Buyer Beware

Understanding the impacts of the private company council election and rollover equity on deal value

CFGI

Although not new, the PCC option is still often misunderstood

Private companies involved in business combinations that require recognition of the fair value of acquired assets may be aware of a Financial Accounting Standards Board (FASB) accounting alternative. What many may not know is how, when, and whether to elect the alternative.

The private-company option originated in a Private Company Council (PCC) proposal that sought to provide businesses with an alternative to the requirement that they separately recognize certain customer-related intangible assets and noncompetition agreements at fair value. The FASB agreed, and codified the alternative in FASB Accounting Standards Update No. 2014–18, Business Combinations (Topic 805) in December 2014 (the "PCC Option").[1]

The FASB alternative allows private businesses to not recognize the fair value of intangible assets separate from goodwill in two areas: customer-related intangible assets, unless they can be sold or licensed independently from other business assets, and noncompetition agreements.

According to the PCC Option, qualification as a customer-related intangible depends on whether the company would be able to sell or license the asset. Examples of salable customer-related intangibles include mortgage-servicing rights, commodity supply contracts, core deposits, and many customer lists and information.

The PCC Option states that customer relationships and data that are controlled by an individual cannot be separately sold by the reporting entity. Additionally, not-for-profit organizations and employee benefit plans are excluded from the accounting alternative.

Entities that elect the accounting alternative must amortize goodwill over 10 years or less. Doing so will require prospective amortization of all previously recorded goodwill, as well as goodwill acquired in the future. Under GAAP, goodwill is not amortized. Instead it is analyzed for impairment at least annually or upon certain triggering events like the loss of a substantial customer account.

Potential impacts on valuation fees

A key goal of the accounting alternative is to enable private companies to reduce the cost and complexity of preparing their financial statements—without diminishing the usefulness of the information to users of the statements. In practice, however, costs often depend on the requirements of the acquirer's audit firm.

Even though customer-related assets and noncompetition agreements are ultimately subsumed into goodwill, many audit firms still require valuation of these assets. That's because the returns on these assets differ from those of goodwill, and an accurate valuation analysis should balance the weighted average return on assets (WARA) acquired with the internal rate of return (IRR) on the deal and the weighted average cost of capital (WACC) for the entity.

Because the auditor must invest time and resources in valuing customer-related assets and noncompetition assets—even if they don't separately account for them—there is often no reduction in fees. In other words, the assumed benefit of reduced fees associated with the opening balance sheet might not come to fruition. There is, however, a potential for reduced valuation fees related to future goodwill impairment testing.

Before you decide whether to adopt the accounting alternative, it may be worthwhile to consult your audit firm. This could help you better understand potential accounting implications and anticipate fees from both the acquirer and auditor.

[1] Financial Accounting Standards Board, *FASB Accounting Standards Update No. 2014-18: Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination, December 2014*

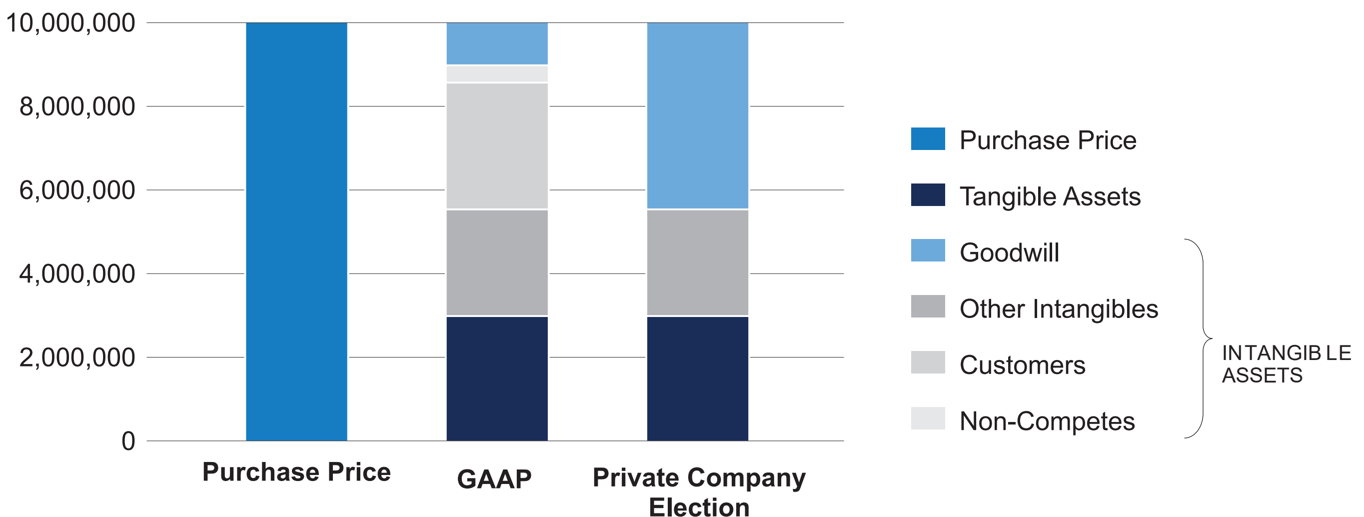
The pros and cons

When weighing the use of the accounting alternative, you'll need to factor in the needs of current and future users of the company's financial statements, as well as whether the benefits outweigh the potential costs. In general, companies that elect the alternative will initially recognize fewer intangible assets and will record a larger amount of goodwill (see Figure 1). But they will likely recognize higher levels of amortization expense on a go-forward basis, which can reduce earnings before interest and taxes (EBIT). For this reason, companies should carefully review loan covenants for agreements that tie EBIT performance to loan conditions.

The accounting alternative can also reduce the likelihood of goodwill impairment because the carrying amount of goodwill is reduced over time and impairment is only assessed after a triggering event. IPOs and acquisitions by public companies, however, can complicate accounting for companies that adopt the alternative. In the event of a future acquisition by a public company or an IPO, the purchase accounting could need to be revised to reverse the election, a difficult and costly undertaking that might also cause delays which could derail a transaction.

Other red flags include lenders, creditors, and regulators that require traditional US GAAP accounting, as well as investment by a public company.

Given these considerations, most private companies forgo the accounting alternative. In fact, our experience shows that approximately one-quarter of eligible companies make the election. The most-cited reasons include a lack of significant fee reductions, potential complications to future exits, and a balance sheet that does not favorably compare with those of businesses that use GAAP.



Rollover equity—different classes must be reconciled

Whether or not a business elects to use the private-company alternative, it will still have to account for rollover equity, when applicable.

Rollover equity occurs when certain target company equity holders—often key executives and founders—roll a portion of their ownership stake into the new capital structure of the acquiring firm. It's an acquisition arrangement that is commonly used by private equity firms.

Rollover equity can benefit both buyers and sellers. It allows the acquirer to limit its cash outlay and build incentives with the target's management. Sellers, on the other hand, can maintain partial liquidity of their investment while taking advantage of post-acquisition increases in the value of the business.

> **"While rollover equity can benefit both buyers and sellers, valuation issues can arise when management receives a different class of equity than that invested by the acquirer."**

A potential rollover valuation issue can occur when management receives a different class of equity than that invested by the acquirer. In this scenario, the headline price (the publicized per-share value) may differ from the fair value price per share. The rollover shares are typically separately valued to establish the allocable purchase price under fair value accounting.

Most businesses employ an option pricing method (OPM) to allocate the value of the total equity to the various classes of equity securities. The OPM treats securities as call options on the company's equity value, with exercise prices based on the liquidation preferences and conversion features of preferred stock and the strike prices of options and warrants. The incremental option value is allocated to the classes of securities that participate in the additional upside of the company beyond the exercise price based on the rights and preferences of the security.

Considerations for accurate equity valuation

The economic differences between the rights and privileges of the various equity security classes should be analyzed to help assure accurate and fair valuation.

As a quick example, assume the Acquirer invests $9,000,000 in exchange for 90,000 preferred shares with a liquidation preference of $100 per share (i.e., 1x their investment). These shares participate with common shares pro-rata after the liquidation preference. The management team of the Target receives 10,000 rollover common shares. The headline price of the transaction s therefore $100 per share at a valuation of $10,000,000 (i.e., $9,000,000 / 90% of fully-diluted shares outstanding). Figure 2 below illustrates how this simple liquidation preference may skew the values received by the preferred and common shareholders under difference exit scenarios.

In addition to the valuation of rollover equity, private businesses must also value add-on deals. Offering stock consideration can add complexity because the value of the acquirer differs from that paid for the target. Consequently, the total equity value of the acquirer must be established, usually through a combination of income-based and market-based methods. This value is then allocated to the various classes of equity securities.

Complications can also arise when the value of the per share price communicated to management is substantially different than fair value. Businesses should fully explain pricing to retained management early in the process to avoid awkward, and sometimes divisive, situations.

As with intangible assets, the valuation requirements for rollover equity expand the scope and cost of the valuation. In the end, most companies find that the value of rollover shares are less than that of preferred shares.

Figure 1: Allocation of Purchase Consideration

Future Sale Price	$ 5,000,000	$ 10,000,000	$ 15,000,000	$ 19,000,000
Less: Liquidation Preference	$ 5,000,000	$ 9,000,000	$ 9,000,000	$ 9,000,000
Remainder to Allocate Pro-Rata	$ —	$ 1,000,000	$ 6,000,000	$ 10,000,000
% to Preferred	90%	90%	90%	90%
% to Common	10%	10%	10%	10%
Allocation to Preferred	—	$ 900,000	$ 5,400,000	$ 9,000,000
Allocation to Common	—	$ 100,000	$ 600,000	$ 1,000,000
Value of Preferred	$ 5,000,000	$ 9,900,000	$ 14,400,000	$ 18,000,000
Value of Common	$ —	$ 100,000	$ 600,000	$ 1,000,000
Per Share Value of Preferred	$ 55.56	$ 110.00	$ 160.00	$ 200.00
Per Share Value of Common	$ —	$ 10.00	$ 60.00	$ 100.00

Getting help in evaluating adoption of the PCC Option

The decision to elect the private-company option to not recognize certain customer-related intangible assets and noncompetition agreements in business combinations will not be quick or easy. Acquiring firms will need to evaluate a number of intricate factors to fully understand the potential implications to current and future business financials and accounting. These include intersecting aspects such as goodwill amortization, EBIT, loan arrangements, and future exit opportunities, to name a few.

For many companies, the evaluation will be a complex, time-consuming initiative. That's where CFGI can help. Our qualified valuation specialists have helped acquirers in hundreds of business combinations since the 2014 release of ASC 805. Leveraging that experience, our valuation teams can guide you through the complexities of valuing the tangible and intangible assets acquired in a business combination. We fully understand current and future implications of the accounting standard, and what auditors will expect from businesses that adopt the alternative.

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