Asset Acquisition Accounting

Understanding the Available Guidance

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A business combination is a transaction or event by which an acquirer obtains control of a business (i.e., the acquiree). If the acquisition of an asset or asset group (including liabilities assumed) does not constitute a business, however, the transaction is no longer a business combination and the acquirer accounts for it as an "asset acquisition." An asset acquisition transaction uses a cost accumulation model, whereas a business combination within the scope of ASC 805, "Business Combinations," uses a fair value model.

The key consideration when classifying a transaction as an asset acquisition or a business combination is the definition of a business. In January 2017, FASB issued Accounting Standards Update (ASU) 2017-01, *Clarifying the Definition of a Business*. This ASU provides a new framework for determining whether a transaction is an asset acquisition or a business combination transaction.

This article provides insights and technical guidance on the accounting implications of asset acquisition transactions. The accounting framework of asset acquisition transactions is currently enmeshed with business combinations; thus in many instances, management needs to make accounting policy decisions by analogy to business combination guidance.

Latest Developments

FASB currently has a project on its agenda to better align the accounting for asset acquisition transactions with business combination transactions. FASB has approached this project in three phases, and it has issued two ASUs addressing the first two phases of the project discussed in detail below:

- Phase 1—ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*
- Phase 2—ASU 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*

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(Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets

- Phase 3—Deliberation of whether any differences between the asset acquisitions and business combinations could be aligned.

In May 2021, FASB continued its deliberations on the accounting for contingent consideration at the acquisition date for both business combinations and asset acquisitions, but it has not yet reached any decision as of the date of this article.

FASB directed its staff to bring the following issues to its future meetings:

- The initial and subsequent accounting for contingent consideration in a business combination (including a summary and analysis of outreach with private company stakeholders)
- The initial and subsequent accounting for contingent consideration in an asset acquisition, including additional analysis on what is included and excluded from the scope of that guidance (including a summary and analysis of outreach with private company stakeholders)
- The interaction with the derivatives and other financial instruments guidance.

FASB's definition of business. In January 2017, FASB issued ASU 2017-01, which has created a new framework that companies must use to evaluate whether an integrated set of assets and activities is a business and should be accounted for as a business acquisition. FASB defines a business as a set of activities and assets that include an input and a substantive process; however, the fair value of the set is not usually concentrated in single or multiple assets. This set of inputs and processes usually provides goods and services to customers and return to stakeholders (ASC 805-10-55-3A and ASC 805-10-55-4). The new guidance requires an initial screening test to determine if substantially all of the fair value of the assets acquired is concentrated in one asset or a group of similar assets.

The initial test starts with Step 1 to determine that the acquired 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 acquired set is not a business, and the transaction should be accounted for as an asset acquisition.

If the acquirer fails Step 1, the acquirer proceeds to Step 2. At this stage, it evaluates whether an input and substantive process exists (ASC 805-10-55-5 through 55-9). ASC 805-10-55-3A defines a business "as 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 cost, or other economic benefits directly to investors or other owners, members, or participants." Thus, a business needs to have an input and a substantive process that together contribute to its ability to create output.

Even though ASU 2017-01 has changed the framework for application of asset purchase accounting, it has left the basic principles of the standard intact.

SEC's definition of business. FASB's revised definition of business offers a different vantage point from the SEC's definition of business, and it is not meant to encroach the SEC's definition of business based on Article 11 of Regulation S-X. The SEC never aligned its definition of business with FASB's definition, and it did not change it to comply with ASU 2017-01. Registrants use the SEC's definition to determine when they need to prepare financial statements and pro forma information in their SEC filings subsequent to a significant acquisition.

The SEC's Division of Corporate Finance notes that companies may treat a transaction as an asset acquisition based on FASB's guidance, but as an acquisition of business under Regulation S-X, Rule 11-01(d), and vice versa. The SEC's definition of business aims primarily to determine whether the nature of the revenue-producing activity has generally remained the same after acquisition. This article focuses on FASB's definition of business based on ASU 2017-01.

Derecognition of Nonfinancial Assets

In February 2017, FASB issued ASU 2017-05, which clarifies FASB's guidance on nonfinancial asset sales. In an asset acquisition where consideration consists of nonfinancial assets (e.g., intangible assets, lands, buildings) and in-substance nonfinancial assets (e.g., accounts receivable), companies need to determine whether the transaction is within the scope of ASC 610-20, "Other Income, Gains and Losses from Derecognition of Nonfinancial Assets," or ASC 845, "Nonmonetary Transactions."

Most asset acquisitions involve exchanging cash or other monetary assets for nonmonetary assets. In some asset acquisition transactions, however, the consideration given consists of nonfinancial assets or nonmonetary assets. If an entity has exchanged noncash assets in an asset acquisition and the transaction is not within the scope of ASC 610-20, the entity should consider whether the transaction is a nonmonetary exchange within the scope of ASC 845.

The provisions of ASC 610-20 are similar to ASC 606, "Revenue from Contracts with Customers." ASC 610-20 requires that the assets acquired should be treated as noncash consideration and any gains or losses should be recognized accordingly, similar to the provisions of ASC 606. Thus, an entity would apply the guidance in ASC 606-10-25-6 through 25-8 if an arrangement fails to meet the criteria in ASC 606-10-25-1 for determining the existence of a contract.

ASC 845 requires that, in nonmon-

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etary exchanges, the acquiring entity derecognizes the assets that it has surrendered and recognizes the value of nonmonetary assets it has acquired, using the fair value of assets it has relinquished (unless the fair value of the assets acquired is more evident than the fair value of the assets surrendered).

ASU 2017-05 amended ASC 610-20 to clarify that it does not apply to nonmonetary transactions within the scope of ASC 845. It remains challenging, however, to determine whether a transaction is within the scope of ASC 610-20 or ASC 845, and ASU 2017-05 fails to provide a clear guidance. Thus, diversity in practice in application of ASC 610-20 or ASC 845 for nonmonetary transactions shall persist.

Asset Acquisition Transactions

The fundamental premise of accounting for an asset acquisition transaction differs from the principles that apply to a business combination transaction. The acquirer in a business combination measures assets and liabilities at fair value, whereas in an asset acquisition, the acquirer accounts for them based on the cost accumulation and allocation method, albeit with a few limited exceptions. Furthermore, there are several other differences in the application of these two methods that are documented and scattered throughout the accounting literature. The discussion below highlights some of the main differences based on Subtopic 805-50 guidance.

Acquisition Considerations

Transaction costs. The transaction costs (e.g., legal and advisory fees) are included in the cost of acquisition in an asset acquisition transaction. ASC 805-50-30-1 states that "assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets' carrying amounts on the acquiring entity's books." Thus, acquisition-related costs in an asset acquisition are part of the cost of the acquisition, and the acquirer capitalizes them as a component of the acquired assets (ASC 805-50-30-1), whereas in a business combination such costs are expensed as incurred (ASC 805-10-25-23).

Contingent considerations. Contingent considerations are conditions, situations, or circumstances about a possible gain or loss that depends upon the occurrence of a future event. In asset acquisition transactions, the acquirer recognizes contingent considerations if they are probable and estimable, whereas in business combinations the acquirer recognizes them based on their fair values.

Contingent obligations of an acquirer could comprise the transfer of additional assets or equity interests to the former owners if a certain event occurs (ASC 805-10-20). In an asset acquisition, if the contingent transaction is a derivative, the acquirer recognizes it at fair value based on Topic 815, "Derivatives and Hedging" (many equity-settled arrangements are within the scope of this topic); otherwise, the acquirer recognizes the contingency based on Topic 450, "Contingencies," if it is probable and estimable.

Contingencies in an asset acquisition are usually accounted for based on ASC 450-20-25-2. The acquirer initially recognizes any loss contingency as long it is probable and can be reasonably estimated, and any subsequent changes to estimates are reflected in earnings. But the acquirer does not recognize any gain contingency until it is realized. If a contingency gain or loss exists, but the acquirer cannot recognize it at the date of the transaction for any reason, it still allocates the cost of transaction to assets that it has acquired; as a result, certain assets may have an allocation that is higher or lower than their fair values.

In a business combination, on the other hand, the acquirer recognizes contingent considerations at fair value and classifies them as a liability, asset, or equity on the acquisition date (ASC 805-30-25-5). In subsequent periods, any changes in the fair value of the recognized contingent assets and liabilities (excluding equity considerations) are reflected in earnings.

Goodwill and Bargain Purchase Price

ASC 805-50-30-3 states that "the cost of a group assets acquired in an asset acquisition shall be allocated to the individual assets acquired or liabilities assumed based on their relative fair values and shall not rise to goodwill." In asset acquisition transactions, the acquirer does not recognize any goodwill (excess purchase price), because goodwill is by definition the expected synergies and other benefits that occur in a business combination, and an asset acquisition is not a business merger.

Thus, the acquirer allocates any implied goodwill in an asset acquisition to the value of the assets acquired; however, it excludes liabilities from this allocation because liabilities are in fact a component of the assets acquired. Furthermore, any implied goodwill is usually allocated only to nonfinancial assets because any allocation of it to financial assets may result in an immediate impairment subsequent to an asset acquisition transaction. In this allocation process, the acquirer needs to ensure that it has recognized all of the assets before allocating the excess cost to nonfinancial assets acquired. This allocation method may result in certain nonfinancial assets bases to be greater than their respective fair values.

There are instances in an asset acquisition transaction that the fair value of the assets acquired exceeds the purchase consideration. In such

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circumstances, the acquirer does not recognize any bargain purchase gain or negative goodwill (similar to the earlier argument that the acquirer does not recognize any goodwill). The acquirer follows goodwill allocation process for allocation of any negative goodwill or bargain purchase gain. In this case, it would be appropriate to allocate the negative goodwill to both financial and nonfinancial assets, because this allocation reduces the balance of such assets and does not expose them to any post-acquisition impairment.

A business combination by contrast is predominantly based on a fair value model (with certain exceptions). In such transactions, the acquirer recognizes goodwill or bargain purchase price (negative goodwill) as the difference between the sums of the consideration transferred and the identifiable assets acquired and liabilities assumed.

Measurement Period

An acquirer in a business combination has a measurement period to identify and measure the fair value of the assets and liabilities in a business combination. The measurement period ends when the acquirer has all the information that it has arranged to obtain or that is known to be obtainable (ASC 805-10-25-13 thru 25-19). Because an asset acquisition transaction uses a cost accumulation method instead of fair value, it does not have the concept of a measurement period; therefore, all assets and liabilities must be measured by the next reporting cycle.

Leases

In a business combination, acquirers assume the carry over basis of an acquiree's lease classification (i.e., operating leases, capital and finance leases) unless the contract has been significantly modified (ASC 805-20-25-8 and ASC 840-10-25-27). ASC 805-50 does not specifically address the reclassification of leases in an asset acquisition. Therefore, an acquirer in an asset acquisition can follow the guidance in the business combination standard by analogy.

As an alternative, the acquirer in an asset acquisition can argue that any lease acquisition in reality is a sublease based on ASC 840-10-25-32. If so, the acquirer can reclassify the lease as an operating and finance lease under ASC 842-10-25-2 subsequent to acquisition. Such a reclassification may change the amount of right-of-use (ROU) or lease liability that acquirees had reflected in their books prior to asset acquisition; most likely, it will also impact the future years' expenditures.

Intangible Assets

Intangible assets, unlike financial assets, lack physical substance. They meet the following two criteria:

- Identifiability (i.e., they arise from contractual or other legal rights).
- Separability (i.e., the acquirer can separate them from the acquisition and sell, transfer, license, rent, or exchange them).

FASB follows different trajectories for the recognition of intangible assets in asset acquisitions versus business combination transactions. FASB generally holds a lower threshold for recognition of intangible assets in asset acquisition transactions. Nevertheless, the recognition criteria for intangible assets in asset acquisition and business combination transactions remain inextricably linked; management often determines the treatment of intangible assets in asset acquisitions by analogy and with reference to business combination guidance.

An acquirer recognizes intangible assets in an asset acquisition transaction if they meet the asset recognition criteria under FASB Concepts Statement 5. But in business combinations, an acquirer recognizes the intangible assets at fair value if they are identifiable and separable.

Assembled Workforce

An assembled workforce is a collection of employees that exist prior to acquisition and enables the acquirer to operate its business operation subsequent to acquisition without any interruption (ASC 805-20-55-6). An acquirer in an asset acquisition does not recognize an assembled workforce, because an assembled workforce by definition assumes that a substantive process (or business) is in place under ASC 805-10-55-3A.

An acquirer in a business combination does not recognize assembled workforce as an intangible asset either, because an assembled workforce is neither an identifiable nor a separable asset to meet the intangible assets recognition criteria in business combinations.

There is a divergence in practice, however, and some nonauthoritative accounting literature have considered an assembled workforce to be an intangible asset because it meets the asset recognition criteria in FASB Concepts Statement 5. Nevertheless, this author takes the position that an assembled workforce is not an intangible asset due to the reasons stated above.

Customer List

A customer list contains contact and other information about a number of identifiable customers. Because customer lists may be sold and leased independently, they meet the identifiability and separability criteria; however, separability criterion is not met if the acquirer is contractually prohibited to lease or otherwise exchange the customer information.

As a result, an acquirer in a business combination can potentially recognize a customer list as an intangible asset. Customer lists generally have a relatively low fair value and short lives due to their nature.

It can also be argued that an acquirer in an asset acquisition can recognize a customer list as an intangible asset

because the existence of a customer list per se does not necessarily imply that a process or business exists.

IPR&D

In-Process Research and Development (IPR&D) is an intangible asset used in research and development activities. The acquirer in a business combination measures IPR&D at fair value using market participation assumptions and capitalizes them as indefinite-lived assets and amortizes them (or impairs them if needed) in the future depending on its ability to use the IPR&D during the post–business combination period.

In an asset acquisition, on the other hand, the acquirer expenses the acquired IPR&D if it has no alternative future use. If the acquirer has purchased the IPR&D and has determined that it has future alternative use, however, it should account for it as an intangible asset in an asset acquisition transaction [ASC 730-10-25-2(c)].

Deferred Tax Assets and Liabilities

An acquirer in business combinations recognizes deferred tax assets and liabilities (DTA, DTL) for temporary differences between financial and tax accounting in accordance with ASC 740. An asset acquisition, however, does not recognize any goodwill; thus, it uses the gross-up approach method for the calculation of DTAs or DTLs (ASC 740-10-25-49 through 25-55) for temporary differences between financial and tax accounting. Under the gross-up approach (unlike the income statement approach), the acquirer does not recognize any DTAs or DTLs in earnings immediately; rather, it records them as an adjustment to the carrying value of the property. The acquirer uses a simultaneous equations method to calculate the final book basis of the acquired assets, DTAs, and DTLs (ASC 740-10-25-52 and ASC 740-10-55-171 through 55-182).

Settlement of Preexisting Arrangements

An acquirer in a business combination measures any noncontractual arrangements at fair value as of the acquisition date, whereas it measures contractual arrangements at the lesser of the following amounts (ASC 805-10-55-21):

The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with current market 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.

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 above, the difference is included as part of the business combination accounting.

Because FASB does not have any guidance on how to account for the settlement of any preexisting arrangements in asset acquisition transactions, the acquirer should use consistent judgment and apply the business combinations guidance by analogy to record any preexisting arrangements in asset acquisition transactions.

Contract Assets and Contract Liabilities

In October 2021, FASB issued ASU 2021-08, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*, which amends ASC 805 and requires that an acquirer apply ASC 606 to measure and recognize contract assets and contract liabilities in a business combination. Thus, as a result of this standard, an acquirer generally measures and recognizes acquired contract assets and contract liabilities consistent with how an acquiree recognized and measured them in the first place in its preacquisition reporting.

In asset acquisition transactions, an acquirer uses judgment and apply the business combination guidance by analogy to record any contracts assets and contract liabilities.

More Clarity Needed

This article juxtaposed the prevailing guidance on asset acquisition and business combination transactions and explicated the pervading differences that exist between the two types of transactions. ASU 2017-01 has significantly clarified the definition of business, and ASU 2017-05 has clarified FASB's guidance on the derecognition of nonfinancial assets, but this is not to say that all issues have been resolved.

Currently, there is scant guidance for companies to follow when accounting for asset acquisition transactions; the profession needs clearer guidance on how to coalesce asset acquisition and business combination transactions. Asset acquisition now is an orphan of the business combination standard, and practitioners often exercise significant judgment to draw certain guidance by analogy from the business combination standard to account for asset acquisition transactions.

In response to this issue, FASB currently has initiated a project to better align the accounting for asset acquisition transactions with business combination transactions. This project constitutes another phase of FASB's "definition of a business" project and underscores the existing polemic nature of asset acquisition transactions. ■

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