



Avoiding pitfalls in business combinations

Five common challenges



With transaction volume up significantly in recent months, we thought it would be a good time to revisit common issues that arise when accounting for business combinations. Below are five common pitfalls to avoid when performing a purchase price allocation under ASC 805.

1. Identifying purchase consideration and compensation expense¹

Surprisingly, issues can arise in acquisition accounting because an incorrect purchase consideration is used. While this does not happen often, it can occur with complex transaction structures and can significantly impact the results. One such example is when the purchase price includes consideration paid that should be viewed as employee compensation expense. This can be the case if the acquiree has issued share-based payments that do not need to be replaced upon acquisition. If the acquirer is obligated to replace the acquiree awards, then all or a portion of the fair-value-based measure of the acquirer's replacement awards is included in measuring the consideration transferred in the business combination. However, if the acquirer is not obligated to replace the acquiree awards, but chooses to do so voluntarily, then all of the fair-value-based measure of the replacement awards is recognized as compensation cost in the acquirer's postcombination financial statements rather than consideration transferred. Therefore, an acquirer needs to make a determination as to whether it is obligated to replace the acquiree awards. This determination is based on whether the

acquiree, or its grantees, have the ability to enforce replacement. This evaluation is also required when an award has a change-of-control provision that accelerates vesting of awards.²

2. Poorly supported discount rates

Many valuations lack sufficient quantitative support and documentation for the discount rates used. One example is the reconciliation of the internal rate of return (IRR), weighted average cost of capital (WACC), and the weighted average return on assets (WARA), which is used as an analytical tool to compare and contrast the discount rates (or required returns) of the acquired assets to their respective risk profile. The WARA analysis takes a holistic view of the individual discount rates to assess if the assigned returns are reasonable in relation to each other. In theory, these three indications should be closely aligned. However, some valuations lack sufficient convergence, which could indicate further analysis may be required. As an example, the WACC and WARA are sometimes reconciled to the IRR without first confirming that the consideration paid is reflective of fair value.³ After sufficiently documenting the transaction is reflective of fair value, a company-specific risk premium (CSRP) may be required to reconcile the WACC with the IRR. While not uncommon, it is

¹ See paragraphs 11.017—11.033 of the KPMG Business Combinations Handbook.

² See paragraphs 11.036—11.041 of the KPMG Business Combinations Handbook.

³ In situations where the purchase price reflects an overpayment or bargain purchase, the resulting IRR will not be indicative of a market participant rate of return.

not appropriate to simply use the CSRP as a plug value. Instead, the CSRP should be quantitatively supported and well documented as part of the reconciliation process.

Oftentimes, appraisers will use the same discount rate for all intangible assets without adequate consideration of risk differences between the assets. Further, these discount rates are frequently determined by subjectively adding a premium (often 100 or 200 basis points) to the WACC. The resulting discount rates for the intangible assets may not be appropriate when considering how much debt financing is implied in the discount rates. Moreover, in cases where the WACC includes a CSRP, intangible asset discount rates often fail to consider how each asset may be impacted by the risk factors represented by the CSRP. Lastly, the implied goodwill returns in the WARAs are sometimes found to be significantly higher than the returns for the intangible assets. While it is generally expected that goodwill returns will be higher than those of identified intangible assets,⁴ one would not expect the returns to be dramatically different. When these situations arise, it can be indicative of an underestimation of a discount rate for one or more tangible or intangible assets. The opposite can also occur when the risk differences between identified intangible assets and goodwill is understated. However, assessing whether the implied return on goodwill is reasonable is not just a mechanical exercise as qualitative factors also need to be considered. As an example, goodwill for a mature company will mainly represent the replacement of current intangible assets like customer relationships and one would expect the return on goodwill to be closely aligned, albeit higher than those intangible assets. In contrast, a high-growth company where goodwill represents new markets, new products, etc, will see a greater differential between returns on identified intangible assets and goodwill.

3. Contributory asset charge

Whenever a multiperiod excess earnings method (MPEEM) is used to value an intangible asset, the contributory asset charge (CAC) assumption can be one of the most significant inputs to the valuation. Unfortunately, it can also be one of the most common areas where mistakes are made; especially, when a CAC is applied to a portion of the business's overall revenue stream. Sometimes

a mismatch between the way the CAC is calculated and how it is applied can occur.⁵ Other times, the CAC may be calculated off an unreasonably low or high growth rate. In addition, when royalty rates are a component of the overall CAC, issues can arise due to confusion over net and gross royalty rates.

If a "gross" royalty rate assumption is used, then it is typically assumed that the licensor is responsible for all future development costs for the intangible asset. As a result, it would not be appropriate to include the expenses attributable to the licensor in the prospective financial information of the MPEEM. For example, if a gross technology royalty rate is used, then any research and development expenses related to that technology should be excluded from the projections since they are already captured in the royalty payment. Otherwise, these expenses would be double counted in the MPEEM. Likewise, when a gross royalty rate is used for a brand or trade name, it would be inappropriate to include any advertising expenses in the PFI since these expenses are already captured in the royalty payment.

By contrast, when a "net" royalty is used, the licensee is responsible for a portion of the expenses related to the licensed property. When a net royalty assumption is used, it is important that an appropriate level of costs is reflected in the PFI that is consistent with the responsibilities outlined in the licensing agreements forming the basis of the royalty assumption.

4. Selected royalty rates

Royalty rate assumptions can sometimes lack sufficient quantitative support, leading to challenges during the audit. Oftentimes the royalty selection process begins with a reasonable set of comparable licensing agreements; however, the resulting data points can infer a wide range of possible royalty rate assumptions. Problems can arise when this range is narrowed by using a rule of thumb or other subjective methods. Instead, when selecting a royalty rate assumption, the valuation specialist should:

- Apply a supportable search strategy to identify appropriate third-party licensing agreements
- Review the resulting licensing agreements for comparability and document the rationale for excluding any licensing agreement

⁴ It is often the case that a large portion of the goodwill value reflects the value of future versions of the identified intangible assets and would carry a greater level of risk.

⁵ For example, the CAC may be calculated on a pretax basis but applied after tax.

- Narrow the resulting royalty range by giving greater weighting to those agreements most comparable to the subject intangible asset and/or using a profit split or “return on” asset analysis to estimate the portion of operating profit attributable to the subject asset.

After performing these steps, the valuation specialist should also thoroughly document the process followed, preferably in accordance with the guidance provided in A.36 of the Application of the Mandatory Performance Framework for the Certified in Entity and Intangible Valuations™ (CEIV) credential.

5. Economic obsolescence

Situations can arise where the sum of the appraised asset values exceeds the purchase consideration. While this can occur in bargain purchases, such transactions are quite rare, and it is more likely that economic obsolescence⁶ wasn't sufficiently considered. For assets valued using a cost approach, economic obsolescence should be considered whenever the asset holder is expected to have low, or negative, operating margins. Often the quantification of economic obsolescence becomes an iterative exercise based on the value of the entity, the degree to which other assets support the value of the fixed assets, and other assumptions used when valuing the entity's fixed asset. This can be time consuming and often necessitates dynamic spreadsheet modeling skills and a high degree of coordination between tangible and intangible asset appraisers performing the valuation.

In addition, when economic obsolescence is considered, it isn't always applied at the appropriate level. Oftentimes, this is done at the reporting unit level, which can mask economic obsolescence at the asset group level when the reporting unit holds multiple asset groups that have independent cash flows. Instead, one should perform valuations at the facility level with the lowest level of independent cash flows to determine if there is sufficient economic value to support the resulting cost approach values or if a downward adjustment for economic obsolescence is appropriate.

Summary

While not comprehensive, this document describes some of the most common issues that can arise in a purchase price allocation for a business combination. Hopefully, by being mindful of these potential pitfalls, one can reduce the risk of unanticipated challenges and delays arising during the next audit.

Additional resources

For additional insight into business combinations and the CEIV credential, be sure to check out these resources:

- [KPMG Business Combination Handbook](#)
- [Avoiding Pitfalls in Business Combinations](#)
- [Financial Reporting Valuations](#)
- [What is the CEIV and why does it matter for fair value measurements.](#)

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⁶ Economic obsolescence is defined as an incurable loss in value caused by factors external to the asset such as a decline in the industry's outlook or changes in legislation.

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