Impending Guidance on Business Combinations

Working Draft of The AICPA Accounting and Valuation Guide: Business Combinations

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Executive Summary

- The AICPA issued the Working Draft of The AICPA Accounting and Valuation Guide: Business Combinations (the "Guide") in September 2022.
- The Guide is expected to be finalized later this year. Upon issuance of the final version of the Guide, valuation specialists will be expected to align purchase price allocations with the guidance provided.
- While the Guide is considered non-authoritative accounting and valuation guidance, it nevertheless represents a collection of best practices and generally agreed-upon methodologies on these topics.
- Gaining a full understanding of the updated guidance prior to the release of the final Guide will allow valuations specialists and their clients to seamlessly transition upon its release.
- In this article, we outline topics in the Guide which contain new or evolving guidance. We also drill down on the guidance provided in *Chapter 11: Selecting Valuation Approaches and Techniques for Acquired Intangible Assets.*

Introduction

In September 2022, the AICPA issued a working draft of its Accounting and Valuation Guide: Business Combinations (the "Guide"). The Guide addresses many accounting and valuation issues that have emerged over time and will help preparers, auditors, valuations specialists and other interested parties understand and comply with the requirements of FASB ASC 805, *Business Combinations*. While the Guide is based on US GAAP, the valuation issues addressed are also generally applicable to IFRS 3, *Business Combinations*. The development of the Guide has involved the multi-year efforts of several professional services firms, with preparers and specialists on both the accounting and valuation subgroups.

While the Guide is considered non-authoritative accounting and valuation guidance, it nevertheless represents a collection of best practices and generally agreed-upon methodologies on these topics. The Guide is expected to be finalized in late 2023.

Topics covered which contain new or updated guidance include the following:

- New guidance on simulated royalty rate analyses
- More detailed guidance on internal rate of return analyses
- Updated guidance on inventory valuations
- Updated guidance on the valuation of non-controlling interests
- More detailed discussion on "enabling technology" – Any intangible asset that allows another intangible asset to function
- Clarified guidance on accounting for contingent consideration which is settled in the acquirer's stock
- Discussion of crypto assets in business combinations

The updated guidance expected to have the most significant impact on the work of valuation specialists is included in *Chapter 11: Selecting Valuation Approaches and Techniques for Acquired Intangible Assets.*

Valuation Method Selection Process

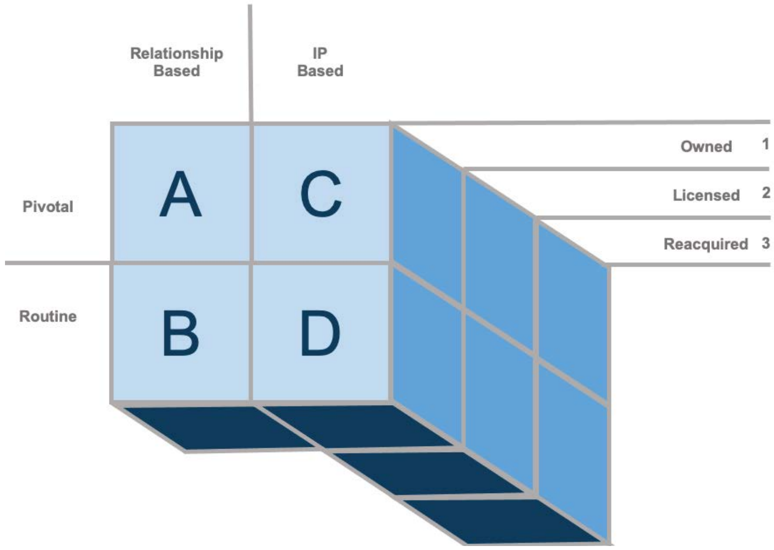
The Guide provides a new valuation method selection process, as follows:

1. Identify whether the intangible asset is Relationship-Based or IP-Based
2. Evaluate whether the intangible asset is Pivotal or Routine
3. Apply the method and inputs that capture the economics of the intangible asset as if it was owned by the acquiree
4. If a Pivotal, IP-Based intangible asset is accessed through a contract, estimate the fair value of the intangible rights asset assuming it was owned and then adjust for any license or royalty payments being made
5. To the extent that the Pivotal, IP-Based intangible asset is a reacquired right, estimate the fair value assuming it was licensed from a third party and then adjust to exclude expected contract renewals and any off-market terms which are recognized as a settlement gain or loss

We will explain each of the steps and terms above in the following sections.

New Framework For Selection of Valuation Methods

The Guide provides a new framework that analyzes intangible assets on three fronts, for use in determining appropriate valuation methods, inputs, and assumptions. The graphic below can be helpful in understanding the framework.



Intangible assets can be broadly categorized as **IP-Based** or **Relationship-Based.**

IP-Based intangible assets derive their value directly from attributes that create excess profits[1] and/or the benefit of general legal protection.

Relationship-Based intangible assets derive their value indirectly through the contributions of intellectual capital and other assets, and they may be formed through relationships between specific individuals.

Intangible assets can also be broadly categorized as **Pivotal** or **Routine**.

Pivotal intangible assets provide an owner or licensee with the ability to create a significant portion of the excess profits in the business unit or value chain. Their functions are not available from alternative sources because they are unique or scarce assets.

Routine intangible assets are not unique or scarce; they provide functionality that can be accessed from a third party in an arms-length transaction (for IP-Based intangibles) or the functions and activities that provide a routine profit (for Relationship-Based intangibles).

Intangible assets can be accessed in one of three ways: **Ownership, Licensing, and Reacquisition.**

Relationship-Based intangibles are typically owned, not licensed or reacquired.

When an IP-Based intangible is owned, the intangible has two components of value to the owner: commercial value and the value of the underlying IP itself.

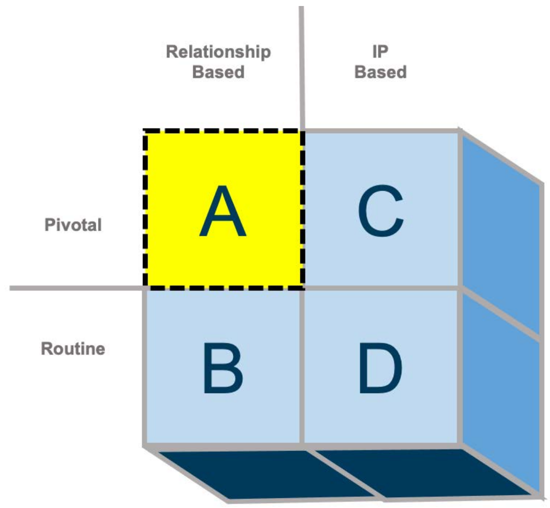
Licensees obtain the right to use and exploit an underlying intangible asset for a specified purpose, in a defined territory, over a certain term. When an IP-Based intangible is licensed, the value of the underlying IP is not included in the fair value measurement.

Reacquired rights are, in substance, acquired intangible rights assets, where access to the underlying IP was obtained from the acquirer prior to the business combination through an agreement.

[1] Excess profits are defined as returns, or profit, in excess of returns on routine assets utilized (e.g. working capital, fixed assets, and other routine assets) and routine functions.

Pivotal, Relationship-Based Intangibles

Pivotal, Relationship-Based assets make a significant contribution to the value chain and excess profits. Intellectual capital is an important aspect of Relationship-Based intangibles, making important contributions to the value chain in many ways. It can have a significant impact on the consumer's purchase decision process capturing the attributes of a product or service that customers pay for as opposed to the relationship itself. The pivotal nature of Relationship-Based intangibles can be gauged by evaluating the indirect contributions of intellectual capital to the customer decision-making process.



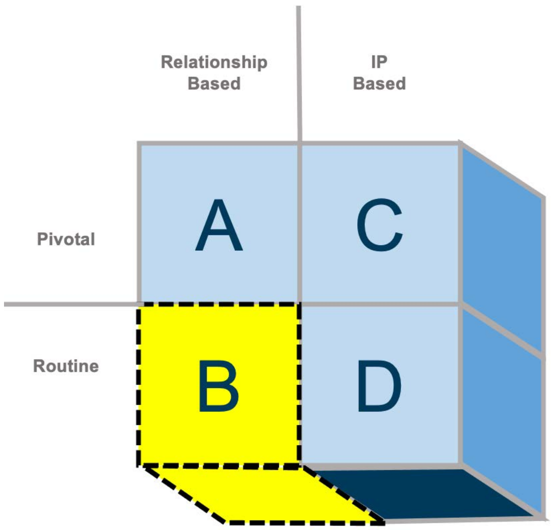
Since they are not licensed, the multi-period excess earnings method ("MPEEM") is the preferred form of measurement.

Inputs which drive the substance of the MPEEM include:

- The degree to which the Relationship-Based assets are considered in the customer purchasing decision process
- The degree to which the intellectual capital is institutionalized and retained within the business rather than individual employees
- The relative contributions of Pivotal IP-Based assets
- The product or service attributes that provide the greatest utility to customers
- Asset class splitting analyses assessing the relative amount of "investment" and the duration of the investment
- The stage in the product cycle – IP-Based assets likely make more prominent contributions to excess profits in early years – shifting towards relationship-based later
- The degree to which personal relationships influence the buying decision

Routine, Relationship-Based Intangibles

When IP-Based intangibles or other assets make the greatest contributions to the value chain, Relationship-Based assets may not play a predominant role in the customer's decision process and would be more routine in nature. Intellectual capital may not always provide a competitive advantage, but the related functions and activities are a routine and necessary element of operations. Routine Relationship-Based asset contributions to the value chain take a variety of forms with economic benefits ranging from internal operating efficiencies to elements of the relationship that a customer may take for granted.



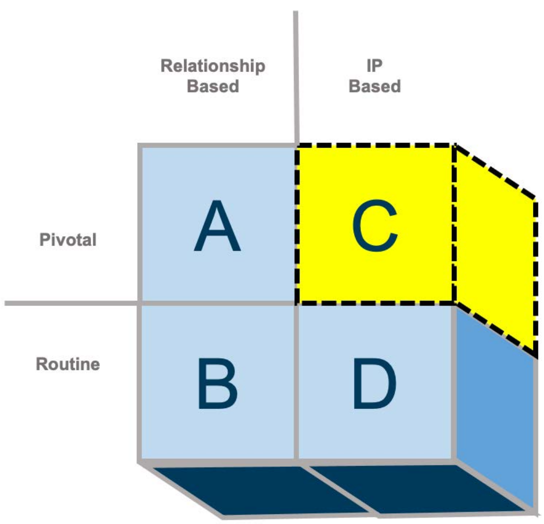
The replacement cost method, or an income approach such as the cost savings method or the avoided costs method, are commonly used to measure Routine, Relationship-Based intangibles. The relief from royalty method and the MPEEM are not commonly applied for intangibles in this category. However, use of the MPEEM is not precluded; it could be applied to measure a routine customer relationship when the excess profits are captured in the measurement of a related IP-Based intangible using a simulated relief from royalty method that also serves as a contributory asset charge.

Pivotal, IP-Based Intangibles

There are two elements of value attributable to Pivotal, IP-Based intangibles:

1. The value of the underlying IP
2. The commercial value or excess profits created by exploiting, investing in, and commercializing the underlying IP

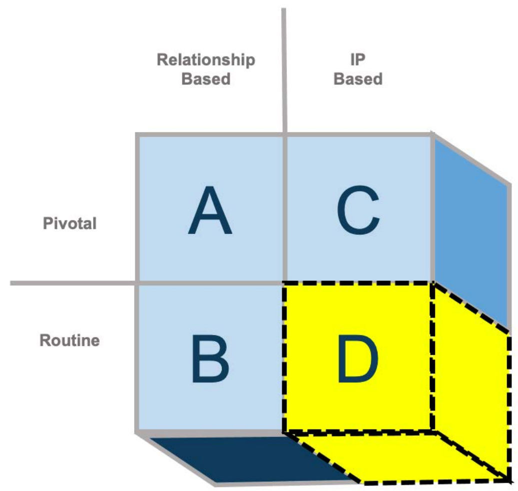
When the IP is owned, the underlying IP and related commercial rights are measured in aggregate as a single asset. This is generally straightforward when the business is limited to a single Pivotal asset. However, when multiple Pivotal assets exist, it is helpful to measure the contribution of the underlying IP in order to isolate the commercial value and facilitate the functional attribution to the overall commercial value among the Pivotal assets.



When Pivotal, IP-Based intangibles coexist with Pivotal, Relationship-Based intangibles, the relief from royalty method is typically used to value the IP-Based intangible and the MPEEM is typically used to value the Relationship-Based intangible. A simulated royalty analysis would typically be used in this scenario instead of selecting a royalty rate based on market data in order to avoid solely allocating the commercial value to the Relationship-Based intangible.

Routine, IP-Based Intangibles

IP-based assets may not always provide a competitive advantage, but the related functions and activities are a routine and necessary element of operations. To some extent they provide benefits that a customer may take for granted and will not directly impact their purchasing decision. The following are examples of Routine, IP-Based intangibles that play a supporting role:

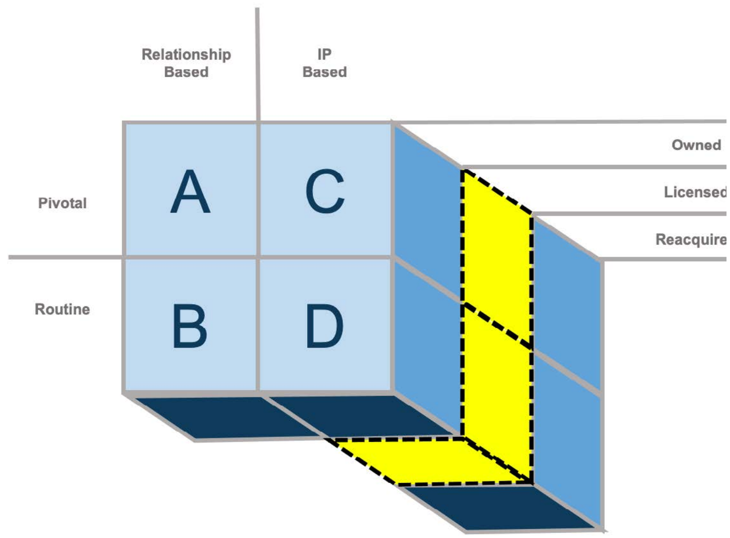


- Process Patents or Knowhow – IP enables increased manufacturing efficiency and cost savings
- Wholesale or B2B Trade Name – The trade name is not critical to wholesale operations, but the name recognition does provide some economic benefit
- Distribution Management System – The software supports efficiency and on-time product delivery
- Unpatented IP – Such assets are not unique and alternative IP with similar functionality is available in the market. For example, component designs, consulting tools, and applications

Relief from royalty, replacement cost, cost savings, or avoided cost methods are commonly used to measure the fair value of routine IP. The relief from royalty, based on comparable market rates rather than simulated royalties, is commonly applied because these assets are capable of being licensed and do not contribute to any of the commercial value. Routine IP is not considered critical to the overall performance of a business. Therefore, valuation methods that capture a wider array of income, such as the MPEEM, are generally not applied.

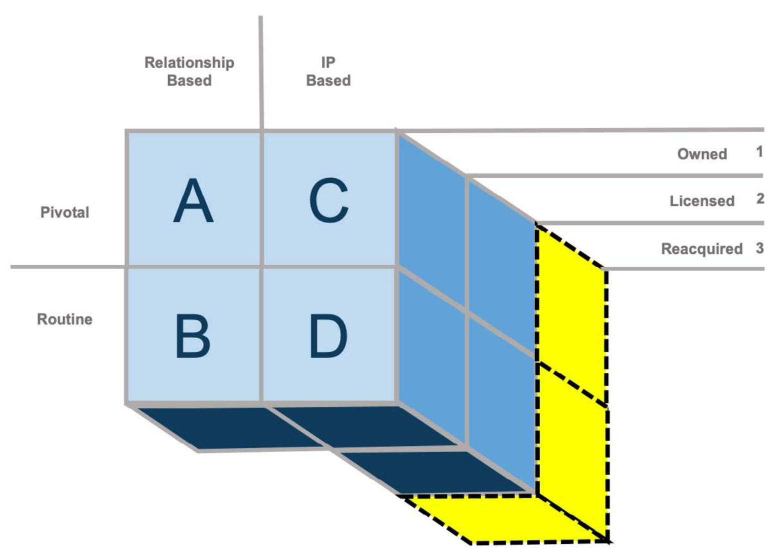
Valuation of Licensed, IP-Based Intangibles

The economics are essentially the same between owned and licensed IP-Based intangibles, except that the licensed underlying IP is not included in the fair value measurement for licensed IP assets. In order to ensure that the value of the underlying IP is not captured, the royalty payments to the licensor are deducted in the financial projections.



The fair value of Licensed, IP-Based intangibles that are derived from access to pivotal underlying assets is generally measured with the MPEEM, reflecting contributory asset charges ("CACs") and royalty payments for the use of the underlying intangibles. Excess earnings would consider market participant expectations of renewing the contract and may also reflect any off-market terms of the license agreement. Applying a relief from royalty method with a simulated royalty to capture the excess profits of the intangible rights asset over and above the license agreement payment for the underlying IP could be an alternative approach.

License agreements for Routine IP assets do not provide any excess profits over and above the royalty payments being made for use of the underlying IP. The in-place contract value of an intangible rights asset providing access to routine intangibles is generally minor and generally measured based on the cost to negotiate and replace the agreement. The negotiated royalty rate would reflect the degree of exclusivity of the agreement and is not a direct factor in the valuation of intangible rights assets.



Valuation of Reacquired, IP-Based Intangibles

The value of reacquired rights is determined by first estimating the fair value of the intangible rights asset based on market participant assumptions. Then, any expected contract renewals a market participant would otherwise consider are excluded from the analysis. Additionally, a settlement gain or loss for any off-market element of the agreement is recognized in the acquirer's financial statements.

If the license agreement's royalty rate is at-market, then the licensor is being fully compensated for the use of the underlying asset. By reacquiring the right, the licensor is not acquiring any incremental cash flow that it did not already have. Therefore, the value of the reacquired right would be zero and the value created would reside in other assets. The value associated with the reacquired rights of Routine IP-Based intangible assets is generally minor and typically measured based on the cost to negotiate and replace the agreement.

Conclusion

Upon issuance of the Guide, valuation specialists will be expected to adopt the updated guidance it contains. Gaining a full understanding of topics which contain new or updated guidance will allow valuations specialists and their clients to seamlessly transition upon the Guide's release. The new framework for the selection of valuation methods is likely to be an area of increased focus, and therefore, it is especially important that valuation specialists have complete grasp on the guidance provided in this section.

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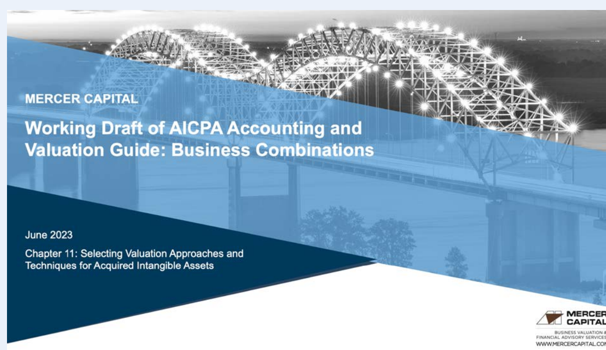
Want to Learn More About Chapter 11 of the AICPA Accounting and Valuation Guide?

Download our PDF for a summary of guidance on income approach methods and an in-depth review of each of the topics covered in this article.



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