Understanding ASC 805: What PE Firms and CFOs Need to Know Ahead of Transactions

Merger and acquisition (M&A) activity started off strong in 2022 but by the end of the year tailed off significantly and was slow to start 2023, however, activity is expected to potentially pick back up as 2023 progresses. Traditional credit markets are tight but private equity (PE) firms continue to have dry powder to deploy. As they seek out new acquisitions, both PE firms and CFOs of target companies should have a robust understanding of ASC 805 – Business Combinations (ASC 805) – to streamline accounting and avoid unintended risks.

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USING ASC805 TO CHART A PATH FORWARD

ASC 805 establishes a framework for assessing whether an M&A transaction should be accounted for as a business combination or an asset purchase. The standard further discusses significant considerations required for a business combination, including determining:

- The acquiring entity.
- The acquisition date.
- The transaction price.
- The identification and valuation of the assets acquired and liabilities assumed.
- The accounting treatment for concurrent arrangements entered between the buyer and seller and for the various costs associated with the transaction.
- Certain elections to simplify purchase accounting afforded to privately owned companies.

In addition, the standard discusses the accounting treatment for transactions that do not meet the criteria to be a business combination and therefore must be accounted for as an asset purchase.

An asset purchase is when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets or if the acquired set lacks an input and a substantive process to apply to the input.

A business is 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 costs, or other economic benefits directly to investors or other owners, members, or participants. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. However, when assets are acquired in a variable interest entity, the accounting is more similar to that of a business combination. Determining whether the target company meets the definition of a business or is a variable interest entity can be complex and require the application of professional judgment.

A key component of purchase accounting under ASC 805 is identification of the assets acquired and liabilities assumed and the determination of their respective fair values, often referred to as the purchase price allocation. This purchase price allocation aims to provide investors with increased transparency into the assets acquired and liabilities assumed in order to better quantify the value of the target company and understand how the transaction will impact their portfolios.

The standard references ASC 820 – Fair Value Measurements (ASC 820) – to provide a framework for determining fair value pursuant to U.S. GAAP. Certain components of working capital may have carrying values on the closing balance sheet that are representative of their fair values. Other components of working capital, as well as long-term assets and liabilities, may require complex analysis and valuation techniques to determine their respective fair values. Beyond this, the acquirer is required to identify assets or liabilities that were not recorded on the closing balance sheet (for example, intangible assets).

Although the application of ASC 805 and ASC 820 may seem straightforward, below the surface complexities arise. Both PE buyers and CFOs of target companies should familiarize themselves with these complexities before engaging in an M&A transaction. Financial statement errors resulting from a misunderstanding of how to apply these accounting standards can lead to costly consequences like delayed filings and restatements.

ADDRESSING KEY CONSIDERATIONS THAT AFFECT BUYER & SELLER

To address some of the nuances associated with ASC 805, we've listed six M&A considerations relevant to both PE companies and target company CFOs — and broken down how these considerations can affect a deal.

Consideration	Impact
Does the transaction qualify as a business combination, or should it be accounted for as an asset purchase?	This determination has an impact on the underlying accounting for the transaction, specifically related to: ▶ The recognition of goodwill or a bargain purchase ▶ The treatment of transaction related expenses
When does the acquirer take control of the target company?	If the acquiring entity obtains control of the target company other than at month-end or the end of a reporting period: ▶ An interim date may require rollforward or rollback steps for accounting purposes ▶ Establishing rollforward or rollback processes can be cumbersome if not considered in advance
Is the transaction price limited to the transfer of cash at closing?	Consideration is not limited to cash exchanged — it can take other forms, such as other assets, contingent consideration, common or preferred equity instruments, options, warrants: ▶ All forms of consideration must be measured at fair value ▶ Certain forms of consideration might require complex valuation exercises ▶ These valuations can impact conclusions related to goodwill or bargain purchases
Do the parties have preexisting relationships? Did they enter other arrangements during the negotiations?	Preexisting relationships and other arrangements require an evaluation to determine whether they should be accounted for as either: ▶ Part of the business combination, likely impacting the transaction consideration ▶ As separate transactions, that may require an evaluation to determine the proper accounting
Have both parties taken the necessary steps to recognize and measure identifiable assets and liabilities?	The acquirer must determine the fair value of the assets acquired, liabilities assumed and any noncontrolling interests in the target company: ▶ Determining the fair value of all assets and liabilities often requires complex valuation techniques ▶ Consideration must be given to items that did not qualify for recognition on the historic financial statements/balance sheet at closing
Will the company apply the private company council (PCC) accounting alternatives?	The company should determine if it will elect the PCC accounting alternatives: ▶ ASU 2014-18 allows private companies (as defined in U.S. GAAP) the option to not recognize certain intangible assets separately from goodwill, most commonly customer relationships. If not adopted, intangible assets are required to be recognized separately from goodwill. ▶ ASU 2014-02 allows private companies to amortize goodwill for a period of up to 10 years. Companies who elect ASU 2014-18 are required to apply ASU 2014-02, however, companies may opt only to apply ASU 2014-02. An important consideration when determining whether or not to apply the PCC elections discussed above is the PE's long-term exit plan. If a public offering is being contemplated, caution should be exercised in applying the PCC elections.

DIVING DEEPER INTO THE PCC ELECTIONS

ASU 2014-18 allows private companies the option to not recognize separately from goodwill customer-related intangible assets, unless they can be sold or licensed independently from other assets of a business and noncompetition agreements. As noted in the table above, customer relationship intangible assets would generally qualify to be subsumed into goodwill, whereas customer contracts are generally able to be sold or licensed independently from other assets of a business.

ASU 2014-02 provides private companies a simplified alternative for the subsequent accounting for goodwill, including impairment testing. This ASU allows private companies to choose one of the following options in an effort to simplify the accounting and reduce costs associated with performing annual impairment tests:

1. Amortize goodwill on a straight-line basis over a useful life of up to 10 years
2. Test goodwill for impairment only when a triggering event occurs instead of annually
3. Test goodwill for impairment at either the entity level or the reporting unit level

ASU 2014-02 also eliminated step two of the goodwill impairment test.

As noted in the table above, a PE firm's long-term exit strategy with respect to its investment in the portfolio company should be considered prior to applying the PCC elections. As these elections are not afforded to public business entities (PBEs), these elections may have to be unwound, and prior period financial statements may have to be restated in the future in the event of a public exit. Companies may be required to retroactively determine the acquisition-date fair value of customer relationships and noncompetition agreements. Further, retroactive goodwill impairment analysis may be required to support goodwill recorded at the acquisition date, without the subsequent amortization permitted pursuant to the PCC election. As such, the short-term cost savings realized from the initial election may prove to be more costly in the event they must be unwound in the future. The terms "private company" and "public business entity" are defined terms in U.S. GAAP, and are not intuitive to apply; therefore, a company should carefully consider whether it can apply these elections.

NAVIGATING DEALMAKING IN 2023

M&A transactions have inherent complexities, as do subsequent accounting policy elections made by PE companies and management. Planning and preparation as transactions are being contemplated can alleviate unintended accounting consequences, streamline reporting considerations and reduce the risk of financial statement restatements in future periods.

A third-party professional can help PE firms and CFOs of target companies manage the ASC 805 implications of a potential or upcoming deal. To increase transparency and improve accounting accuracy, consider engaging industry professionals who can break down the nuances and next steps.

BDO offers specialists who can analyze transactions to help determine how best to apply ASC 805 and assist with subsequent complex accounting and fair value determinations.

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