Asset Purchase Method of Accounting for Better Risk Management

“The safest way to double your money is to fold it over once and put it back in your pocket.” Frank McKinney Hubbard, Cartoonist, Humorist and Journalist

The process of analyzing merger and acquisition opportunities consists of three phases known as planning, search and screen, and financial evaluation. The analysis should answer the following six questions in detail:

1. What is the maximum price that should be paid for the acquisition?
2. How was that price calculated?
3. What are the principal areas of risk?
4. What are the cash flow, earnings and balance sheet implications?
5. What is the best way of financing the acquisition?
6. What is the projected payback period and Return-On-Investment (ROI) after the purchase?

Acquisition versus Purchase Method of Accounting

A business combination is defined as a transaction where the entire business is purchased. In our article titled “Acquisition Method of Accounting as a Tool for Forming Strategic Partnerships,” we recommended that the purchaser use the “Acquisition Method” of accounting to optimize the value of the transaction to both the buyer and seller.

An asset purchase is when either a single asset or group of assets is purchased and both the buyer and seller remain owners of their separate businesses.

The buyer purchases individual assets such as equipment, fixtures, leaseholds or licenses. Asset sales normally do not include cash and the seller typically retains any long-term debt obligations.

For example, the purchase of an entire company including all its operations will use the “Acquisition Method” of accounting and the purchase of a single machine will use the “Purchase Method” of accounting.

How to Determine Which Method to Use

The following three steps are critical in determining which accounting method to use according to the accounting firm PricewaterhouseCoopers LLC (PWC):

1. Identify the elements in the acquired group (the assets purchased and processes transferred).

2. Assess the capability of the elements to generate economic benefits.
3. Assess the impact of any missing elements on a market participant's ability to generate economic benefits

Below are the primary determinants:

Business Combination	Asset Acquisition
Key business processes acquired	No processes acquired or only administrative processes acquired
A market participant could manage the assets to provide a return to its owners	A market participant could not manage the assets to provide a return to its owners without combining them with other assets
Key elements are missing but can be easily replicated or obtained	Key elements are missing and cannot be easily replicated or obtained
Key employees hired	No employees hired
Able to produce "Day 1" outputs	Not able to create economic benefits
Presence of liabilities and/or goodwill	No goodwill present

Area	Business Combination	Asset Acquisition
Measurement of assets and liabilities	Fair value	Allocate purchase consideration based on relative fair values
Transaction costs	Expense	Capitalize
Contingent Consideration	Generally, record at fair value; mark to market through P&L post-close if a liability	Generally, record when probable and reasonably estimable
In-Process Research & Development	Capitalize as an indefinite asset until the project is completed or abandoned	Expense assuming no alternative future use
Goodwill	Recognize as standalone asset	Cannot be recognized
Acquired contingencies	Recognize at fair value if determinable; otherwise, when probable and reasonably estimable	Generally, record when probable and reasonably estimable
Assembled workforce	Absorbed in goodwill	Recognize as a standalone asset

Source pwc.com

Risk Management

We recommend the buyer use the Purchase Method when it is believed the risk of acquiring the entire business including all its existing and potential liabilities exceeds the value of the company. This method is also recommended when the buyer only wants to purchase a particular asset such as a patent or single product line.

The financial effects of acquisitions can be very complex. It is highly recommended that you consult with a professional before embarking on this journey.

How We Can Help You

Pacific Crest Group (PCG) provides professional services that keep your business focused on your critical objectives. We provide strategic Accounting and Human Resource (HR) services created specifically to help you meet your goals. Through exemplary customer service, clearly defined policies and procedures as well as a forward looking perspective, we provide the outsourced solutions your business needs to grow. A PCG professional is happy to meet with you to discuss solutions for your unique requirements designed to maximize all of your business opportunities.