

HEMMING  
MORSE, LLP

CERTIFIED PUBLIC ACCOUNTANTS,  
FORENSIC AND FINANCIAL CONSULTANTS

**Purchase Price Allocations  
Under ASC 805:  
A Guide to Allocating Purchase Price  
for Business Combinations**





HEMMING  
MORSE, LLP

CERTIFIED PUBLIC ACCOUNTANTS,  
FORENSIC AND FINANCIAL CONSULTANTS

## Executive Brief

When your company is on the buy-side of an acquisition, you are burdened with the responsibility of reporting all items related to the transaction on your financial statements. Large companies under high levels of scrutiny must pay particular attention to how the purchase price is allocated to the acquired assets.

This whitepaper will guide you through the process of allocating purchase prices for business combinations under ASC 805. You will learn how to:

- Identify a business combination
- Meet acquirer requirements
- Recognize various intangible assets
- Select the appropriate valuation method
- Allocate purchase prices for income tax purposes

Following these steps and being precise in your purchase price allocation will ensure your company is compliant with GAAP reporting rules and prevent future compliance issues after the acquisition is complete.

## HISTORY

Prior to June 2001, business combinations were accounted for according to APB Opinion No. 16, Business Combinations, which was issued in 1970. Under APB 16, a business combination could be accounted for using either the purchase method or the pooling of interests method, which had very different treatments of intangible assets. Due to certain ambiguities, the two methods were often misapplied, resulting in drastically different financial statements for similar business combinations.

On June 30, 2001, the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 141 (SFAS 141), Business Combinations, to simplify accounting for business combinations by requiring virtually all business combinations to be accounted for by the purchase method. However, SFAS 141 complicated the recognition of intangible assets.

In response, on December 7, 2007, the Financial Accounting Standards Boards released SFAS 141R, a revision of SFAS 141. SFAS 141R continued the evolution toward fair value reporting and introduced some new accounting concepts involving the definition of a business and a business combination, the treatment of contingent consideration, acquired contingencies, acquisition costs, and restructuring costs.

In July 2009, the FASB introduced the Accounting Standards Codification. The Codification superseded most previous US GAAP standards and rendered all literature not included in the Codification non authoritative. FASB Accounting Standards Codification Topic 805 (ASC 805), Business Combinations, became the definitive guidance on business combinations. It combines the content of SFAS 141R, EITF abstracts, FASB staff positions, SEC regulations, SEC staff guidance, and other authoritative guidance on Business Combinations. ASC 805 became effective for business

combinations with acquisition dates during financial reporting periods beginning on or after December 15, 2008.

## **BREAKING DOWN PURCHASE PRICE ALLOCATIONS UNDER ASC 805:**

### **Identifying a Business Combination**

Under ASC 805,

A **business** is defined as:

*An integrated set of activities and assets that is capable of being conducted and managed or the purpose of providing a return.*

This definition is broad and can result in many transactions qualifying as business combinations when they are actually only asset acquisitions. When determining if a set of assets and activities is a business, the relevant factor is **whether or not the integrated set is capable of being conducted and managed as a business** and not if the seller operated the set as a business or if the acquirer intends to do so. Unless there is evidence to the contrary, any set of assets that includes goodwill is assumed to be a business. However, the existence of goodwill is not required to meet the definition of a business. If the acquired assets are not a business, the acquirer will account for the transaction as an asset acquisition.

A **business combination** is defined as:

*A transaction or other event in which an acquiring entity obtains control of one or more businesses.*

The definition goes on to explicitly discuss mergers of equals. A change of control can occur without the exchange of consideration or even without the acquirer holding any ownership interest. The acquisition date is defined as the date the acquirer obtains control of the acquiree, regardless of the legal date of the transfer or the date the consideration is transferred.

If a business combination is affected primarily by transferring assets or by incurring liabilities, the acquirer is usually the entity that transfers the assets or incurs the liabilities. If a business combination is affected by transferring equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called reverse acquisitions, the issuing entity is the acquiree. In a reverse acquisition the legal acquirer is defined as the acquiree for accounting purposes.

If a business combination occurs because of a bankruptcy reorganization or troubled debt restructuring under fresh start accounting, the purchase consideration should take into account the value of the restructured debt. In these cases the original book value of the debt will likely differ from its fair value.

### **Consideration Transferred**

ASC 805 requires that all consideration transferred be measured at its acquisition date's fair value.

The **consideration transferred** in a business combination is calculated as:

assets transferred by the acquirer + liabilities incurred by the acquirer to the former owners + equity issued by the acquirer

Since the issuance of SFAS 141R, transaction costs are treated as period expenses and not capitalized as part of the purchase price.

If a business combination is achieved without the transfer of consideration, the acquirer would use the fair value of the acquired interest as a substitute for the consideration transferred.

## Contingent Consideration

Contingent consideration is an obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquired business if certain future events occur or conditions are met. Such an obligation would be recorded as a liability on the acquirer's books. Contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met. This right would be recorded as an asset on the acquirer's balance sheet. All contingent consideration is included in business combination accounting and is measured at its acquisition date's fair value. Typically, the fair value of contingent consideration will be determined by estimating the probability of various outcomes actually occurring.

In some cases, contingent consideration will require the seller to perform certain services over the period of the contingency. In such cases, what may appear to be contingent purchase consideration will actually be compensation. If the future payments are not actually a component of the purchase price, they should be accounted for as an expense in future periods.

## Identification of Intangible Assets

ASC 805 requires that all identifiable assets acquired, including identifiable intangible assets, be assigned a portion of the purchase price based on their fair values.

**Fair value** is defined in ASC 820 Fair Value Measurement as:

*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

An intangible asset is recognized apart from goodwill if it arises from contractual or legal rights, or if it is considered "separable," meaning capable of being separated from the acquired entity and transferred, individually or in combination with a related asset or liability.

The following categories of intangible assets must be considered in the search for identifiable intangible assets during the allocation of the purchase price:

**Marketing-related intangible assets**, which can include trademarks, trade names, non-compete agreements, and internet domain names.

**Customer-related intangible assets** include customer lists and existing customer relationships, whether or not they are contractual in nature. A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. Customer relationships may arise through means other than contracts, such as regular contact by sales or service representatives.

**Artistic-related intangible assets** meet the ASC 805 criterion for separate recognition if the assets arise from contractual or legal rights such as those provided by copyright. Copyrights can be transferred either in whole through assignment or in part through licensing agreements. In determining the fair value of an intangible asset protected by copyright, consideration shall be given to the existence of any assignments or licenses of the acquired copyrights. Artistic-related intangible assets include works of art and literature.

**Contract-based intangible assets** are those that “arise from contractual arrangements,” such as permits, franchise agreements, licensing and royalty agreements, and other contractual rights granted.

**Technology-based intangible assets** relate to “innovations or technological advances. The future economic benefits of those assets are often protected through contractual or other legal rights. Thus, many technology-based intangible assets meet the contractual-legal criterion for recognition apart from goodwill.” Such assets include technology that may or may not be patented, as well as databases and trade secrets.

Other intangible assets not considered recognizable under ASC 805 criteria include the value of the assembled workforce. The fair value of an assembled workforce would be included within goodwill.

## Valuation Methods

The valuation profession recognizes three general approaches to estimating value. In valuing a business or an intangible asset, a valuation analyst will apply one or more valuation methods that fall within these approaches.

**The income approach** is based on the practice in the securities markets of estimating the present value of net future economic benefits (including cash earnings, cost savings, tax savings, and proceeds from sale) that accrue to the owners of an asset or a business interest. One variation of the income approach, the discounted cash flow method, uses future estimated cash flows from the investment, discounted to the valuation date at an appropriate rate of return that reflects the risks of that specific investment, usually by comparison to similar investments.

Methods under the income approach are often used to value the primary acquired asset in a business combination. The most common of these methods is the excess earnings method, which identifies the cash flows attributable specifically to the asset being valued.

**The cost approach** measures the value of an asset, an interest, or a company based on the amount necessary to construct or acquire an asset of equal “utility.” This approach also incorporates adjustments to reflect deterioration, or physical or economic obsolescence. This approach is often used to establish the value of secondary assets or the assembled workforce, an intangible asset incorporated into goodwill for financial accounting purposes.

**The market approach** determines value through the analysis of the market price of comparable assets or business interests that have been traded in arms-length transactions. This approach is often difficult to apply to intangible assets due to the lack of comparable transactions available. However, market data such as royalty rates can be used in applying the relief from royalty method, a valuation method within the income approach. The guideline public company method, a form of the market approach, is often applied as a secondary method and/or a “sanity check” in determining the company’s business enterprise value.

## Goodwill

For accounting purposes, goodwill is considered a residual amount. Goodwill is an asset representing the future economic benefits arising from the other assets acquired in a business combination that have not met the criteria for being individually identified and separately recognized.

Under acquisition accounting, an acquirer will recognize goodwill, which is measured as the excess of the sum of the consideration paid, any non-controlling interest, and previously held interest over the net of the amount of identifiable assets acquired and liabilities assumed.

## Bargain Purchases

In some cases, an acquirer may make what ASC 805 terms a bargain purchase. A **bargain purchase** is a business combination where the net amount of identifiable assets acquired and liabilities assumed exceeds the sum of the consideration paid plus any non-controlling interest plus any previously held interest. If a bargain purchase has occurred, the acquirer will recognize any excess as a gain on the acquisition date.

### Example

On October 15, 2010, Celgene Corporation acquired the outstanding common stock of Abraxis BioScience, Inc. The transaction was referred to as a merger, with Abraxis becoming a wholly-owned subsidiary of Celgene. As part of the accounting for the merger as a business combination, Celgene used the acquisition method with the assets and liabilities of Abraxis being recorded on Celgene's balance sheet at fair value as of the acquisition date.

The June 30, 2010 balance sheet for Abraxis included only \$132 million in intangible assets. But because ASC 805 requires the acquirer to record these intangible assets at fair value, we see the intangibles on Celgene's December 31, 2010 balance sheet at their actual values. A review of notes to Celgene's December 31, 2010 financial statements shows that in recoding the acquisition, Celgene recorded:

- Developed product rights, \$1.17 billion
- In-process research and development product rights, \$1.29 billion
- Other finite-lived intangible assets, \$.97 billion
- Goodwill, \$1.13 billion

The developed product rights asset was valued using the income approach based on the expected cash flows from sales of ABRAXANE®, an oncology compound used in the treatment of metastatic breast cancer.

The in-process research and development product rights were valued using the income approach based on the probability-weighted cash flows associated with future ABRAXANE® approval for the treatment of non-small cell lung cancer, pancreatic cancer, and melanoma. In-process research and development is classified as an indefinite-lived asset until successful completion or abandonment of the R&D efforts.

The other finite-lived intangible assets included licensing contract rights, non-compete agreements, and future compassionate use sales.

**Result:** prior to its acquisition by Celgene, the vast majority of Abraxis's highly valuable intangible assets were not recorded on the company's books. Only through the requirements of ASC 805 did the fair value of these assets appear on the balance sheet of the merged companies.

### **PURCHASE PRICE ALLOCATIONS FOR INCOME TAX PURPOSES:**

Internal Revenue Code (IRC) Section 1060, Special Allocation Rules For Certain Asset Acquisitions, provides guidance related to purchase price allocations for asset acquisitions. According to IRC Section 1060, the total purchase price should be allocated among specifically defined classes of assets. This purchase price allocation is performed to determine the acquirer's basis in each acquired asset and the seller's gain or loss on the transfer of each asset.

The seven asset classes defined in Section 1060 are:

- Class I – cash and general deposit accounts

- Class II – actively traded securities
- Class III – assets that are marked to market annually
- Class IV – inventory and property held for sale.
- Class V – assets that do not fall within the other classes
- Class VI – IRC Section 197 assets (intangible assets) except goodwill and going concern value
- Class VII – goodwill and going concern value

Section 1060 requires that the purchase price be allocated sequentially to each asset class based on the fair market value of the acquired assets. After allocating portions of the purchase price to tangible assets in classes I through V, a portion of the purchase price is then allocated to the acquired IRC Section 197 intangible assets except goodwill and going concern value. The amount of the purchase price allocated to goodwill is then calculated as the amount after allocating the purchase price to all other acquired tangible and intangible assets in classes I through VI.

### **Amortization of Intangible Assets**

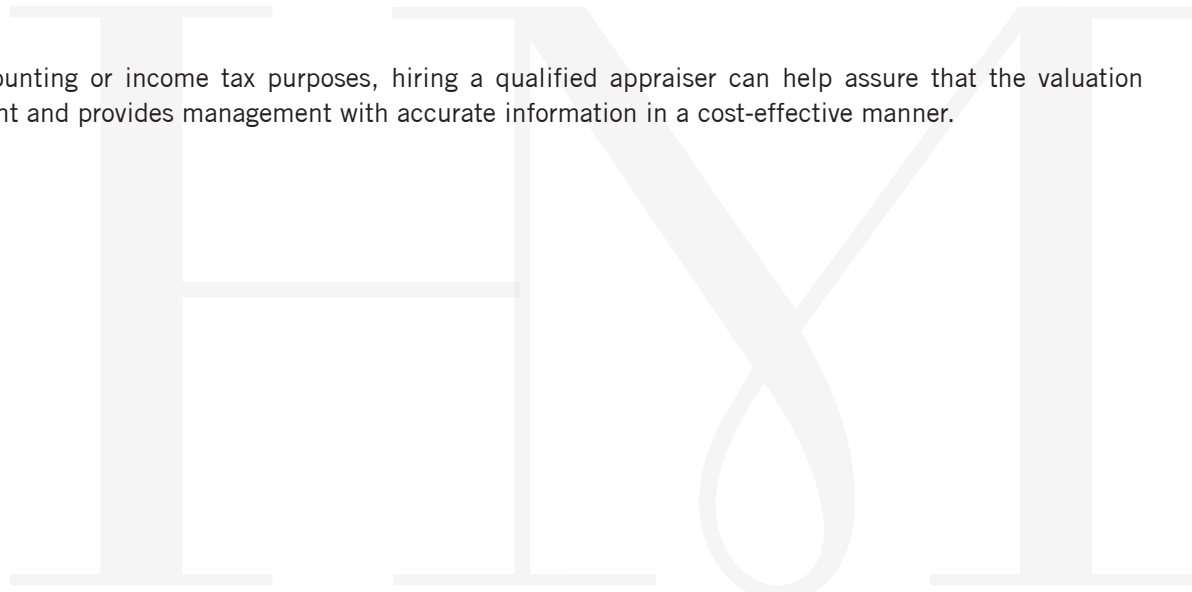
In estimating the value of an intangible asset, the appraiser must make an assumption as to the life of that asset. Because of this, the life assumption in a valuation model can be different from the asset's actual economic life.

When amortizing an intangible asset, the life variable should represent the economic life, which will usually be longer than the life estimate for valuation purposes. In many cases, intangible assets such as developed technology, covenants not to compete, and customer lists will have finite lives. Other assets such as trade names can have infinite lives. Infinite lived intangible assets, as well as goodwill, are not amortized but rather tested for impairment periodically. Under federal income tax regulations, all IRC Section 197 intangible assets are amortized over a 15-year period regardless of their actual life or the economic life used for amortization under GAAP.

### **CONCLUSION**

After remaining static for more than 30 years, accounting for business combinations has evolved significantly since 2001. SFAS 141 (and 141R) eliminated much of the subjectivity in accounting for business combinations and provided guidance for the comparability of the reporting on such transactions. Under the Accounting Standards Codification, the guidance in this area continues to evolve and be clarified, including 36 amendments and additions since July 2009.

Whether for accounting or income tax purposes, hiring a qualified appraiser can help assure that the valuation process is efficient and provides management with accurate information in a cost-effective manner.



## **ABOUT HEMMING MORSE, LLP AND THE AUTHORS**

Hemming Morse, LLP advises clients throughout the nation, with a strategic focus on financial and forensic consulting services. Founded in 1958 and headquartered in San Francisco, Hemming Morse has seven offices throughout California. For more information, please visit [www.hemming.com](http://www.hemming.com).

Carl Saba is a partner in Hemming Morse's Financial and Forensic Consulting Service Group. He advises companies on valuation issues for financial reporting, tax applications, mergers and acquisitions, and litigation matters. His valuation expertise includes businesses, intellectual property, options and other complex derivatives. Carl is a founding member and Executive Committee Chair of the Fair Value Forum, and he is on the board of the Valuation Roundtable of San Francisco.

He can be reached at [sabac@hemming.com](mailto:sabac@hemming.com)

Joseph Emanuele is a Principal in the Financial and Forensic Consulting Service Group in the Los Angeles office of Hemming Morse, LLP. Joseph has performed valuations for purposes that include taxation, financial reporting, internal decision-making, marital dissolutions, and non-profit to for-profit conversions. He also provides litigation consulting services and performs financial investigations.

He can be reached at [emanuelej@hemming.com](mailto:emanuelej@hemming.com)

