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From reaching new geographic markets to expanding product offerings, mergers, acquisitions, and other types of business combinations offer many benefits to the parties involved. However, the initial accounting for the business combination can be complicated and often requires extensive time and effort.

The authoritative accounting and reporting guidance for business combinations under US GAAP is included in Topic 805, Business Combinations, of the FASB Accounting Standards Codification. Here, we take a high-level look at this guidance.

Understanding the scope

A business combination is a transaction in which an acquirer gains control over a business. To determine if a business combination has happened, an acquirer must first evaluate whether it has acquired a business or a group of assets. The distinction is critical because the accounting treatment is very different based on the determination.

Under US GAAP, a business is defined as a set of activities and assets that both is self-sustaining and is managed to provide a return to investors. A business generally has three elements: inputs, processes, and outputs, but it does not have to include outputs. ASU No. 2017-01 revises the definition of a business, which may change whether a transaction is a business combination.

If an entity acquires assets and liabilities that do not meet the definition of a business, the transaction is not a business combination; instead, the entity accounts for the transaction as an asset acquisition under Subtopic 805-50, Business

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acquisition transaction. An acquirer might obtain control, however, without transferring any consideration. In some cases, identifying the acquirer requires a lot of judgment.

2. Determine the acquisition date.

The acquisition date is the date on which the acquirer obtains control of the acquiree and the measurement date for recording the assets acquired and liabilities assumed in the transaction. During the measurement period, an acquirer may be allowed to adjust its initial accounting for the business combination. The measurement period exists to give an acquirer enough time to gather the information necessary to account for the business combination. The measurement period may extend for a maximum of one year from the acquisition date.

Improper application of the guidance on the measurement period is a common cause of errors and misstatements in an acquirer's financial statements. Some frequent pitfalls in applying this guidance are:

- Presuming that the measurement period lasts for a full 12 months. Twelve months is the maximum time that the measurement period can remain open. The measurement period ends when the acquirer obtains the information necessary to evaluate the conditions that existed as of the acquisition date;
- Failing to provide the required disclosures indicating the provisional items outstanding. If this happens, an acquirer cannot record an adjustment to goodwill; instead, the adjustment is recognized through earnings;
- Recording corrections of errors or events happening after the acquisition date as measurement period adjustments.

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acquiree's net assets, even when other parties retain a noncontrolling interest.

The general measurement principle for business combinations is that all assets acquired and liabilities assumed must be measured at fair value as of the acquisition date. Fair value is the price an entity would receive to sell an asset (or pay to transfer a liability) in a transaction that is orderly, takes place between market participants, and occurs at the acquisition date.

In practice, entities often use a market approach (such as a quoted market price) or an income approach (such as a present value technique). Regardless of the approach selected, an acquirer must maximize the use of observable inputs and minimize the use of unobservable inputs. Also, an acquirer must be careful to use assumptions consistent with those that a market participant would use.

4. Recognize and measure any goodwill or gain from a bargain purchase.

Goodwill is defined as the future economic benefits arising from the other assets purchased in a business combination that are not identified and recognized separately. The amount of goodwill is determined using the fair value of the consideration transferred. The basic formula to calculate goodwill is adjusted if a business combination has no consideration or if the business combination is achieved in stages.

If the calculation of goodwill results in a negative balance, the transaction might be a bargain purchase. In a bargain purchase, the acquirer essentially buys the net assets of the acquiree at a discount. Bargain purchases are rare, but they do occasionally arise. For instance, a bargain purchase might happen if the acquiree is under financial distress and must sell its business to survive.

Goodwill is not amortized but is subject to impairment testing. Topic 350 provides

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other relevant GAAP for the item (such as Topic 470, Debt, for debt obligations or Topic 330, Inventory, for inventory).

Providing disclosure

Each business combination is unique, and therefore, a reporting entity's overall objective is to provide disclosures about the nature and financial effects of business combinations. Disclosures are required for business combinations that happen both during the reporting period and after the end of the reporting period, but before the financial statements are issued or available to be issued.

All material business combinations must be disclosed separately. If business combinations are immaterial on an individual basis, but material on a collective basis, disclosures may be provided in the aggregate. An acquirer also must provide disclosures about adjustments recognized during the period that relate to business combinations that happened either in the current or prior reporting period (such as measurement period adjustments).

Staying informed

And in-depth understanding of the accounting and reporting requirements of mergers, acquisitions, and other types of business combinations is critical in applying the guidance appropriately. While this article provides a high-level overview, you can find more detailed information in our free special report, *Accounting and Reporting for Business Combinations*.

For more information about Checkpoint Catalyst: US GAAP, go to tax.tr.com/checkpoint-catalyst-us-gaap.

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