Buyer Beware

Understanding the impacts of the Private Company Council election in purchase accounting

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 non-competition 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. CFGI developed a sensitivity matrix that assigns hypothetical values and returns to customer-related assets and non-competition agreements, which gives the audit firms comfort that the weighted average return on assets (WARA) acquired and the internal rate of return (IRR) on the deal align with the weighted average cost of capital (WACC) for the target company.

[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

Adopting the PCC Option can reduce the fees associated with preparing the purchase price allocation. In addition, there is the potential for reduced valuation fees on a go-forward basis arising from the fact that annual goodwill impairment testing is no longer required.

While there should be fee savings in the near term, there could be substantial incremental fees in the longer term if the PCC Option needs to be reversed and GAAP standards applied. This could be the case if the exit is an IPO or material acquisition by a public company. Before you decide whether to adopt the accounting alternative, it may be worthwhile to consult your audit firm and private equity sponsor (if applicable). This could help you better understand potential accounting implications, exit scenarios, and impacts on fees.

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 material acquisition by a public company or an IPO, the purchase accounting could need to be revised to reverse the election, a costly undertaking in hindsight. What's more, the time required to reverse the election could delay the exit process.

Other red flags include lenders, creditors, and regulators that require traditional US GAAP accounting.

Given these considerations, the decision to elect the PCC Option is not one that should be taken lightly. The most-cited reasons for making the election are cost savings on the purchase price allocation and future goodwill impairment testing. The most-cited reasons for sticking with GAAP treatment are the potential (even remote) of a material sale to a public company or IPO, and the outsized fees and delays that will result from having to reverse the election.

Figure 1: Allocation of Purchase Consideration

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 thousands of business combinations since the 2014 release of the PCC Option. Leveraging that experience, our valuation team 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.

To have a deeper discussion, please contact:

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