes in estimates of cash flows. The entity should always adjust the liability for increases due to the passage of time prior to adjustments resulting from changes in cash flow estimates. Increases in the liability from passage of time, referred to as accretion in ASC 410-20, are computed by using the interest method of amortization. The interest method is the application of the discount rate used in the computation of the present value amount to the beginning liability balance. An expense will be debited and the retirement liability will be credited for the amount of the accretion. The expense is reported in the income statement as an operating expense; however, the amount of the accretion cannot be used as part of interest expense for purposes of applying the provisions of ASC 835-20 related to interest capitalization. Increases and decreases in the amount or timing of cash flows should be used to increase or decrease both the retirement liability and the related long-lived asset. Increases in cash flows should be discounted at the current risk-adjusted discount rate and decreases in cash flows should be discounted using the discount rate that was used when the cash flows were originally discounted if it is possible to determine the rate used. If the rate is not determinable, a weighted average discount rate should be used for cash flow decreases. Any increase or decrease in the long-lived asset account should be treated as a change in accounting estimate in accordance with the provisions of ASC 250.

The increase in the long-lived asset from the recognition of an asset retirement liability is allocated over its remaining useful life using a systematic and rational method. However, in some situations, an enterprise may capitalize and expense the same amount in a specific accounting period. To illustrate, assume an enterprise has a long-lived asset with a five-year remaining life where 20% of the asset retirement liability is capitalized each accounting period. The entity generally would not violate the systematic and rational method rule by expens-

ing in the same accounting period the 20% of the liability capitalized (ASC 410-20-35-2).

When testing the long-lived assets for impairment using the provisions of ASC 360, the carrying amount of the long-lived asset used in the testing process should include the amount of the asset retirement liability included in the long-lived asset. However, cash flows related to the asset retirement liability should be excluded from the computation of fair value and the undiscounted cash flows used in testing recoverability of the asset. The fair value of the asset retirement liability is used to increase the fair value of long-lived assets if a quoted market price is used instead of cash flows to determine fair value and the quoted price incorporates the costs of asset retirement (ASC 360-10-35, paragraphs 18 and 19).

An entity may acquire insurance policies, guarantees by other companies, surety bonds, or other items to provide assurance for the asset retirement obligation. Acquisition of assurance or other funding does not satisfy the asset retirement obligation or allow retirement of the related liability. However, such assurances may impact the credit-adjusted risk-free discount rate used in the present value computations. Changes in assurances also may impact the credit-adjusted risk-free rate used in the discounting of the increases in cash flows. Any cost incurred by the entity related to assurances is not accounted for as part of the asset retirement obligation.

A regulated entity subject to the provisions of ASC 980 may have costs related to asset retirement obligations that will be recovered from customers. There may be a difference in the timing of amounts used for rate-making purposes and the amounts reported in the financial statements using ASC 410-20. When a regulated entity meets the requirements of ASC 980 and reports different amounts for rate-making purposes as compared to the amounts reported on the financial statements resulting from a timing difference, a regulatory asset or liability should be reported for this difference (ASC 980-410-25-2).

Technical Considerations

Three examples are used to illustrate the technical aspects of asset retirement obligations. Assumptions for Example 4-1 are as follows.

Example 4-1

Assumptions for Asset Retirement Obligations

1. Fischer, Inc. (Fischer) a December 31 year-end company, placed an offshore oil platform in service on January 1, 20X6. Fischer has a legal requirement to remove the platform at the end of its five-year useful life.
2. On January 1, Fischer incurred an asset retirement liability and the company measures the fair value of the liability using expected cash flows; this fair value measurement is assumed to be in accordance with ASC 410-20. The expected cash flows adjusted for market risk related to the asset retirement obligation is \$1,000,000. The credit-adjusted risk-free rate of interest is 7%.
3. The increase in the long-lived asset from the asset retirement obligation is depreciated over the five-year life using a straight-line method.

4. Fischer used an outside contractor to settle the asset retirement obligation at a cost of \$921,000.

Because Fischer has a legal requirement to remove the offshore oil platform at the end of its useful life of five years, it has incurred an asset retirement obligation on January 1, 20X6. Next, Fischer should determine the expected cash flows related to the obligation and then estimate fair value of the liability by computing the present value of expected cash flows using a credit-adjusted risk-free rate of interest. Fischer has determined that expected cash flows adjusted for market risk are equal to \$1,000,000, and the credit-adjusted risk-free rate of interest is 7%. Using this information and the expected life of five years, the fair value of the liability can be computed as below:

Expected cash flows	\$1,000,000
Present value of \$1 factor (5 periods at 7%)(Appendix E)	.712986
Present value of expected cash flows (fair value)	\$712,986

Using the fair value amount of \$712,986, the journal entry required to record the liability on January 1, 20X6, is as follows:

Long-Lived Asset	712,986	
Liability For Asset Retirement		712,986

The liability for asset retirement will increase over the five-year useful life based on the passage of time. This annual increase (accretion expense) is computed using the interest method, which is the application of the 7% discount rate to the beginning balance of the asset retirement liability. The annual accretion expense is computed in Table 4-1.

Table 4-1 Computation of Accretion Expense for Asset Retirement Obligation

Date	Accretion Expense	Liability Balance
Beginning Balance		\$712,986
20X6	\$49,909 ^a	762,895
20X7	53,403	816,298
20X8	57,141	873,439
20X9	61,141	934,580
2010	65,420	1,000,000
Total	\$287,014	

^a \$712,986 × 7% = \$49,909.

In Table 4-1, the increase in the asset retirement liability from the accretion expense causes the liability to equal \$1,000,000 at the end of the life of the asset. The \$1,000,000 liability balance is the amount of the expected cash flows adjusted

for market risk. Next, the depreciation of the asset retirement obligation added to the long-lived asset must be computed. The component is depreciated using a straight-line method over a five-year useful life. Table 4-2 shows the computation of the annual depreciation amount.

Table 4-2 Computation of Annual Depreciation Expense

Date	Depreciation Expense	Liability Balance
Beginning Balance		\$712,986
20X6	\$142,597 ^a	570,389
20X7	142,597	427,792
20X8	142,597	285,195
20X9	142,597	142,598
20Y0	142,598 ^b	0
Total	\$712,986	

^a \$712,986/5 Years = \$142,597.

^b Rounded

Using the information from Tables 4-1 and 4-2, journal entries at December 31, 20X6 to record accretion and depreciation expense are presented below:

Accretion Expense	49,909	
Liability For Asset Retirement		49,909
Depreciation Expense	142,597	
Accumulated Depreciation		142,597

Accretion and depreciation expense are reported in the income statement as operating expenses. Journal entries for accretion and depreciation expense for the remaining four years are the same as show above, except for amounts. Amounts for the remaining four years for accretion and depreciation expense can be taken directly from Tables 4-1 and 4-2.

At the end of 2010, the asset retirement obligation is settled by an outside contractor for \$921,000, which is \$79,000 (\$1,000,000 – \$921,000) less than the entity expected to incur to eliminate the liability. Therefore, Fischer has a \$79,000 gain from settlement of the obligation. The entry to settle the asset retirement obligation and to report the gain at the end of 2010 is as follows.

Liability For Asset Retirement	1,000,000	
Accounts Payable		921,000
Gain On Settlement Of Liability For Asset Retirement		79,000

The gain on settlement of the asset retirement liability is reported in the income statement as a line item in income from continuing operations. This completes the discussion of Example 4-1. Example 4-2 covers issues related to the computation of an asset retirement obligation using expected cash flows. Assumptions for Example 4-2 are as follows.

Example 4-2
Assumptions for Asset Retirement Obligations

- Lang Enterprises (Lang), a December 31 year-end company, placed a long-lived asset in service on January 1, 20X6. Lang has a legal requirement to remove the long-lived asset at the end of its five-year useful life.
- On January 1, Lang incurred an asset retirement liability, and it measures fair value of the liability using expected cash flows. Lang has estimated expected cash flows for labor costs as follows: a 10% probability that cash flows will be \$250,000, a 30% probability that cash flows will be \$325,000, a 40% probability that cash flows will be \$400,000, and a 20% probability that cash flows will be \$450,000.
- Lang allocates overhead and equipment usage to labor at a 75% rate, which is equivalent to the percentage used by outside contractors. A profit margin of 15% is added to labor and allocated costs, and a risk premium of 4% of inflation adjusted expected cash flows is included in the cash flow computations.
- A rate of inflation of 2% is assumed for the five-year life of the long-lived asset. The risk-free discount rate is 6%; 2% is added to the risk free rate to reflect Lang's credit standing.
- This fair value measurement is assumed to be in accordance with ASC 820's fair value measurement requirements.

Because Lang has a legal requirement to remove the long-lived asset at the end of its useful life of five years, it has incurred an asset retirement obligation on January 1, 20X6. Next, Lang will determine the fair value of the liability by using expected cash flows. Lang should determine the expected cash flows related to labor cost for the obligation. Because Lang has estimated four possible streams or options of cash flows for labor costs with specific probabilities for each option, each cash flow option will be weighted based on its percentage of probability of occurring. After each option has been weighted, all weighted options are totaled to arrive at a \$372,500 probability weighted average cash flow for the labor cost as shown in Table 4-3.

Table 4-3 Computation of Probability Weighted Average Cash Flows

Cash Flow Options	Net Cash Flows	Probability Assessment	Probability Weighted Average Cash Flows
1	\$250,000	10%	\$25,000
2	\$325,000	30%	97,500
3	\$400,000	40%	160,000
4	\$450,000	20%	90,000
Total		100%	\$372,500

Once cash flows for labor costs have been computed, cash flows adjusted for market risk may be computed. After cash flows adjusted for market risk have been determined, the present value of the market risk adjusted cash flows using Lang's credit-adjusted risk-free rate of interest of 8% can be calculated to arrive at fair value of the asset retirement liability. Table 4-4 shows these calculations.

Table 4-4 Computation of Expected Cash Flow Adjusted for Market Risk and Present Value of Cash Flows

Cash flows for labor costs (from Table 4-3)	\$372,500
Allocation of equipment and overhead (\$372,500 × 75%)	279,375
Total cash flows for labor and allocated costs	\$651,875
Markup (\$651,875 × 15%)	97,781
Cash flows prior to inflation adjustment	\$749,656
2% inflation adjustment:	
Cash flows prior to adjustment	\$749,656
Future Value of \$1 (2% for 5 periods)	1.10408
Cash flows with inflation adjustment	\$827,680
Cash flows prior to adjustment	749,656
2% inflation adjustment	78,024
Expected cash flow adjusted for inflation	\$827,680
Adjustment for market risk premium (\$827,680 × 4%)	33,107
Expected cash flows after market risk adjustment	\$860,787
Present value of \$1 factor (8% for 5 periods) (Appendix E)	.680583
Expected present value of expected cash flows (fair value)	\$585,837

The computation of expected cash flows after adjustment of market risk includes all items that an outside contractor would normally use to compute an estimate for asset retirement. It incorporates an allocation of equipment and overhead costs, profit margin, inflation adjustment, and a premium for market risk. Using information from Table 4-4, the journal to record the asset retirement liability and the related increase in the long-lived asset at January 1, 20X6 is presented below:

Long-Lived Asset	585,837
Liability For Asset Retirement	585,837

Once the liability is recorded, it must be increased each year for the accretion due to passage of time. Because the company's credit-adjusted risk-free rate of

General Discussion

ASC 805 specifies the accounting and reporting requirements for business combinations. Under ASC 805, all business combinations are accounted for using the acquisition method. However, the provisions of ASC 805 do not apply to the following: (1) formation of a joint venture, (2) combination where the businesses or entities are under common control, (3) acquisition of a for-profit entity by a not-for-profit entity or a combination of not-for-profit entities, and (4) asset acquisition not considered a business.

What Is a Business Combination?

A business combination is a transaction or event whereby an entity (the acquirer) gets control of one or more businesses of another entity (the acquiree). An acquirer may gain control of the acquiree in several ways, including transferring cash or other assets, issuing equity interests, or incurring liabilities. The acquirer in a business combination is the entity that gets control of the acquiree, and the acquiree is the business or businesses that are controlled by the acquirer. A business in a business combination is defined as a set of assets and activities that can be used to provide a return to owners and investors. Control used in the definition of a business combination has the same meaning as used in ASC 810 for a controlling financial interest. As noted in the definition of a business combination, the acquisition must be a business for the acquisition to be treated as a business combination. If the acquisition is not considered a business, the transaction is accounted for as an asset acquisition. Business combinations may be structured in various ways. Examples follow: (1) a business becomes a subsidiary of an acquirer, (2) net assets of an acquiree business are merged (legally) into the acquirer entity, or (3) all of the combining companies transfer their net assets to an entity that is newly formed.

Steps in the Acquisition Process

Once a transaction is classified as a business combination, the combination should be accounted for using the acquisition method. The acquisition method involves the following process: (1) the acquirer must be identified, (2) the acquisition date must be determined, (3) the identifiable assets, liabilities, and noncontrolling interest must be recognized and measured, and (4) the amount of goodwill or any bargain purchase gain must be recognized and measured. The acquirer is the entity that gets control of the acquiree.

Step 1: Identify the Acquirer

The provisions of ASC 810 are used to determine which entity in the business combination is the acquirer. For example, when cash or other assets are transferred or liabilities incurred to consummate the business combination, the entity that transfers the assets or incurs the liabilities generally is the acquirer. In addition, when equity interests are exchanged in the business combination, the entity that transfers the equity interest is the acquirer entity. The primary beneficiary is the acquirer entity when the business combination involves a variable interest entity.

Step 2: Identify the Acquisition Date

The second step in the business combination process is to identify the acquisition date. The acquisition date is the date on which control of the acquiree is obtained by the acquirer entity. The acquisition date is generally the closing date of the business combination; in other words the date that consideration is legally transferred and the acquirer entity acquires the assets and assumes the liabilities of the acquiree. The closing date may be before or after the closing date if the acquirer entity obtains control of the acquiree before or after the closing date.

Step 3: Recognize and Measure Assets Acquired, Liabilities Assumed and Noncontrolling Interests

The identifiable assets acquired in a business combination as well as liabilities assumed and any noncontrolling interest in the acquiree must be recognized and measured by the acquirer entity as of the acquisition date. Identifiable assets are those that meet one of the following criteria: (1) the assets can be separated or divided from the enterprise and can be either individually or as a group sold, rented, licensed, etc. (referred to as the "separability" criteria) or (2) the assets are a result of a contract or other legal rights, even if the rights cannot be separated from the entity or from other rights (referred to as the "contractual/legal" criteria). The identifiable assets should be recognized and measured separately from any goodwill in the business combination. Acquired assets and assumed liabilities in a business combination should only be recognized by the acquirer entity on the date of acquisition when they meet the definitions of assets and liabilities in FASB Statement of Financial Accounting Concepts No. 6. Some assets and liabilities acquired and recognized by the acquirer entity in the combination may not have been recognized by the acquiree entity prior to the business combination. For example, some assets may have been developed internally by the acquiree, such as customer relationships, patents, and brand names, and were not reported in the acquiree financial statements prior to the combination. However, such assets are identifiable assets and must be recognized by the acquirer entity. All identifiable assets, including both tangible and intangible assets, should be recognized. Identifiable intangible assets should be reported separately from goodwill in a business combination. Intangible assets, which are assets with no physical substance, are separately identifiable when one of the following criteria is met: (1) contractual/legal or (2) separability. The contractual/legal criterion is described above in the discussion of identifiable assets. An intangible asset meeting the contractual/legal criterion is considered an identifiable asset regardless of whether it can be separated or transferred from the acquiree or from other obligations or rights. An intangible asset meets the separability criterion when it can be separated or divided from the acquiree and can be either individually or as a group sold, rented, licensed, etc., regardless of whether the acquirer entity expects or intends to sell, rent, or license the intangible. In addition, the separability criterion is met when there are exchange transactions for that intangible asset type or similar intangible asset types. ASC 805 divides identifiable intangible assets into different types of intangible assets and provides examples of the different types of identifiable intangibles that may

be acquired in a business combination. Table 8-1 lists types of intangibles, examples of each type and whether the intangible meets the contractual/legal or separability criterion.

Table 8-1 Types and Examples of Identifiable Intangible Assets

Type of Identifiable Intangible	Example	Contractual/Legal or Separable
Market-related	Trademarks, trade dress, service marks, trade names, certification marks, Internet domain names, and noncompetition agreements	Contractual/legal
Customer related	Customer lists, customer contracts, and customer relationships	Contractual/legal
Customer related	Noncontractual customer relationships and order backlogs	Separable
Artistic related	Plays, operas, books, newspapers, musical works, pictures, and video material	Contractual/legal
Contract related	Licensing agreements, royalty agreements, advertising contracts, lease agreements, franchise agreements, employment contracts, and use rights	Contractual/legal
Technology related	Patents, computer software, and trade secrets	Contractual/legal
Technology related	Databases and unpatented technology	Separable

More information about the types and examples of intangible assets is covered in ASC 805. Once an identifiable intangible asset is recognized in a business combination using the provisions of ASC 805, subsequent accounting for the intangible is provided for by ASC 350 and 360.

The acquirer entity should not recognize assets and liabilities of the acquiree as part of the combination if they relate to separate transactions between the acquiree and acquirer entity. Only assets and liabilities acquired as part of the exchange should be recognized as part of the business combination. The acquirer entity should not recognize as part of a business combination costs that the acquirer does not have an obligation to pay on the date of acquisition but expects to pay at some future date. These costs should be reported as liabilities in financial statements subsequent to the date of the combination using generally accepted accounting standards that apply to such costs. Some assets acquired or liabilities assumed in a business combination require the acquirer entity to either classify or designate them on the acquisition date for purposes of future accounting because different accounting may be required depending on the classification or designation of the asset or liability. The acquirer entity should determine the classification or designation using factors existing on the date of acquisition, such

as terms of contracts, economic conditions, accounting and operating policies, and other factors that may be relevant to the situation. Examples of assets and liabilities that require classification or designation include the following: (1) whether investments covered by ASC 320 are divided into either trading, available for sale, or held to maturity; (2) whether derivative instruments in accordance with ASC 815 are designated as hedges; and (3) whether embedded derivatives are separated using the provisions of ASC 815. However, ASC 805 provides an exception to the classification or designation for two items: (1) classification of leases as operating or capital using the provisions of ASC 840 and (2) classification of contracts covered by the provisions of ASC 944. Contracts covered by ASC 944 should be classified by the acquirer entity using the contractual terms and other factors at contract inception. Generally, an asset or liability should not be reported for an operating lease when the acquiree entity is the lessee. However, when the acquiree entity is the lessee or lessor in an operating lease, the acquirer entity should report an intangible asset if the terms of the acquired leases are favorable on the date of acquisition compared to the market terms of leases with items that are similar or the same. When the market terms of the lease are unfavorable as compared to market terms, the acquirer entity should report a liability. In some cases the operating lease terms are equivalent to market terms at the date of acquisition, but the acquirer entity records an intangible asset for the lease, because market participants will pay a price for the lease such as retail space in a prime shopping area.

The identifiable asset acquired, the liabilities assumed, and the noncontrolling interest, if any, in a business combination should be measured by the acquirer entity at their fair values on the date of acquisition. Fair value is the amount that would be received on the measurement date from the sale of property or the amount paid to transfer a liability between seller and buyers (market participants) in an orderly transaction.

Exceptions to Recognition and Measurement Principles

ASC 805 provides for certain exceptions to the recognition and measurement principles discussed above for identifiable assets acquired and liabilities assumed in the business combination. These exceptions include contingent assets and liabilities, income taxes, employee benefit arrangements, and indemnification of assets.

First, assets acquired and liabilities assumed in a business combination that arise from contingencies (as defined in ASC 450) are accounted for using the provisions of ASC 805 rather than the provisions of ASC 450. An asset or liability arising from a contingency is to be recognized at the acquisition date if the acquisition-date fair value can be determined during the measurement period or if both of the following criteria are met: (1) 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 and (2) the amount of the asset or liability can be reasonably estimated. If the acquisition-date fair value of a recognized asset or liability can be determined during the measurement period, the asset or liability is to be measured at its acquisition-date fair value. Otherwise, the recognized asset or liability is to be measured using an estimated

amount. Any asset or liability arising from a contingency that does not meet the recognition criteria at the acquisition date is to be accounted for by the acquirer in periods after the acquisition date in accordance with other applicable GAAP (e.g., ASC 450) as appropriate.

Next, the deferred tax assets, deferred tax liabilities, and tax uncertainties of an acquiree should be recognized and measured on the date of acquisition by the acquirer entity using the provisions of ASC 740.

Another exception relates to employee benefits. Any liabilities or assets related to employee benefit agreements of the acquiree entity should be reported and measured using other appropriate accounting standards. See ASC 805 for examples of other accounting standards that apply to employee benefit agreements.

Another recognition and measurement exception relates to an asset indemnification by the seller in a business combination. An indemnification asset exists when the seller in the business combination contractually indemnifies the acquirer entity against the outcome, for example, of a contingency or uncertainty related to assets and liabilities. For example, the seller may provide a guarantee that the liability of the acquirer entity will not exceed a specified amount. The acquirer entity should report an indemnification asset at the time that the item that is indemnified is reported. In addition, the indemnification asset should be reported using the same measurement process as used for the indemnified item. For example, if the indemnified item is reported at the date of acquisition using fair value on the date of acquisition, the indemnification asset is also reported at fair value on the date of acquisition. In some cases, a valuation allowance may be needed for the uncertainty regarding uncollectible amounts. However, when fair value is used in the measurement of the indemnification asset, uncertainty is included in the fair value measurement and a valuation allowance is not needed. In some cases an indemnification by the seller relates to assets and liabilities that are exceptions to the general recognition and measurement principles specified in ASC 805. In these cases, any recognition and measurement of the indemnification asset should be consistent with recognition and measurement of the indemnified items.

In addition to the exceptions noted above, ASC 805 provides several exceptions related exclusively to the general measurement principle of fair value. These exceptions relate to reacquired rights, share-based payments, and assets held for sale.

A reacquired right is a right that the acquirer entity provides to the acquiree entity, such as the right to use a trade name, that the acquirer entity receives in the business combination. The acquirer entity should recognize the reacquired right as an identifiable intangible asset at fair value. A settlement gain or loss may be reported when the contract terms of the reacquired right are favorable or unfavorable comparable to the current market for such transactions.

The next exception relates to share-based payment awards. When the acquirer entity replaces share-based award payments of the acquiree with share-based award payments of the acquirer entity, a liability should be measured by

the acquirer entity using the method provided in ASC 718. However, ASC 805 provides additional guidelines when accounting for share-based award payments in a business combination.

When an acquirer entity acquires in a business combination long-lived assets that are classified as held for sale by the acquiree entity, the acquirer entity should measure the held for sale assets at fair value less the cost of the sale using the provisions of ASC 360.

Step 4: Determine the Amount of Goodwill

After the acquirer entity measures identifiable assets, liabilities, and any noncontrolling interests, the amount of goodwill or gain from a bargain purchase, if any, should be determined. Goodwill is defined in ASC 350, as an asset acquired in a business combination that has future economic benefit and is a result of acquired assets that could not be separately recognized and identified individually. The amount of goodwill should be reported as of the date of acquisition is the difference between (1) the aggregate fair value of the consideration transferred and (2) the net amount of the assets acquired and liabilities assumed.

The aggregate amount of consideration transferred in the business combination, includes the fair value of any noncontrolling interest plus the fair value of the equity interest in the acquiree held prior to the combination by the acquirer.

The net amount of the identifiable assets or liabilities on the date of acquisition is the difference between the identifiable assets acquired and the liabilities assumed in the business combination measured using ASC 805.

In some cases, a business combination may be consummated by exchanging equity interests, and the equity interest of the acquiree may be a better indicator of the fair value of the equity interest transferred on the date of acquisition than the fair value of the equity interest of the acquirer entity. When this is the case, any goodwill should be determined by using the fair value of the acquiree equity interest. In some cases, no consideration is exchanged in a business combination. When no consideration is exchanged, the acquirer entity should use a valuation technique, as illustrated in ASC 805, to compute goodwill in place of the fair value of the consideration transferred, as indicated above.

If the amount of (2), above, exceeds the amount of (1), above, the acquirer entity has made a bargain purchase and a gain should be reported on the date of acquisition for the amount that (2) exceeds (1). The gain from the bargain purchase is related to the acquirer entity. However, before the gain from the bargain purchase can be reported, the acquirer entity must reevaluate the recognition and measurement process used when determining the following to determine that all items that should be recognized have been recognized and that all items have been measured properly: (1) identifiable assets and liabilities, (2) noncontrolling interest, (3) transferred consideration, and (4) fair value of the equity interest in the acquiree held prior to the combination by the acquirer when the business combination occurs in stages. If the reassessment indicates that no changes should be made, the gain from the bargain purchase should not be

adjusted. However, if changes are indicated the gain should be adjusted for any required changes.

This completes the general discussion of business combinations; however, several additional issues require discussion: (1) form of consideration transferred in a business combination, (2) achievement of a combination without the transfer of consideration, (3) measurement period for the business combination, (4) business combination achieved in stages, (5) transactions that are not part of the business combination, and (6) accounting subsequent to the date of the business combination.

Form of Consideration Transferred

Consideration transferred by the acquirer entity may consist of many forms, such as cash, other types of assets, equity instruments, options, warrants, contingent consideration, a business of the acquirer, or other consideration. When there is a difference in the carrying amounts and fair values of the assets or liabilities of the acquirer entity transferred as consideration in a business combination, the acquirer entity should report a gain or loss in income for such differences, unless the acquirer entity has control of the assets or liabilities before and after the business combination. Therefore, any assets or liabilities that the acquirer entity controls before and after the combination should be measured at the carrying amounts just before the combination and no gain or loss is reported. When contingent consideration is transferred by the acquirer entity in the combination, the contingent consideration should be reported at fair value for purposes of determining the amount of consideration transferred in the combination. When there is an obligation to pay contingent consideration, the acquirer entity should use the provisions of appropriate accounting standards to determine whether the obligation should be classified as debt or equity.

Achieving a Business Combination without Transferring Consideration

In some cases, a business combination may be achieved without the acquirer entity transferring consideration to the acquiree. Examples of situations where no consideration is required to achieve a business combination follow: (1) the acquirer entity and the acquiree entity enter into a contract to combine their businesses, (2) the acquiree repurchases its own shares that allow the acquirer, which is an existing investor, to gain control of the acquiree entity, or (3) the acquirer entity gains control as a result of the lapse of minority veto rights. When a business combination is achieved by entering into a contract and the acquirer entity holds no equity interest before or after the acquisition, the net assets of the acquiree, using the provisions of ASC 805, should be attributed to the acquiree equity holders (the noncontrolling interest).

Measurement Period

The measurement period is the time period after the date of acquisition that the acquirer entity has to obtain the necessary information to adjust any provisional amounts reported for the business combination and to record any additional assets or liabilities based on facts that existed at the date of acquisition. However, the time period should not be greater than one year from the date of

acquisition. All pertinent information should be used to determine whether the information acquired after the date of acquisition results from events that occurred after the acquisition date and would not require an adjustment to any provisional amounts reported or whether the information relates to events on the acquisition date that require an adjustment to provisional amounts reported. When additional information is obtained during the measurement period that requires an adjustment to any provisional amounts, increases or decreases in assets or liabilities should be reported as an increase or decrease in goodwill. Adjustments to provisional amounts as a result of additional information should be reported as if the combination had been completed on the date of acquisition. Any changes in provisional amounts after the end of the measurement period should only be made to correct an error. The provisions of ASC 250 should be used for any error correction.

Acquisition in Stages

When an acquirer entity holds an equity interest in an acquiree prior to the acquisition date and on the acquisition date purchases additional equity interest that provides control to the acquirer entity, the business combination is assumed to have occurred in stages. For example, prior to January 1, 20X8, XYZ Company holds a 45% interest in the equity of ABC Company. On January 1, 20X8, XYZ purchases an additional 50% interest in the equity of ABC. XYZ Company now holds a 95% interest in ABC and is assumed to control ABC. ASC 805 states that when an acquirer entity acquires another entity in stages, the equity interest held prior to the acquisition date must be revalued to fair value on the acquisition date and any gain or loss from the revaluation should be reported as part of income. When an equity interest is revalued to acquisition-date fair value, any unrealized gain or losses included in other comprehensive income in prior accounting periods should be included in the computation of the gain or loss on the revaluation on the date of acquisition.

Transactions That Are Not Part of a Business Combination

Some transactions may appear to relate to the business combination but are actually part of a preexisting relationship prior to the beginning of negotiations for the business combination. An acquirer entity must determine which amounts relate to the preexisting relationship and which actually relate to the business combination. Only the amounts exchanged between the acquirer entity and the acquiree in the business combination for the acquisition of the acquiree entity should be treated as consideration transferred for the acquiree. Other transactions should be treated as separate transactions and accounted for using other appropriate accounting principles. A separate transaction is likely to be one that is entered into for the benefit of the acquirer entity or the combined entity as opposed to a transaction entered into for the benefit of the acquiree or the former owners of the acquiree. Examples of separate transactions include the following: (1) transactions that result in the settlement of a relationship between the acquirer entity and the acquiree that existed prior to the business combination, (2) transactions that provide payments to former owners or employees of the acquiree entity for future services, and (3) reimbursements to the former owners