Introduction to Purchase Price Allocations

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A "business combination" results in the need for a Purchase Price Allocation ("PPA"). A PPA is an allocation of the purchase price paid to the assets and liabilities included in a transaction. PPAs represent a reporting requirement for both financial and tax reporting purposes. This article focuses on PPAs for financial reporting purposes.

Recent History

In 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 FASB released SFAS 141R, a revision of SFAS 141, which 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 FAS introduced the Accounting Standards Codification ("ASC"). The ASC superseded most previous U.S. GAAP standards and rendered all literature no included in the ASC as non-authoritative. ASC Topic 805 – Business Combinations became the definitive guidance on business combinations. It combined the content of SFAS 141R, EITF abstracts, FASB staff positions, SEC regulations, SEC staff guidance, and other guidance on business combinations.

Guidance from ASC Topic 820 – Fair Value is also relevant, as ASC 820 indicates, among other precepts, the standard of value to be used in purchase price allocations. Specifically, the standard of value is fair value, defined 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.

Objective of a PPA

Guidance pertaining to purchase price allocation is outlined under ASC Topic 805. Subsequent to all business combinations that involve a change in control, companies are required to complete a PPA (regardless of whether the transaction is structured as an asset deal or a stock deal).

The objective of a PPA is to measure the fair values of the identifiable assets for allocation on an opening balance sheet. As mentioned, the ASC defines *fair value* 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. The principles regarding the business combinations topic are addressed in ASC Topic 805, portions of which are excerpted below. Following a determination of market revenue and market share, the build-out of an operating infrastructure must be considered. In this regard, the company may first have to purchase or lease land. Next, fixed assets such as towers, antennae, transmitters, building and improvements, and others must be designed and constructed. The analyst must consider both the cost to acquire and construct, as well as the associated timeframe to completion.

In general, an acquiring company shall measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable GAAP for those items, depending on their nature. As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. The ASC lists such identifiable intangible assets to include trade names, technology, contract rights, customer relationships, non-competition agreements and customer backlog, among others.

ASC Topic 805-Subtopic 25 presents the criteria by which intangible assets shall be recognized assets apart from goodwill. Essentially, the asset must arise from contractual or other legal rights (the contractual/legal criterion) <u>or</u> if it is separable, that is, if it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged, regardless of intent to do so (the separable criterion).

ASC Topic 805-Subtopic 55 provides examples of identifiable intangible assets and categorizes such assets as follows: marketing-related, customer-related, artistic-related, contract-based and technology-based assets. Examples of assets within each category are presented below:

- ***Marketing-related intangible assets include:*** trademarks, trade names, trade dress, service marks (collectively referred to as "trade names"), and non-competition agreements.
- ***Customer-related intangible assets include:*** customer lists, order or production backlog, customer contracts and related customer relationships and non-contractual customer relationships.
- ***Artistic-related intangible assets include:*** books, magazines or other literary works, pictures, photographs, and audio-visual materials.

- ***Contract-based intangible assets include:*** licensing, royalty and standstill agreements, advertising, service or supply contracts, lease agreements, construction permits, franchise agreements, operating and broadcast rights, use rights (such as drilling, etc.), servicing contracts and employment contracts.
- ***Technology-based intangible assets include:*** patented and unpatented technology, computer software, databases, and trade secrets, formulas, and proprietary processes.

Practically, we regularly prepare PPAs with value allocated to the following asset categories:

- Net working capital
- Real property
- Personal property
- Intangible assets
  - Trade names and marks
  - Customer lists / customer relationships
  - Developed technologies
  - Covenants not-to-compete
  - Goodwill

Other assets are sometimes present, as well. We are typically engaged by the acquiring entity after the transaction has been closed. However, there are circumstances in which we are engaged prior to a deal being closed, most notably by companies seeking to fully ascertain the tax consequences of a deal, or by public company acquirers who are seeking to understand the (pro forma) impact the PPA will have on earnings.

Information Requirements

The typical information requirements relative to a PPA include the following:

- Historical financial statements of target entity
- Projected financial statements of target entity
- Copies of any deal models
- Copies of the legal documents governing the transaction (e.g. Purchase Agreement)
- Copies of any Confidential Offering Memoranda

Business Valuation & Advisory

Key Recommendations and Our Approach

MPI's value-added approach incorporates the following steps to assist companies and their advisors in accounting for business combinations.

- One of the most difficult aspects of purchase price allocation assignments is the identification of the key assets (and, in some cases, liabilities) to be valued. We engage in a detailed scoping process of prospective assignments, including the provision of assistance to management teams with regard to asset identification based on our experience.
- We recommend and offer our time for an upfront call including you and your audit team to review the assignment, identified assets, and contemplated valuation methodologies. Our flexibility and time commitment to clients ensures that MPI, the client, and the audit team are "on the same playing field" as the process begins.
- Review client information and conduct due diligence. Our due diligence process is not limited by hourly time constraints. We'll spend as much time as needed to develop a full understanding of the subject company and its assets.
- Prepare PPA analysis, including development of fair values and remaining economic lives of the identified tangible and intangible assets.
- Communicate results in a thoroughly documented report. We understand that you appreciate the opportunity to review our work. Therefore, we always first tender a draft report, allowing time for review.
- Follow up call with client and audit team to provide an overview of our analysis methodologies, and opinions. Our comprehensive approach keeps all parties informed and up to date with information so as to make the process as fluid and transparent as possible for our clients.

Summary

MPI stands ready to assist you with the valuation related aspects of ASC Topic 805 and purchase price allocations, either on a consultative basis or by providing independent valuation opinions that are thoroughly supported and well-reasoned. Our approach involves working closely with you, as clients, and your other professional advisors in order to make sure the entire team is aligned. With our dedicated purchase price allocation and intangible asset allocation team, MPI has the resources and experience necessary to prepare your purchase price allocation, including business enterprise or reporting unit valuations, evaluations of contingent consideration, and asset-level valuations.

As always, we remain committed to consistently delivering supportable valuation opinions and the highest quality documented reports to our clients. Please contact us for more information.