Valuation Challenges During Due Diligence - Purchase Price Allocation Issues

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Why Should We Care?

- **Earnings per share impact of the transaction - will the deal be accretive or dilutive?**
  - Acquisition related costs are expensed versus capitalized
  - Number of assets (and liabilities) recognized
    - Backlog and deferred revenue are often overlooked but important
  - Finite lived assets vs. indefinite lived assets - amortization expense vs. annual impairment testing
  - Useful life considerations
  - Inventory step-up
  - Leases - favorable / unfavorable
- **Structuring purchase consideration**
  - Contingent consideration - balance sheet and income statement effects
  - Off-balance sheet entities - consolidation surprises
  - Financing deals - financial instruments with mandatory redemption provisions - liability vs. equity treatment
- **Other pre-deal issues**
  - Collaboration of management, auditors, and valuation specialists is essential up-front
  - How liabilities are recognized will affect liquidity measures in debt covenants
  - Board / investor expectations must be **aggressively** managed

Acquisition Related (Transaction) Costs

- Transaction costs that the acquirer incurs to affect a business combination are not part of the consideration paid. These costs are to be accounted for separately from the business combination.
  - Costs include direct payments to investment bankers, advisors, attorneys, appraisers and accountants.
  - Most of these costs will only affect the first year w/noticeable impact on earnings and on the financial projections used to model the deal.
- Most restructuring costs intended to achieve synergies (plant closings, severance payments and golden parachutes, etc.) will be expensed after closing.
  - Benefits will be received in the future, if at all.
- Costs are expensed when incurred, except debt and equity issuance costs.
- The acquirer's reimbursement of amounts paid by the acquiree, or its former owners, for acquisition related costs of the acquirer should also be accounted for separately from the business combination.
  - These costs are incurred primarily for the benefit of the acquirer rather than the acquiree, or its former owners, and therefore are not part of the business combination transaction.
- **Investor expectations must be managed**
  - Companies must explain the nature and amount of deal-related costs as these costs directly affect net income and EPS.

Contingent Consideration

- The value of the consideration transferred (purchase price) includes the acquisition date fair value of any contingent consideration.
- Contingent arrangements of the acquiree assumed by the acquirer will **also** be measured at fair value. These unresolved contingencies from prior acquiree transactions can also have a material impact on earnings volatility of the acquirer.
- Contingent consideration will take the form of either:
  - The right to a return of previously transferred consideration is classified as an **asset**.
  - The obligation to pay additional consideration is classified as either a **liability** or **equity**.
- A contingency classified as an **asset** or a **liability** will be adjusted to fair value at each reporting date through earnings.
- A contingency classified as **equity** will not be remeasured. The settlement of the contingency will be accounted for within equity.
- **Counterintuitive Accounting Treatment & Potential Risks**
  - If the initial fair value measurement of the earn-out is less than the actual payment, a loss is recorded in the income statement upon the occurrence of the payment even if the business performed better than originally expected.
  - If the initial fair value measurement is greater than the actual payment, a gain is recorded in the income statement even though the business is performing worse than originally expected.

Leases - Operating, Capital or Failed / Sale Leaseback

- Recognition of operating leases (normally applies to real property)
  - The acquirer recognizes an intangible **asset** if the terms of an acquiree's lease are favorable (below market) as of the acquisition date
    - Asset would require amortization
  - The acquirer recognizes a **liability** if the terms are unfavorable (above market) as of the acquisition date
    - Liability is additional consideration
- Recognition of capital leases (normally applies to personal property)
  - Asset would be fair valued as of the acquisition date
    - Step-up would not be uncommon (10%-40%?)
    - Similar for owned personal property & inventory
- Failed / sale leaseback
  - Determination that operating leases were incorrectly classified by the acquiree
    - Asset would remain on acquirer's balance sheet and the lease obligation would be classified as a liability. This is a major issue and could affect debt covenants.
- **Potential Risks**
  - Unexpected increases in amortization, depreciation and liabilities are common
  - Fair value determination can be a lengthy process causing issues w/debt covenants

In-Process Research & Development (IPR&D)

- Tangible and intangible assets used in R&D are recognized at their acquisition date fair values and are not immediately charged to expense, regardless of whether they have any alternative future use in another R&D project. This is a change in previous accounting treatment.
- Considered an indefinite-lived asset (no amortization) until project is completed or abandoned
  - Amortized once completed
  - Write-off if abandoned
- Acquirer would determine the useful life of the intangible asset on the completion of the R&D efforts
- Costs incurred and assets acquired after the acquisition date are expensed as incurred, if used in R&D activities w/no alternative future use
- Careful determination must be made as to the existence of IPR&D
  - In any case, acquirer will either amortize the asset or impair the asset in future periods

Deferred Revenue

- Involves transactions where a product or service has been sold, but not yet delivered
- Deferred revenue is typically associated with the sale of:
  - Technology licenses
  - Service & maintenance agreements
  - Implementation agreements
  - Work under contract w/associated retainers
    - Large transactions where the acquirer has multiple LOB can result in numerous deferred revenue accounts requiring valuation
- Does a legal performance obligation exist?
  - If Yes > FV the liability based on discernible costs to complete plus a normal profit margin
  - If No < the acquiring company should not recognize a liability as of the acquisition date
    - This can significantly reduce future revenue with adverse consequences for EDITDA & EPS projections

Defensive Assets

- A defensive asset is an asset that a buyer does not intend to actively use, but intends to prevent others from using by withholding the asset from the marketplace. This is done to prevent competition, or to enhance the value of an existing asset.
- A common example of a defensive asset is an acquired brand that an entity may plan to use for a transition period, before re-branding the product to its own.
  - The buyer then "locks up" the acquired brand and will not make it available for others to use. Buyer removes a competitor and hopes to increase its own market share.
- Acquirer's intentions do not influence the fair value estimate. Assets are measured using market participant assumptions.
  - Acquirers will need to consider the direct and indirect incremental cash flows created by withholding the asset from the marketplace in ascribing value and determining the economic life of the asset.
- Initial measurement of defensive assets
  - Acquirer's determination of how a market participant would use an asset will have a direct impact on the initial value ascribed to each defensive asset. Therefore, identifying market participants, developing market participant assumptions and determining the appropriate valuation basis are critical components in developing the initial FV value measurement for defensive assets.
- Not all unused assets are defensive assets
  - If an acquirer does not intend to actively use an asset and does not intend to prevent others from using it, the asset is **not** a defensive asset.