# ACCOUNTING FOR BUSINESS COMBINATIONS: WHY YOU NEED ANOTHER VALUATION

Despite a  weak economy and uncertainty related to the COVID-19 pandemic, merger and acquisition activity has been consistent if not escalated over the past two years. Many companies that have not previously made acquisitions are surprised to learn that accounting guidance requires them to hire a third-party to value the assets they just purchased.

## Why do I need to value something I just purchased?

Paying a valuation expert to value assets that were recently purchased in an arm's length transaction (two or more unrelated and unaffiliated parties agree to do business, acting independently and in their self-interest) may sound silly on the surface, but the goal is to ensure the company's financial statements are accurate. For example, if Company A purchases Company B for $20 million, they will need to determine how much of that $20 million purchase price relates to net working capital, machinery and equipment, inventory, intangible assets and goodwill. The valuation of these assets and subsequent purchase price allocation is governed by Accounting Standards Codification 805 – Business Combinations (ASC 805). Company A will be required to hire a third-party valuator post-close to execute the purchase price allocation. Most often the assets that need to be valued include:

- Inventory
- Real property
- Personal property
- Beneficial/detrimental leasehold
- Trademarks / trade names
- Internally developed technology/know-how
- Restrictive Covenants
- Customer-related intangible assets

Additionally, Accounting Standards Codification 350 - Intangibles — Goodwill and Other (ASC 350) requires companies to test any acquired goodwill annually for impairment and to write goodwill down if its carrying amount exceeds its implied fair value. Privately-held companies may also choose to adopt private company GAAP alternatives created by the FASB's Private Company Council. This accounting alternative makes the purchase price allocation exercise slightly less burdensome on the company by eliminating restrictive covenants and customer-related assets from the list of separately identifiable intangible assets. Companies that choose the private company GAAP alternative for business combinations are then required to amortize goodwill on a straight-line basis over ten years rather than test goodwill annually.

## Contingent consideration conundrum

ASC 805 also requires companies to recognize acquired assets and assumed liabilities at fair value. This can significantly affect an acquiring company's balance sheet and earnings. The impact is particularly dramatic when contingent considerations, such as earnout agreements, are part of a transaction. In the past, the portion of the purchase price that was contingent on the acquired company achieving certain earnings targets was not recognized until the contingency was resolved. But under current rules, payments tied to future performance are recognized at their acquisition-date fair value — despite uncertainty over whether they'll be paid.

Many earn-out calculations are dependent upon the acquired company meeting certain revenue or profitability targets in months or years following the closing of the transaction. Earn-outs are often valued using a Monte Carlo Simulation, which simulates the probability of the acquired company hitting the earn-out thresholds detailed in the purchase agreement based on management's expectations and other market data points. Many times, we see earn-out agreements that are unnecessarily complicated which can create valuation and accounting headaches after a transaction has closed. Management's projections at the time of close may also vary greatly from actual results which can create a need for accounting adjustments years after the transaction has closed.

## Planning for post-close valuation and accounting requirements

If your company is looking to make an acquisition, be prepared for the post-close valuation requirements. It is also smart to not overcomplicate earn-out agreements. Simple, yet accurate language can usually achieve the desired results of the earn-out while avoiding accounting headaches down the road. In the big scheme of things, the post-closing valuation and accounting work is probably a drop in the bucket compared to the diligence and legal work conducted on the front-end of most transactions. Nonetheless, the post-closing requirements often catch business owners off guard. Being prepared for post-close requirements can help businesses focus on a smooth integration of their new acquisition rather than spending too much time on pesky accounting requirements.