

The Purchase Price Allocation

Analyze Early to Avoid Future Earnings Surprises

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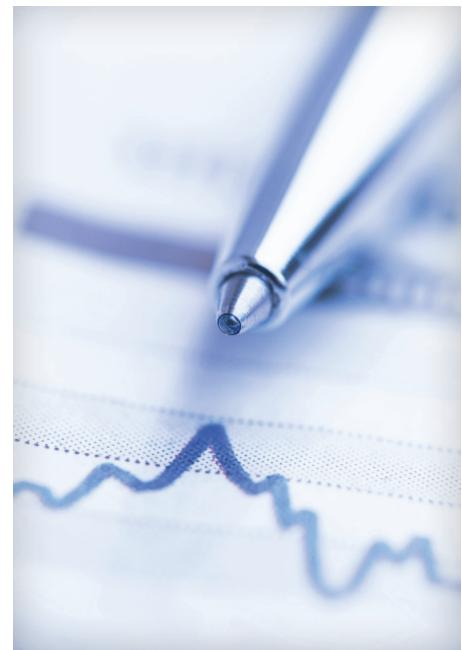
The purchase price allocation (PPA) process, often treated as an afterthought in mergers and acquisitions (M&A), can help guide a deal to a more predictable conclusion. In the most rewarding deals, a prompt PPA process helps acquirers analyze, from a financial reporting point of view, the primary drivers or intangible values associated with the transactions. The PPA process can help align an acquirer's business vision with its financial reporting – a necessary first step toward realizing the anticipated earnings per share. A well-considered and well-executed process can also prevent Day Two earnings surprises due to unanticipated dilutive (or accretive) effects from larger- (or smaller-) than-anticipated accretion, depreciation, and amortization expenses of the acquired assets and liabilities.

The PPA process often is not a priority until after a deal has closed. However, for companies that integrate it into their M&A procedures early in the deal, and have the help of valuation experts, the PPA process tends to run more smoothly. Early valuation involvement also is likely to produce more consistency between due diligence expectations and post-closing realities.

Managing the process well can help an acquiring company understand the financial accounting aspects of the assets and liabilities it is acquiring. Good process management also provides the opportunity for early exposure of the buyer and its auditor to the acquisition's effect on the buyer's financial statements after the deal.

Understanding the Basics of a PPA

A PPA is simply the allocation of the total consideration transferred among tangible assets (net working capital and fixed assets), intangible assets (separately identified intangible assets and goodwill, which is treated as a residual), and liabilities (including debt). Occasionally, total consideration transferred is more than the fair value of the identified assets acquired and liabilities assumed. In such case, the acquirer would recognize the gain in its earnings on the acquisition date. The acquired assets and liabilities generally are adjusted to reflect their respective fair value on the opening balance sheet, often referred to as the Day One balance sheet.



Determining how to express an acquisition's value in accounting terms might seem academic to deal-makers who have studied a purchase inside and out and view the target as an integrated whole. It could be tempting, therefore, to treat the PPA process as an exercise in post-deal rationalization.

However, the PPA can affect companies' earnings and, in the case of financial institutions, their regulatory capital. The acquired fixed assets are adjusted to fair value and depreciated at different rates depending on the estimated useful lives of the fixed assets. With respect to intangible assets, distinctions must be made among the separately identified intangible assets. Liabilities need to be adjusted to current market expectations for assuming those liabilities. Financial institutions also must adjust the fair value of loans issued and include expectations of both credit and market factors in the resulting values.

Separately identified intangible assets, such as patents, copyrights, and licenses, are amortized at different rates, depending on each asset's estimated useful life, including an indefinite life if appropriate, and other circumstances specific to the asset. Goodwill, on the other hand, is not amortized by public business entities for book purposes but tested annually for impairment instead. (See "Reacting to a Changing Landscape" later for discussion of the U.S. generally accepted accounting principles (GAAP) alternative to amortize goodwill available to nonpublic business entities.) Therefore, if these separately identified intangible assets are not identified and valued appropriately, the amortization expenses might be overstated or understated. This, in turn, can affect future earnings, which is an important financial indicator to investors, especially for public companies, for which stock prices are often assessed by short-term performance indicators such as earnings per share.

Using the Checklist Approach

A proper PPA process benefits from a regimented structure. The foundational first steps are determining the rationale behind the acquisition and studying the consideration transferred, including the buyer's anticipated internal rate of return.

These steps help an acquirer and its auditor understand from an accounting perspective the assets being purchased and liabilities being assumed.

After the fair value of the tangible assets is identified, the next step is to identify the intangible assets. To do that, it helps to understand the transaction's main driver, which in most cases will serve as the primary income-generating asset. Other intangible assets also need to be identified and valued separately. An assessment of how these intangible assets create value (whether through cost savings or premium pricing) and how long these assets are expected to generate value (for example, through life cycle or attrition analysis) provides the basis for value. For financial institutions, acquirers must also address matters such as loan valuations, core deposit intangible assets, unfunded commitments, and expected purchase accounting adjustments for liabilities assumed.

Preparing for a PPA Audit

In the PPA process, an acquirer needs to be able to walk the valuation appraisers and auditors through a deal from start to finish. Following is a list of questions an acquirer is likely to be asked during the PPA process. Answering them can help the financial reporting of an acquisition have a good start.

1. Describe the acquisition's rationale. What drove the purchaser's interest, and is the deal the product of a competitive bid?
2. What are the target company's primary income-generating assets, and what methods were used to select them?
3. Were any intangible assets identified but ultimately not valued in the acquisition? If so, why were they excluded?
4. Can the acquirer provide a summary of the components of the purchase price, such as cash, debt assumed, contingent consideration, and valuation of noncontrolling interests?
5. What support is available for the estimated useful life for each identified asset? The acquirer should provide qualitative and quantitative evidence to support its analyses of customer attrition, the life cycle of purchased technology, and the strength of the brand value.
6. Are property, plant and equipment, and inventory being held at fair value? If the answer is no, why not?

Given the varying lives and consumption patterns of tangible and intangible assets, a methodical approach is vital. Depending on the nature of the intangible assets, different valuation methods are applied to value those assets.

Because of the inherent complexity of the process, companies new to M&A often have an understandable desire to delay a PPA until after a deal has been established. However, the process's importance has led acquirers to incorporate PPAs more frequently into earlier-stage diligence efforts. A benefit of moving up the work is that it facilitates earlier interaction with the auditors and valuation appraisers, thereby inducing buyer, appraiser, and audit teams to be on the same level of understanding and minimizing unnecessary post-deal accounting surprises.

Given the long-term audit implications of PPAs, the process provides an opportunity to integrate financial reporting and strategic considerations. Company management knows what it finds attractive about a deal – and its accountants should as well (see sidebar, "Preparing for a PPA Audit").

Supporting a Smart Purchase Decision

Getting an early start on PPAs can add value. Incorporating the PPA process into M&A diligence can serve as a "sanity check," forcing a rigorous exploration of what besides tangible assets is being purchased.

A well-run PPA process that produces a significant allocation to goodwill might indicate that an acquirer's internal rate of return is below that of the market participants, which could signify an overpayment. Therefore the PPA process can help acquirers to re-evaluate the assumptions used in determining the consideration transferred. However, if the acquirer expects important synergies that other market participants don't, then a high level of goodwill might be appropriate.

A prompt PPA process can provide an opportunity for a closer look at a deal. Often based on rules of thumb, valuations that investment bankers and other consultants give during the diligence process frequently lack the specificity that a PPA requires. In instances where valuations might be contested, a PPA can inject authority and clear metrics into the process. In a negotiation environment, the view of an independent party not involved in the deal can be invaluable.

Reacting to a Changing Landscape

To make PPAs more manageable, industry standard setters are weighing alterations to the process. The Private Company Council (PCC) of the Financial Accounting Standards Board (FASB) issued a draft proposal in mid-2013 that would make a PPA process more manageable for private companies that elect to adopt the PCC guidance.

Responses to the draft suggest that the cost savings from a change would not be material; however, FASB staffers are considering three options. The first is not to recognize any intangibles in a business combination and record all intangible asset value into goodwill. The second is to recognize only assets that can be separated and sold apart from the business at fair value. Finally, maintaining the existing accounting rule is still an option.

With regard to public companies, the FASB staffers have conducted research to identify the relevance of a PPA process for users of financial information. The staffers noted that the fair value information of separately identified intangible assets is important and the cost of the PPA analysis is not considered burdensome.

In January 2014, the FASB issued Accounting Standards Update (ASU) 2014-02 related to an alternative to amortize goodwill over a life not to exceed 10 years that can be applied by electing private companies. But, FASB staffers have not yet made any decisions regarding fair value method alternatives related to PPA procedures for private and public companies.

Gleaning the Advantages

Beyond the changes, however, are clear benefits to taking a proactive, rigorous approach to the PPA process. Armed with the right expertise and a vigorous method, an acquiring company can manage the M&A process to include the PPA considerations sooner and avoid any post-deal earnings or other surprises.

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