ASU 2014-18 allows private companies in certain circumstances to record fewer intangible assets in a business combination. This simplified process is intended to reduce the time and expenses devoted to complying with the requirements of ASC 805. There are, however, some limitations and pitfalls to this simplified approach and companies should proceed with caution.

What is ASU 2014-18?

In December 2014, the Financial Accounting Standards Board ("FASB") issued a guideline to private companies intended to simplify the process of recognizing and measuring intangible assets acquired in business combinations. The new guideline is issued as Accounting Standards Update No. 2014-18 (ASU 2014-18), which relates to Accounting Standards Codification Topic 805 (ASC 805), Business Combinations. ASU 2014-18 allows private companies to recognize fewer intangible assets in business combinations under certain circumstances. FASB concluded that the "benefits of the current accounting for identifiable intangible assets acquired in a business combination often do not justify the related costs." However, the guideline could introduce some unintended complications after adopting ASU 2014-18.

ASU 2014-18 provides an alternative reporting standard based on the Private Company Council’s recommendation to simplify the process of allocating value among intangible assets. ASU 2014-18 may be elected by private companies and applied to two types of intangible assets in a business combination: (i) non-compete agreements and (ii) certain customer-related intangible ("CRI") assets that are not capable of being sold or licensed independently from the other assets of the business. ASU 2014-18 allows these intangible assets to be "subsumed" into goodwill rather than being recognized separately. Electing ASU 2014-18 requires adoption of ASU 2014-02, which mandates goodwill to be amortized over a maximum of 10 years on a straight-line basis. ASU 2014-18 may be elected in fiscal years beginning after December 15, 2015, with early adoption permitted. The election of ASU 2014-18 is permanent; all business combinations thereafter must adhere to the guideline.

Why Did FASB Adopt ASU 2014-18?

FASB indicated that although non-compete agreements are important in a business combination, the fair values of such agreements were not “decision useful.” In addition, FASB noted that non-compete agreements are “among the most subjective and difficult intangible assets to measure and that their value is disregarded by many users.”

FASB also indicated that CRI assets “generally are not transferable or separable from the entity ... because their values depend on too many variables that may be overly subjective.” Citing comments from the Private Company Council, FASB explains that “intangible assets are most relevant when their cash flows can be reliably estimated or they can be sold in liquidation.” Examples of such “relevant” CRI assets that FASB cites are: mortgage servicing rights; commodity supply contracts; core deposits; and customer information. These CRI assets tend to be customer lists or data that can readily be sold or licensed to third parties independent from the other assets of the business. Therefore, these types of CRI assets need to be identified and valued separately from goodwill. CRI assets that have negative values (that is, liabilities) also need to be identified and valued.

ASU 2014-18's Usefulness

ASU 2014-18 is most relevant when a company’s intangible assets are limited to non-compete agreements and CRI assets. However, this is not the case in all business combinations. In many transactions, we identify and value assets such as trademarks and trade names, supply and distribution agreements, backlogs, and proprietary software, among others. If a company operates in the technology sector, we often identify and value assets such as developed technology and in-process research and development, patents, and trade secrets. We also test whether proprietary procedures or protocols...
qualify as separable intangible assets. Real estate and machinery and equipment must also be reported at fair value. It is these transactions involving companies with few identifiable intangible assets that benefit most from ASU 2014-18.

Unforeseen Consequences: Regulation S-X Rule 3-05 and IFRS

Although there can be benefits, adopting ASU 2014-18 may result in some unforeseen consequences. If a company undergoes an initial public offering ("IPO") in the future, which may not have been foreseen when adopting ASU 2014-18, financial statements would need to be restated. The Securities and Exchange Commission (the “SEC”) requires that all accounting alternatives elected while operating as a private company must be retrospectively restated to reflect financial statements as if U.S. GAAP had always been in effect. The same applies if the company is acquired by a public company or by a private equity firm with an IPO exit strategy. Also, if a significant ownership interest is acquired by a public company, then there could be a change in financial reporting requirements as prescribed by the SEC’s Regulation S-X Rule 3-05. Restatements will also be necessary if the buyer is foreign and the reporting standard becomes International Financial Reporting Standards (IFRS). These are possibilities for some of our clients and the time and expenses devoted to reversing ASU 2014-18 could become significant and costly.

Complications May Arise Later

Another issue arises when implementing the guideline. In a business combination, the intangible assets identified may not be limited to the non-compete agreements and CRI assets that can be reported as part of goodwill. They may include a trademark, technology or a customer list. Assets may also include contracts such as supply agreements, favorable lease agreements, and licensing agreements, which are specifically excluded from ASU 2014-18. In this situation, the non-compete agreement and CRI assets that do qualify for ASU 2014-18 may have to be identified and appraised for contributory asset charges necessary to value other assets. If so, all of the intangible assets would have to be valued, just as the assembled workforce is still valued even though it is treated as part of goodwill. Therefore, when some intangible assets qualify under ASU 2014-18 and others do not, adoption of ASU 2014-18 does not simplify the valuation. It would certainly not justify the cost of valuing all of the intangible assets, only to classify the eligible CRI assets and non-compete agreement as part of goodwill. Unless there is a compelling reason, implementing the guideline may not reduce complexity when there are additional intangible assets. This could become the case if management foresees significant growth through acquisitions. ASU 2014-18 is a permanent election; if management expects to make larger and more complex acquisitions down the road, then adopting the guideline could complicate rather than simplify the process. As companies become larger, they tend to make larger acquisitions and the number of identifiable intangible assets often increases with the size of the acquiree.

Consistency and Usefulness of Financial Statements

Consistency and usefulness of financial statements are of paramount concern to investors, owners, lenders, and potential buyers of the business. When ASU 2014-18 is adopted, prior transactions involving non-compete agreements and CRI assets would not be restated. Thus, the company’s financial statements would not be internally consistent, thereby reducing the comparability of a company’s financial statements across time. Furthermore, the comparability of financial statements relative to peer groups and especially public companies would be reduced. It is for this reason that three of FASB’s seven board members, including Vice Chairman James Kroeker, opposed the issuance of ASU 2014-18: “In the dissenting Board members’ view, comparability is a vital qualitative characteristic of decision-useful information ... the Board has not concluded that a difference in accounting for private entities is warranted based on differences in the benefits and/or costs of the reported information to stakeholders of private versus public entities ... [t]he accounting for private and public entities should remain the same.”

Also, ASU 2014-18 is an issue when financial statements are presented to lenders and equity investors for financing, as goodwill and intangible assets may not be regarded in an equivalent manner. This is especially likely as lenders and investors are not used to dealing with public companies or private companies that have adopted ASU 2014-18. It is possible that some lenders will find ASU 2014-18 problematic, as loan covenants and other provisions often assume that traditional GAAP accounting is being followed. Therefore, when adopting the guideline, management should consider the expectations of current and future stakeholders. Many readers of financial statements may prefer the additional detail of
separating identified intangible assets from goodwill. Reporting intangible assets separate from goodwill may be the best option if your company’s future is uncertain.

Conclusion

Management should consider these potential issues before adopting ASU 2014-18. If all of these concerns are duly considered, then ASU 2014-18 could simplify the task of booking intangible assets. However, when the possibility of being acquired by a public or international company, or making more complex acquisitions exists, ASU 2014-18 may not be the best path to take. To discuss these and other issues that arise in a business combination, please contact Appraisal Economics at +1 201 265 3333.

Disclaimer: this article has content that is general and informational in nature. This document is not intended to be accounting, tax, legal, or investment advice. Data from third parties is believed to be reliable, but no assurance is made as to the accuracy or completeness.

Endnotes:


2. Ibid., p. 16.

3. The Private Company Council was formed in May 2012 to explore potential modifications to U.S. GAAP for private companies by considering their needs and those who prepare financial statements on their behalf. FASB has the ultimate authority to rule on such modifications.

4. Ibid., p. 18.

5. Ibid., p. 17

6. Ibid., p. 16.