

Interpretive Response: In accordance with Statement 141, the acquiring company should allocate the cost of an acquired company to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. With respect to contingencies for which a fair value is not determinable at the date of acquisition, the guidance of Statement 5 and Interpretation 14 should be applied. If the registrant is awaiting additional information that it has arranged to obtain for the measurement of a contingency during the allocation period specified by Statement 141, the staff believes that the registrant should disclose that the purchase price allocation is preliminary. In that circumstance, the registrant should describe the nature of the contingency and furnish other available information that will enable a reader to understand its potential effects on the final allocation and on post-acquisition operating results. Management's Discussion and Analysis should include appropriate disclosure regarding any unrecognized preacquisition contingency and its reasonably likely effects on operating results, liquidity, and financial condition.

The staff believes that the allocation period should not extend beyond the minimum reasonable period necessary to gather the information that the registrant has arranged to obtain for purposes of the estimate. Since an allocation period usually should not exceed one year, registrants believing that they will require a longer period are encouraged to discuss their circumstances with the staff. If it is unlikely that the liability can be estimated on the basis of information known to be obtainable at the time of the initial purchase price allocation, the allocation period should not be extended with respect to that liability. An adjustment to the contingent liability after the expiration of the allocation period would be recognized as an element of net income.

8. Business Combinations Prior to an Initial Public Offering

Facts: Two or more businesses combine in a single combination just prior to or contemporaneously with an initial public offering.

Question: Does the guidance in SAB Topic 5.G apply to business combinations entered into just prior to or contemporaneously with an initial public offering?

Interpretive Response: No. The guidance in SAB Topic 5.G is intended to address the transfer, just prior to or contemporaneously with an initial public offering, of nonmonetary assets

in exchange for a company's stock. The guidance in SAB Topic 5.G is not intended to modify the requirements of Statement 141.¹ Accordingly, the staff believes that the combination of two or more businesses should be accounted for in accordance with Statement 141.

9. Liabilities Assumed in a Business Combination

Facts: Company A acquires Company Z in a business combination. Company Z has recorded liabilities for contingencies such as product warranties and environmental costs.

Question: Are there circumstances in which it is appropriate for Company A to adjust Company Z's carrying value for these liabilities in the purchase price allocation?

Interpretive Response: Yes. Statement 141 requires that receivables, liabilities, and accruals be recorded in the purchase price allocation at their fair value, typically the present value of amounts to be received or paid, determined using appropriate current market interest rates. In some cases, fair value is readily determinable from contemporaneous arms-length transactions involving substantially identical assets or liabilities, or from amounts quoted by a third party to purchase the assets or assume the liabilities. More frequently, fair values are based on estimations of the underlying cash flows to be received or paid, discounted to their present value using appropriate current market interest rates.

The historical accounting by Company Z for receivables or liabilities may often be premised on estimates of the amounts to be received or paid. Amounts recorded by Company A in its purchase price allocation may be expected to differ from Company Z's historical carrying values due, at least, to the effects of the acquirer's discounting, including differences in interest rates. Estimation of probable losses and future cash flows involves judgment, and companies A and Z may differ in their systematic approaches to such estimation. Nevertheless, assuming that both companies employ a methodology that appropriately considers all relevant facts and circumstances affecting cash flows, the staff believes that the two estimates of undiscounted cash inflows and outflows should not differ by an amount that is material to the financial statements of

Company Z, unless Company A will settle the liability in a manner demonstrably different from the manner in which Company Z had planned to do so (for example, settlement of the warranty obligation through outsourcing versus an internal service department). But the source of other differences in the estimates of the undiscounted cash flows to be received or paid should be investigated and reconciled. If those estimates of undiscounted cash flows are materially different, an accounting error in Company Z's historical financial statements may be present, or Company A may be unaware of important information underlying Company Z's estimates that also is relevant to an estimate of fair value.

The staff is not suggesting that an acquiring company should record assumed liabilities at amounts that reflect an unreasonable estimate. If Company Z's financial statements as of the acquisition date are not fairly stated in accordance with GAAP because of an improperly recorded liability, that liability should not serve as a basis for recording assumed amounts. That is, the correction of a seller's erroneous application of GAAP should not occur through the purchase price allocation. Rather, Company Z's financial statements should be restated to reflect an appropriate amount, with the resultant adjustment being applied to the historical income statement of Company Z for the period(s) in which the trends, events, or changes in operations and conditions that gave rise to the needed change in the liability occurred. It would also be inappropriate for Company Z to report the amount of any necessary adjustment in the period just prior to the acquisition, unless that is the period in which the trends, events, or changes in operations and conditions occurred. The staff would expect that such trends, events, and changes would be disclosed in Management's Discussion and Analysis in the appropriate period(s) if their effect was material to a company's financial position, results of operations or cash flows.

In summary, the staff believes that purchase price adjustments necessary to record liabilities and loss accruals at fair value typically are required, while merely adding an additional "cushion" of 10 or 20 or 30 percent to such account balances is not appropriate. To arrive at those fair values, the undiscounted cash flows must be projected, period by period, based on historical experience and discounted at the appropriate current market discount rate.

¹ The provisions of Statement 141 apply to transactions involving the transfer of net assets as well as the acquisition of stock of a corporation. This guidance does not address the accounting for joint ventures or leverage buy-out transactions as discussed in EITF Issue 88-16.