Statement of
Financial Accounting Standards
No. 25

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Financial Accounting Standards Committee

Statement of Financial Accounting Standards No.25

Business Combinations

I Introduction

(1) This statement covers the accounting standards for business combinations that use the purchase method.

(2) The scope of this statement includes business combinations where a corporation obtaining control of one or more corporations or a newly formed corporation obtaining control of several existing corporations.

(3) The transactions of acquiring part or all of the shares from the minority stockholders of a subsidiary are not regarded as business combination provided in this statement, but still shall follow the accounting treatment stipulated herein. This statement does not apply when (1) a corporation transfers all assets and liabilities to its newly formed subsidiary, and (2) the transfer of all assets and liabilities or the exchange of shares among affiliated companies (e.g. between parent company and its subsidiaries or among the subsidiaries).

II Definitions

(4) The definitions of terms used in this statement are as follows:

(a) Business combination: Two or more corporations are combined to form an economic entity since an acquirer obtains control of one or more corporations.

(b) Purchase method: This method treats a business combination as a transaction where a corporation acquires another corporation. The acquiring company records net assets at cost. The excess of acquisition costs over the sum of the fair value of tangible and identifiable intangible assets less the liabilities assumed should be recorded as goodwill. The combined profit for the period in which a business combination occurs should include the entire year's net income/loss of the acquiring company and the net income/loss of the acquired company (net of minority interest) after the acquisition date.

(c) Acquisition: It is the transaction accounted for under purchase method, where one corporation (the acquiring company) acquires the equity ownership of another corporation (the acquired company) by issuing stock, paying cash, distributing other assets or assuming liabilities, etc.

(d) Acquisition date: It is the date agreed-upon by the acquiring company and the acquired company or its stockholders to effect the transfer of legal rights and obligations.

(e) Contingency before acquisition: The uncertainty that existed in the acquired company before the acquisition date which very likely would affect the fair value of the assets and liabilities acquired by the acquiring company.

(f) The allocation period of the acquisition price: It is a period of time that the acquiring company takes to allocate its acquisition costs to specific assets and liabilities so that the fair value of assets obtained and liabilities assumed may be identified and determined. When the acquiring corporation cannot get further information to identify and determine the fair value of assets obtained and liabilities assumed, the allocation period of the acquisition price is consummated. If the amount of assets, liabilities or reductions in assets valuation cannot be estimated due to contingencies before acquisition, the allocation period of the acquisition cost may not be extended. The allocation period of the acquisition price

varies depending on circumstances, but may not exceed one year after the date of acquisition.

III Accounting Standards

Historical Cost Principle

(5) In a business combination accounted for by the purchase method, the acquisition of assets, the issuance of stock and the recording of assets and liabilities after the combination should follow the historical cost principle.

The Net Assets Acquisition Method and the Acquisition Cost Measurement Basis

(6) Except for the issuer of equity stock, a corporation adopting the historical cost principle to record acquisitions of net assets should follow the guidelines provided below:

(a) An asset acquired in cash is valued at the amount of cash paid.

(b) An asset acquired by assets other than cash is valued either at the fair value of the non-cash assets contributed or at the fair value of the property acquired, whichever is more objectively evident.

(c) An asset acquired by issuing or assuming a debt is valued at the present value of the debt or at the fair value of the property acquired whichever is more objectively evident.

(7) If the equity stock issued in a business combination is traded in an open market, the market price of the stock usually is more clearly evident than the fair value of the net assets of the acquired corporation and should be used to determine the fair value of the net assets of the acquired corporation. The impacts of possible price variations, trading volumes, issuing costs and other factors are also considered. Furthermore, the market price fluctuations for a

reasonable period of time before and after the announcement of the combination agreement should also be considered.

(8) If the quoted market price of the equity stock issued in a business combination mentioned above cannot represent its fair value, the fair value of the net assets acquired (including goodwill) should be calculated after adjusting for the factors mentioned in the previous paragraph to determine the acquisition cost. All factors relating to the acquisition (e.g. the negotiation process between transacting parties), should be studied and independent appraisals may be used to assist in determining the fair value of securities issued.

(9) The purchase cost of the acquiring corporation in a business combination includes all direct costs of an acquisition, except for the costs of issuing securities which should be deducted from the fair value of the said securities. Indirect costs and general administrative expenses related to acquisitions should be expensed in the current period.

(10) When acquiring another company, a corporation should determine the total cost based on the principles described in paragraphs 6 to 9 and assign the total cost to individual assets acquired and liabilities assumed on the basis of their respective fair values.

Measurement of Minority Interests

(11) The minority interests on the consolidated financial statements should be measured based on the book value of the acquired corporation.

Contingent Consideration

(12) A business combination agreement may, within a certain period in the future (contingency period), provide for the issuance of additional stock, the distribution of cash or other assets contingent on the occurrence of a specified future event or transaction (contingent event). The aforementioned contingent consideration should be accounted for according to rules described in the following paragraphs.

Contingent Consideration Based on Earnings

(13) Where the distribution of additional consideration may be contingent on maintaining or achieving specified future earnings level for the acquired corporation and it is reasonably certain that the event is likely to occur and the amount can be reasonably estimated, then such contingent consideration should be included in the acquisition cost. If the additional assets resulting from recognition of contingent consideration are defined as goodwill, they should follow the principles described in paragraph 21. During the contingency period, when it is reasonably certain that the contingency may occur, the information should be disclosed.

Contingent Consideration Based on Securities Price

(14) Additional consideration may be contingent on the market price of a particular stock issued as a result of a business combination. Unless the price of the stock equals or exceeds the agreed amount on a specified date or dates, the acquiring corporation is required to issue additional equity or debt securities or transfer cash or other assets sufficient to make the total consideration equal to the agreed amount. The securities issued at the acquisition date should be recorded according to the agreed amount. If the price of the securities fails to reach the agreed amount on a specified date or dates, the acquiring corporation must issue additional securities or distribute other assets, however, its acquisition costs are not affected. The acquiring corporation should record the current fair value of the additional securities issued or assets distributed and simultaneously reduce the book value of the securities issued at acquisition date. If acquisition is financed by issuing debt securities, the book value of the originally issued securities should be adjusted and amortized from the date the contingent consideration is paid. If acquisition is financed by issuing equity stock, a debit should be made to the additional paid-in capital of the original stocks or if insufficient, to the retained earnings.

Contingent Consideration Related to Other Conditions

(15) Accounting for contingent consideration related to conditions other than those described above should follow the procedures outlined in

paragraphs 13 and 14. If the contingent payment also depends on both future earnings and future stock price, then the additional payment should be separately calculated and the earnings-related contingent payment should be included in the acquisition cost; whereas the stock price related contingent payment should be deducted from the book value of securities issued at acquisition.

Other Consideration in Contingent Contracts

(16) For contingent payment made related to contingencies, if the substance is to compensate for services provided, property used or profit sharing, then it should be accounted for as period expenses.

The Accounting Treatment for Assets Acquired and Liabilities Assumed

(17) An acquiring corporation should, according to the principles described in paragraph 10, allocate the acquisition cost to the assets acquired and liabilities assumed. The allocation steps are as follows:

(a) All identifiable assets acquired and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired corporation, should be measured based upon their fair values at the acquisition date.

(b) Compare the fair values of all identifiable net assets acquired with the acquisition cost. When the cost exceeds the fair value of identifiable net assets acquired, the excess should be recorded as goodwill. When the fair value of identifiable net assets acquired exceeds the cost, the difference should be assigned to non-current assets acquired (except for (i) financial assets other than investments accounted for by the equity method, (ii) non-current assets held for sale, (iii) deferred tax assets, and (iv) prepaid assets relating to pension or other postretirement benefit plans) proportionate to their respective fair values. If the book values of those non-current assets are reduced to zero, the remaining excess should be recorded as extraordinary gains.

In determining the fair value of assets and liabilities, an acquiring corporation may use independent appraisals or consider subsequent sales prices during the allocation period of the acquisition price. The income tax basis of assets or liabilities should not affect the determination of their fair values.

(18) The fair values of the identifiable assets acquired and liabilities assumed in a business combination are determined as follows:

(a) Financial instruments: If an active market exists, the fair value is measured at the quoted prices; if no active market exists, the fair value is measured by using appropriate valuation techniques.

(b) Account receivable: At present value discounted using the interest rate at the time of acquisition, net of allowance for bad debts and collection costs.

(c) Inventories:

(i) Finished goods and merchandise: At net realizable values less a reasonable gross profit allowance.

(ii) Work in process: At net realizable values of finished goods less the sum of (a)costs to complete, and (b)a reasonable gross profit allowance.

(iii) Raw material: at replacement costs.

(d) Non-current asset (or disposal group) held for sale: At fair value at the time of acquisition.

(e) Plant and equipment: At replacement costs for the plant and equipment of similar capacity at the time of acquisition or at value in use, if the acquiring corporation’s value in use is lower then the replacement costs.

(f) Identifiable intangible assets: Such as contracts, patents, franchises, customers and supplier lists, and favourable leases. If an active market exists, the fair value is measured at the quoted prices; if no active market exists, the fair value is measured by using appropriate valuation techniques.

(g) Other assets: Such as land and depletable natural resources. If an active market exists, the fair value is measured at the quoted prices; if no active market exists, the fair value is measured by using appropriate valuation techniques.

(h) Accounts and notes payable, long-term debt and other liabilities: At present values discounted using the interest rate at the time of acquisition.

(i) Accrued liabilities: Such as after-sales service warranty, paid vacations and deferred compensation of employees, at present values discounted using the interest rate at the time of acquisition.

(j) Other liabilities and commitments: including unfavourable leases, contracts, commitments and segment closing expenses due to the acquisition, at present values discounted using the interest rate at the time of acquisition.

An acquiring corporation should recognize periodically the accrued interest income and interest expenses on assets and liabilities recorded at the present value on the date of acquisition. It should not recognize the goodwill recorded prior to the acquisition by the acquired corporation.

(19) When allocating the acquisition costs to individual assets acquired and liabilities assumed, the contingent items that existed in the acquired corporation prior to the acquisition should be included. The valuation of the contingent items should be determined as follows:

(a) When the fair value of the contingent items can be determined during the allocation period of the acquisition price, the fair

value should be used to allocate the acquisition costs.

(b) When the fair values of the contingent items cannot be determined during the allocation period of the acquisition price, the estimated value should be used to allocate the acquisition costs if both of the following conditions are met:

(i) Before the end of the allocation period of the acquisition price, related information shows that it is very likely that preceding the consummation of the acquisition, the assets and liabilities of the acquired corporation have existed or the asset values have already been impaired.

(ii) The amounts of assets or liabilities may be reasonably estimated.

After the allocation period of the acquisition price ends, any adjustments made for the contingent items that existed prior to the acquisition should be included in the income (loss) of the current period.

(20) The accounting treatment for pensions and income taxes in a business combination should follow paragraph 37 of the Statement of Financial Accounting Standards No.18 and paragraph 28 of the Statement of Financial Accounting Statement of Financial Accounting Standards No.22.

Subsequent measurement of Goodwill

(21) After initial recognition, the acquirer should measure goodwill acquired in a business combination at cost less any accumulated impairment losses. The acquirer should test goodwill for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with the Statement of Financial Accounting Standards No. 35, *Impairment of Assets*. Amortization of Goodwill is prohibited.

(22) Deleted

(23) Deleted

Income (Loss) in the Year of Acquisition

(24) The acquisition cost and the value assigned to the respective assets acquired and liabilities assumed should be determined as of the acquisition date. The income statement of an acquiring company for the period in which a business combination occurs should include income (loss) of the acquired company after the date of acquisition but net of any minority interests. The acquirer should prepare the consolidated financial statement for the year of acquisition in accordance with the Statement of Financial Accounting Standards No. 7, *Consolidated Financial Statements*.

Footnote Disclosures in Financial Statements

(25) The following footnote disclosures should be made in the financial statements of the acquiring company for the period during which the business combination has taken place:

(a) A brief introduction to the acquired company.

(b) The acquisition date, the percentage of ownership acquired and the adoption of the purchase method of accounting for the business combination.

(c) The period for which results of operations of the acquired company are included in the income statement of the acquiring company.

(d) Acquisition cost and the type, number of shares and amount of stock issued as a result of the acquisition.

(e) Initially recognized amount of goodwill, accumulated impairment losses at the beginning of the period, and impairment losses recognized during the period.

(f) Extraordinary gains, which are the remaining excess after the difference between the fair value of identifiable net assets

acquired and the cost has been assigned to non-current assets acquired (except for (i) financial assets other than investments accounted for by the equity method, (ii) non-current assets held for sale, (iii) deferred tax assets, and (iv) prepaid assets relating to pension or other postretirement benefit plans), when the fair value of identifiable net assets acquired exceeds the cost.

(g) Contingent payments, options or commitments included in the acquisition agreement and the proposed accounting treatment.

(h) Significant asset disposal decisions resulting from the business acquisition.

For several minor acquisitions during the same year, the related disclosures may be combined.

(e) and (g) described above should be disclosed continuously in each subsequent period in which goodwill and related issues included in the acquisition agreement remain.

(26) If the acquiring corporation is a publicly traded company, the footnotes to its financial statements for the period in which a business combination occurs should provide the following supplemental information on the performance of its operations on a pro forma basis:

(a) Performance of operations for the current period as though the companies had merged together at the beginning of the period.

(b) If comparative financial statements are presented, the performance of operations for the immediate preceding period as though the companies had merged together at the beginning of that period.

The supplemental pro forma information should, at a minimum, show revenue, income before extraordinary items, net income and earnings per share.

When pro forma information is presented, income taxes, interest expense, preferred stock dividends, depreciation of assets and impairment of goodwill, should be prepared on the accounting basis as though the companies had merged together. Pro forma presentation of performance of operations of periods prior to the merger should be limited to the immediate preceding period.

IV Notes

(27) This Statement of Financial Accounting Standards was announced on March 7, 1996, with the first revision on December 22, 2005, and the second revision on November 30, 2006.

The second revised provision of this Statement should be effective for financial statements with fiscal years beginning on or after January 1, 2007. Earlier adoption is permitted. Upon the effective date of the second revised provision, no retroactive adjustment is necessary for those financial statements that have been originally prepared in accordance with this Statement.

Upon the effective date of the first revised provision, no retroactive adjustment is necessary for those financial statements that have been originally prepared in accordance with this Statement. The entity should stop amortizing goodwill, and prospectively apply the first revised provision to the carrying amount of goodwill (initial cost less accumulated amortization and impairment). The amortization expense recognized in previous periods should not be reversed. Deferred credits recognized in previous periods should be amortized in the remaining amortization period.

(28) This statement may be applied in accounting for the business combinations of non-incorporated companies.

The provisions of this Statement need not be applied to immaterial items.

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