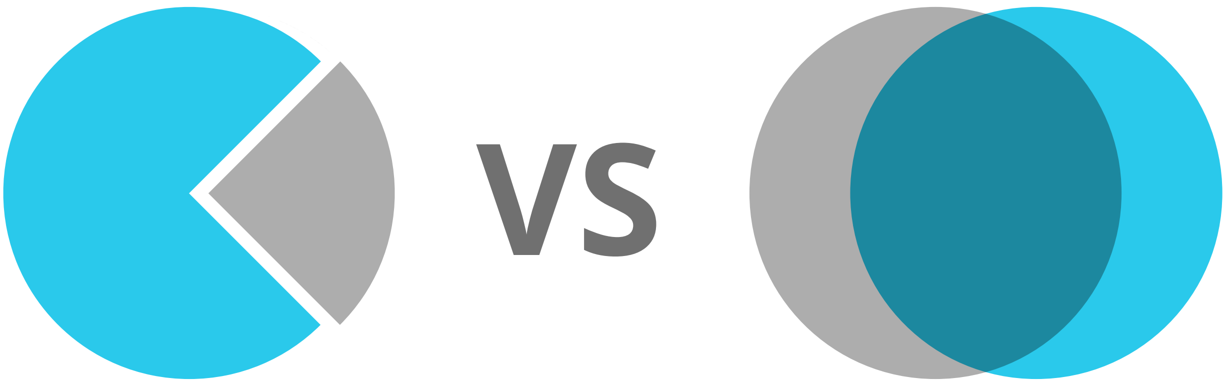

ASSET ACQUISITION VERSUS BUSINESS COMBINATION WHAT IS THE DIFFERENCE?

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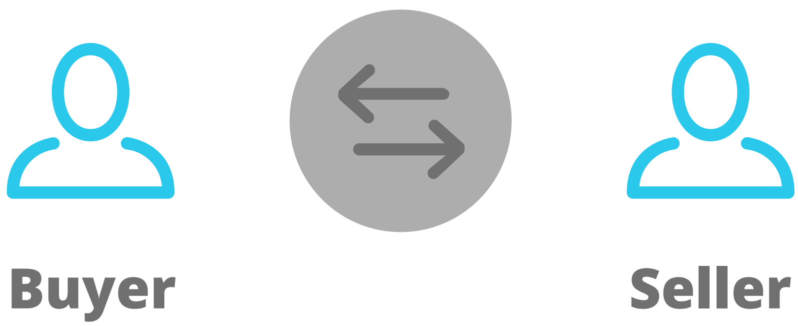
OVERVIEW

When buyers and sellers are negotiating a transaction, one of the key decisions for a buyer to make is whether to purchase a group of the target's assets or its actual business. This decision will impact the buyer's accounting treatment of the transaction and its respective financial statements.

Financial Accounting Standard Board's ("FASB") Accounting Standards Codification Topic 805 ("ASC 805"), Business Combinations, provides an entity with the criteria to evaluate whether a transaction will meet the definition of an asset acquisition versus a business combination and outlines the appropriate guidance to account for the transaction. Furthermore, ASC 805 provides valuation professionals with a framework to identify and to value the net assets acquired based on whether the transaction qualifies as an asset acquisition or a business combination.



DETERMINING IF A TRANSACTION QUALIFIES AS AN ASSET ACQUISITION OR A BUSINESS COMBINATION

Asset Acquisition
The term asset acquisition represents an acquisition of an asset or a group of assets, and the assumption of liabilities that do not meet the U.S. GAAP definition of a business. In January 2017, the FASB issued ASU 2017-01, Clarifying the Definition of a Business, which changed the broader definition of a business as previously outlined under ASC 805 because it often resulted in more entities accounting for transactions as business combinations rather than asset acquisitions.

ASC 805-10-55-4 previously defined three key elements inherent in a business that represent an integrated set of activities as follows: inputs, processes, and outputs (collectively referred to as a set). Below, we briefly define these three elements:

- **Inputs** – Economic resources that create, or have the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (such as buildings or machinery), intangible assets (such as patents, trademarks, or other intellectual property), the ability to obtain access to necessary material or rights, and employees.

- **Processes** – Systems, standards, protocols, conventions, or rules that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes.

- **Outputs** – The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Under the old ASC 805 guidance, to qualify as a business, a set of activities and assets were required to have only inputs and processes, which together were or would be used to create outputs. Furthermore, the FASB indicated that outputs do not need to be present at the acquisition date for a set of activities and assets to be a business.

The new ASC 805 guidance as described in ASC 805-10-55-5A through 5C introduces a screen for determining when a set of activities and assets does not constitute a business. FASB requires that an entity first evaluate whether 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. If this screen is met, then the set is not a business.

For a transaction where the screen is met and the set does not represent a business, the acquiring entity will account for the transaction as an asset acquisition and utilize a cost accumulation model in accordance with the guidance under ASC 805-50.

For a transaction where the screen is not met, the FASB requires that an entity evaluate whether the set meets the definition of a business. Under the new ASC 805 guidance, a set is considered a business if at a minimum it includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Business Combination
Under ASC 805-10, an entity must determine whether a transaction meets the definition of a business combination, which requires that the net assets acquired meet the definition of a business. A business combination represents a transaction in which an acquirer gains control for one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also represent business combinations.

A business combination typically occurs when an acquiring entity purchases the net assets or equity interests of a business in exchange for cash, equity interests of the acquiring entity, or other consideration. We note that a business combination could also occur without the transfer of consideration. If the transaction meets the definition of a business combination and therefore a business, the FASB requires an entity to account for the transaction as a business combination and apply the acquisition method in accordance with the guidance under ASC 805-10.

SUMMARY OF SIGNIFICANT DIFFERENCES BETWEEN ACCOUNTING FOR AN ASSET ACQUISITION AND A BUSINESS COMBINATION

The table below provides a summary of the significant differences between accounting for an asset acquisition and a business combination:

	Asset Acquisition	Business Combination
Scope	Acquisition of an asset (or group of assets) and liabilities that do not meet the definition of a business under ASC 805-10.	Acquisition of a business as defined under ASC 805 - 10
General Methodology	Cost accumulation model: The cost of the acquisition (purchase price) includes certain transaction costs and is generally allocated to the assets acquired on the basis of relative fair values.	Acquisition method: Utilizes a fair value model where the assets acquired and liabilities assumed are generally measured at their fair values.
Contingent Consideration	Recognized at fair value under ASC 815 if the consideration represents a derivative. Otherwise, the consideration is generally recognized when it becomes probable and reasonably estimable.	Recognized at fair value at the acquisition date and is subject to subsequent periodic remeasurement.
Transaction Costs	Capitalized as part of the purchase price.	Expensed as incurred.
Intangible Assets	Recognized on the basis of relative fair value if the intangible assets meet the asset recognition criteria in FASB Concepts Statement No. 5.	Recognized at fair value if the intangible assets meet the contractual-legal criterion or the separability criterion as identifiable intangible assets.
In-Process Research and Development (IPR&D)	Amounts allocated to IPR&D on a relative fair value basis at the acquisition date are expensed unless they have an alternative future use.	Measured at fair value and recognized as an indefinite-lived asset until completion or abandonment of the project. At that point, the IPR&D is reclassified as a finite-lived intangible asset and amortized.

	Asset Acquisition	Business Combination
Assembled Workforce	Recognized as an intangible asset because it meets the asset recognition criteria in FASB Concepts Statement No. 5.	Not recognized as an intangible asset since it is subsumed into goodwill.
Goodwill	Not recognized. Any excess of the cost of the acquisition over the fair value of the net assets acquired is allocated to certain acquired assets on the basis of relative fair values.	Recognized. Any excess consideration transferred over the fair value of the net assets acquired represents goodwill and is recognized as a separate asset.
Bargain Purchase Gain	Not recognized in earnings. Instead, any excess of the fair value of the net assets acquired over the cost of the acquisition is generally allocated to certain assets on the basis of relative fair values.	Recognized as a bargain purchase gain on the acquisition date immediately in earnings.
Measurement Period	No measurement period.	In accordance with ASC 805-10-25-13 through 14, the acquirer reports provisional amounts for the fair values of the assets acquired and liabilities assumed at the acquisition date and may adjust these provisional amounts during the measurement period, which is defined as up to one year from the acquisition date.

In the sections below, we present examples of how the accounting treatment differs between an asset acquisition and a business combination at the acquisition date.

EXAMPLE OF ACCOUNTING FOR AN ASSET ACQUISITION

Company ABC ("ABC") acquires a group of assets from Company XYZ ("XYZ"). These assets include cash with a fair value of $10,000, inventory with a fair value of $30,000, machinery and equipment with a fair value of $100,000, developed technology with a fair value of $400,000, and a trade name that represents an indefinite-lived intangible asset with a fair value of $300,000. The total cost of the acquisition, including transaction costs is $1,000,000. ABC has determined that the assets do not classify as a business and the transaction represents an asset acquisition. As such, ABC allocates the cost at the acquisition date as follows:

Allocation Summary - Asset Acquisition

In USD		Fair Value	Relative Percentage of Fair Value (2)	Cost of the Acquisition (3)	Allocated Cost
Cash	(1)	$10,000			$10,000
Inventory	(1)	30,000			30,000
Machinery and Equipment		100,000	20.0%	660,000	132,000
Developed Technology		400,000	80.0%	660,000	528,000
Trade Name	(1)	300,000			300,000
Totals		**$840,000**	**100.0%**		**$1,000,000**

Notes:

(1) The financial assets cash and inventory continue to be recognized at their respective fair values and cannot be recognized at amounts that exceed their fair value. As such, these assets are ineligible for pro-rata allocation. Additionally, although the trade name represents a nonfinancial asset, it is ineligible for pro-rata allocation since it represents an indefinite-lived intangible asset.

(2) These percentages are calculated based on the nonfinancial assets eligible for pro-rata allocation, which represent machinery and equipment and developed technology.

(3) Represents the excess cost of the acquisition over the fair value of the ineligible acquired assets to be allocated.
This calculation is based on the total cost of the acquisition of $1,000,000 less $340,000, which represents the total fair value of the ineligible assets (cash, inventory, and trade name).

EXAMPLE OF ACCOUNTING FOR A BUSINESS COMBINATION

ABC acquires XYZ in a business combination. The total purchase price of $1,000,000 represents $500,000 in cash, $470,000 in outstanding debt, and $30,000 in buyer transaction costs. The assets acquired include cash with a fair value of $10,000, inventory with a fair value of $30,000, machinery and equipment with a fair value of $100,000, developed technology with a fair value of $400,000, a trade name that represents an indefinite-lived intangible asset with a fair value of $300,000, and an assembled workforce with a fair value of $50,000. Additionally, ABC assumed some current liabilities representing accounts payable of $15,000. ABC has determined that the transaction qualifies as a business and allocates the purchase price to the acquired net assets based on the acquisition method as follows:

Allocation Summary - Business Combination

In USD		Fair Value	% of Consideration
Current Assets	(1)	$40,000	4.1%
Current Liabilities	(1)	15,000	1.5%
Net Working Capital		25,000	2.6%
Machinery and Equipment		100,000	10.3%
Total Tangible Asset Allocation		**$125,000**	**12.9%**
Developed Technology		400,000	41.2%
Trade Name		300,000	30.9%
Total Identifiable Intangible Assets		**$700,000**	**72.2%**
Assembled Workforce	(2)	50,000	5.2%
Goodwill (Excluding Assembled Workforce)		95,000	9.8%
Total Economic Goodwill		**$145,000**	**14.9%**
Total Purchase Consideration Allocated	(3)	**$970,000**	**100.0%**

Notes:

(1) Current Assets represent cash and inventory, and current liabilities represent accounts payable.

(2) Represents the fair value of the assembled workforce that is subsumed within total economic goodwill.

(3) Represents the total purchase consideration to be allocated to the net assets.
Purchase consideration includes cash of $500,000 and oustanding debt of $470,000.
Since this transaction is accounted for as a business combination, under ASC 805-10-25-23, the purchase consideration of $970,000 excludes buyer transaction costs of $30,000.

CONCLUSION

We hope the examples presented above assist you as a starting point, when you are contemplating a transaction, to carefully consider the accounting impacts to your financial statements and any possible tax implications. We suggest conferring with both your auditors and tax advisors before deciding whether to purchase either a group of the target's assets or its business. After you make this important decision, Scalar is happy to assist you with the next steps of allocating the purchase price paid and valuing the assets acquired and liabilities assumed.