mpi Business Valuation & Advisory

Case Study

Purchase Price Allocation

Overview

When one company acquires another, U.S. GAAP requires an allocation of the purchase price paid to the assets acquired in the transaction. This article provides background regarding a purchase price allocation, select complex issues, and the process imparted by MPI.

MPI was contacted by the chief financial officer of a publicly traded company which had just completed a business combination transaction wherein it acquired 80% of the outstanding securities of a target company using its own publicly traded stock to fund the transaction.

Target company was engaged in manufacturing and distribution of specialty chemicals, and sold product into numerous geographic jurisdictions. From an accounting view, the acquirer segregated the target's business into three reporting units following the provisions of ASC Topic 280 – Segment Reporting.

The purchase consideration associated with the transaction was initially thought to be $160 million, an amount calculated by taking the publicly traded stock price as of the transaction date and multiplying by the number of shares issued to target company's shareholders. However, the stock which was used as currency was a thinly traded security; therefore, additional valuation work was required. Further, the fair value of the non-controlling interest (NCI) required an evaluation.

The identified assets to be valued included personal property (i.e., equipment, furniture, fixtures, etc.), trade name and related trademarks, customer lists, select processing technologies used in manufacturing, and chemical product registrations.

MPI provided invaluable guidance with respect to complex valuation issues that are often present in business combination transactions.

Solution

MPI was retained as a trusted advisor to provide acquisition accounting valuation services in connection with ASC Topic 805 – Business Combinations. The assignment encompassed the following steps conducted by MPI:

- Developed an understanding of the transaction, including transaction rationale, purchase consideration, and key assets acquired.
- Developed a plan of action to address the following valuations complications: (1) determine fair value of purchase consideration; (2) allocate purchase consideration to three reporting units; and (3) evaluate the fair value of the remaining NCI.
- Conducted due diligence with management, including review and analysis of target company operations, business strategy, historical and projected financial statements, transaction documents, etc.
- Determined appropriate company-level and reporting unit discount rates (IRR & WACC); further determined appropriate asset specific discount rates giving important consideration to a stratification of rates concept.
- Developed comprehensive company-level valuation model incorporating three forms of the market approach to valuation and discounted cash flow analyses.
- Developed comprehensive asset valuation model incorporating intangible asset methodologies such as relief from royalty, multi-period excess earnings, and replacement cost approaches.
- Documented the analysis in a self-contained valuation report.
- Provided follow-up consultation with management and its CPA firm.

MPI: Trusted Advisor

The company's management team relied on MPI to consider and implement solutions to complex valuation issues applicable to the transaction.

Regarding the purchase consideration, ASC 805-30-30-7 indicates the purchase consideration in a business combination should be measured at fair value. In the instant case, the public company common stock was thinly traded *and* there was reason to believe it may not be representative of fair value. Accordingly, to address this issue, we conducted valuation analyses at the company-level to determine the fair value of the acquirer's securities, giving consideration to the publicly traded price and also our own independent assessment. Our independent analyses were compared to the publicly traded market capitalization. A reconciliation analysis, wherein we sought to identify reasons for differences between the indications of value, was also conducted. Ultimately, we corroborated the reasonableness of the market indication of value.

Another complex valuation issue surrounded the allocation of purchase consideration to the three reporting units. To this end, we conducted valuation analyses at the reporting unit level, specifically emphasizing (but not limiting the analysis to) discounted cash flow analyses. The results of our valuations at the reporting unit level were used to allocate the purchase consideration and determine a starting point for asset allocations to each segment.

Finally, MPI conducted an analysis of the remaining non-controlling interest. ASC Topic 805-30-30-1 indicates the fair value of NCI should be considered in a purchase price allocation. In the instant case, the implied value of the NCI using extrapolation was $40 million ($160 million divide by 80% multiplied by 20%). However, an extrapolation analysis assumes the cash flows attributable to the minority interest are the same as those attributable to the controlling interest. Therefore, we analyzed the cash flows and transaction considerations with a view to establishing whether or not a control premium was present and, if so, whether minority investors would be willing to pay the same amount (on a per share basis) for the cash flow stream.

In addition to advising on complex valuation issues, the assignment included the following elements:

- MPI's valuation analysis and report were fully compliant with Uniform Standards of Professional Appraisal Practice and were prepared in a manner consistent with all available acquisition accounting guidance promulgated by the FASB and other constituents.
- The purchase price allocation was prepared and delivered within the timeframe established at the outset of the engagement.
- The auditors relied on MPI's self-contained valuation report and the expertise of our appraisers, resulting in a smooth audit review process.
- The independence and expertise exhibited by MPI continues to represent industry best practices, generating additional comfort for the CPA firm with management's financial reporting for the business combination.

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