Purchase Price Allocations

ASC 805 – Business Combinations

Introduction

- Mergers, acquisitions, and other business transactions have numerous accounting and tax implications.
- Buyers generally identify and report the fair values of the assets acquired and the liabilities assumed.
- The aggregate purchase price, or purchase consideration, is allocated among the assets, commonly referred to as a "purchase price allocation" or "PPA".
- The purchase consideration can be cash, stock, contingent consideration (an "earnout") or other assets provided to the seller, the buyer can assume liabilities of the seller, or a combination.

Importance

- Purchase price allocations allow companies to:
  - Report assets and liabilities on the balance sheet at fair value in accordance with GAAP.
  - Compute the depreciation of tangible assets and the amortization of intangible assets to accurately report subsequent earnings.
  - Perform annual goodwill impairment testing against the book value of goodwill, which is determined in the PPA.

Appraisal Economics
Independent Valuation Experts

Rules and Standards

- PPAs are governed by rules and standards promulgated by the U.S. Financial Accounting Standards Board (“FASB”) and International Financial Reporting Standards (“IFRS”).
- In particular, the FASB’s Accounting Standards Codification Topic 805 (“ASC 805”) and IFRS 3 both address PPAs.

Determining the Purchase Price

- Buyers often convey a combination of cash, securities, and contingent consideration.
- Earnouts — a form of contingent consideration where the amount paid to the seller at a later date depends on a post-acquisition metric of the acquired company's performance. Earnouts must be valued and included in the allocable basis.

Identifying Previously Unreported Assets

- Assets created internally by the target company, which were not previously reported on the target's balance sheet, are identified, valued, and reported on the acquirer's balance sheet after the transaction.
- This means that the assets to be valued must first be identified, and may not initially be obvious.

Intangible Asset Recognition Criteria

- Intangible assets are assessed to determine whether they meet either:
  (i) the separability criterion or
  (ii) the contractual-legal criterion
- An intangible asset is separable if it is "capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged either individually or together with a related contract, identifiable asset, or liability."[1]
- An intangible asset meets the contractual-legal criterion if it "arises from contractual or other legal rights." [2]
- If neither criteria is met, the asset value is included in the residual goodwill that remains after the purchase consideration has been allocated to all other asset categories.

Notes:

1. <http://www.fasb.org/resources/ccurl/218/786/ASU%202014-18.pdf>
2. Ibid.

Recording Assets and Liabilities

- Assets and liabilities are recorded at "fair value", which is:
  - "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." [3]
  - Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are independent, knowledgeable, able to transact, and willing to transact.
  - This may be materially different than the historical cost, net book value, or tax basis, and requires consideration of market participants and the economic conditions as of the measurement date.

Note:

3. <http://www.appraisers.org/Disciplines/Personal-Property/pp-appraiser-resources/definitions-of-value>

Appraisal Economics
Independent Valuation Experts

Process

1. Determine the purchase consideration.
2. Identify assets.
   - Tangible assets
   - Intangible assets
     - Most intangible assets are amortized over their expected lives; this expense can have a major impact on taxes, pretax earnings, after-tax earnings, and cash flows.
3. Allocate purchase price among identified assets.
   - Remainder goes to residual goodwill

Identifiable Intangible Assets

- Major categories of intangible assets are:
  - Marketing-related
    (e.g. trademarks and trade names)
  - Customer-related
    (e.g. customer relationships and customer lists)
  - Artistic-related
    (e.g. patents and literature)
  - Contract-based
    (e.g. permits and franchise agreements)
  - Technology-based
    (e.g. copyrights and trade secrets)

Pre-Closing Analysis

- PPAs are usually performed post-acquisition; however, clients sometimes engage us prior to closing.
- Pre-closing analysis may be useful to the buyer and seller to identify GAAP and tax-basis depreciation and amortization, which will affect earnings.

Valuation Approaches

There are three general approaches to valuation:

1. Income approach
   - Present value of projected future cash flows
2. Market approach
   - Relevant market prices are used to derive multiples applied to metrics and estimate value
3. Cost approach
   - Based on the concept of substitution, methods include reproduction cost, replacement cost, and historical cost less depreciation

Income Approach

- Using the income approach, the values of intangible assets are calculated by discounting the future cash flows expected over their remaining useful lives.
  - The annual after-tax cash flows that the asset will generate are estimated over an appropriate projection period.
  - The after-tax cash flows are then converted to their present value equivalents using a rate of return that accounts for the relative risk of the asset and the time value of money.

Market Approach

- The prices paid for the same or similar assets in actual transactions are used as the basis of value.
- Value is estimated by comparison and interrelationship between the subject asset and other similar assets.
- Considerations such as time and terms of sale are analyzed and adjusted.
- The market approach is most applicable when it is possible to specify a marketplace for the assets being appraised.
- Comparable transactions with sufficient disclosure of material terms are often elusive for many intangible assets.

Cost Approach

- In the cost approach, the cost to replace an asset may be a good proxy for its value.
- It assumes that an investor would pay no more for an asset than the amount for which it could be replaced new.
- If a particular asset provides less utility than a new one, its value will be reduced for physical deterioration, and functional and economic obsolescence.

Goodwill

- Any remaining value that is not allocated to a specific tangible or intangible asset is categorized as residual goodwill.
- Includes the assembled workforce, which is not considered an identifiable intangible asset.
- The goodwill amount computed in the PPA is usually tested for impairment at least annually.
- Generally, goodwill impairment occurs when a company pays more than book value for a set of assets (the difference is the goodwill), and must later reduce the book value of that goodwill.

Conclusion

- Purchase price allocations provide greater transparency for investors and allow for a more detailed view of the components of a company's value.
- Enable accurate computation of future earnings.
- Form the foundation of future impairment testing.

Representative PPAs Performed by AE

- Purchase price allocation and goodwill impairment testing of a premier manufacturer of highly engineered building products for total consideration in excess of $1 billion.
- Pet food manufacturer acquired as part of a private equity roll-up.
- Fully-integrated paper mill in the Pacific Northwest.
- Utility-scale solar operator in New Jersey.
- North American-based integrated manufacturer and wholesaler of branded and private label paper products.
- Assets of a privately held, machine condition monitoring company.

For More Information

www.ae-us.com
+1 201 265 3333

Appraisal Economics Inc.
140 E. Ridgewood Ave. Ste. 380N
Paramus, New Jersey 07652

TM and © 2018 Appraisal Economics Inc. All rights reserved.