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Purchase Price Allocation: Valuation Challenges During Due Diligence

Overcoming Critical Issues Arising in Business Stock and Asset Sales

WEDNESDAY, DECEMBER 21, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Purchase Price Allocation: Valuation Challenges During Due Diligence Seminar

Dec. 21, 2011

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Today's Program

Tax Issues With Pre-Close PPAs — Slide 7 - Slide 23
[Michael Hauser]

Accounting Issues With Pre-Close PPAs — Slide 24 - Slide 39
[Steve Hastings]

Current Hot Topics In The Pre-Close Arena — Slide 40 - Slide 47
[Brian Jones]

Michael Hauser, Maddin Hauser Wartell Roth & Heller

TAX ISSUES WITH PRE-CLOSE PPAs

Overview Of Threshold Issues

1. Taxable or tax-free acquisition
2. Corporation, LLC or partnership being acquired
3. Stock purchase or asset purchase
4. Motivating factors of parties

Types Of Corporate Tax-Free Acquisitions (Sect. 368)

1. "Type A" – Mergers
2. "Type B" – Stock-for-stock
3. "Type C" – Transfer of all assets
4. "Type D" – Spin-offs and split-offs

General Requirements Of Tax-Free Corporate Acquisitions

1. Continuity of shareholder ownership (i.e. target corp. shareholders receive stock in acquiring corp.)
2. Continuity of business enterprise
3. Legitimate non-tax business purpose

Asset Allocation In Tax-Free Acquisitions?

1. Sect. 362(b) – Carry-over basis at net book value (nothing to allocate)

2. Inherit tax attributes of predecessor companies (subject to certain limits to prevent “shopping” in net operating losses, etc.)

Tax-Free Acquisitions Of LLCs And Partnerships

1. Mergers (Reg. 1.708-1)

2. Contributions of assets (or LLC/partnership interests) in exchange for newly issued equity in acquiring LLC

3. Carry-over basis

4. However, asset allocation principles may apply, as partnership tax laws permit special allocation of depreciation to prevent partners from suffering detriment from low-basis assets.

Structuring Taxable Acquisitions (1)

1. Stock purchase

   a. Generally better for seller
   b. Seller of stock assured of capital gain treatment and avoids two-level tax (for C corporations)
   c. Buyer gets basis in stock (non-depreciable) and carry-over basis in corporate assets – ***no depreciable / amortizable basis step-up*****.**
   d. Buyer inherits actual and contingent liabilities.

Structuring Taxable Acquisitions (2)

2. Asset purchase

   a. Generally better for purchaser
   b. Seller of assets may not get capital gain treatment (depends on allocation of assets) and incurs two-level tax (for C corporations).
   c. Buyer gets basis in assets (likely depreciable), rather than carry-over basis, and asset allocation will determine ***depreciable/amortizable basis step-up***.
   d. Buyer does not generally inherit liabilities.

Purchase Price Allocation To Assets

a. Sect. 1060 requires disclosure of purchase price allocation for asset purchase involving ongoing business.

b. Arm's length agreement between buyer and seller on asset allocation will be binding on the parties and generally will be binding on the IRS (absent unusual circumstances).

c. No requirement that buyer and seller agree on allocation

Cost/Benefit Of Allocation Agreement

a. IRS Form 8594 requires “checking box” whether buyer and seller agreed on the allocation, and requests other party’s Tax ID.

b. Agreement will provide a strong presumption that asset allocation should be respected.

c. Agreement will also bind parties with disparate interests to a potentially unwelcome compromise, which they may wish to avoid.

Asset Allocation Categories

Categories listed in IRS regulations:

a. Class I: Cash
b. Class II: Publicly traded securities
c. Class III: Accounts receivable, certain debts
d. Class IV: Inventory
e. Class V: Fixed assets
f. Class VI: Specific intangibles (know-how, TM, NCC)
g. Class VII: Goodwill (residual allocation equal to whatever not allocated to other categories)

Cost/Benefit Of Allocations: Buyer (1)

1. A/R and inventory are generally the best categories for the buyer – fastest write-off (prevent income recognition on turnover)
2. Depreciable fixed assets will have next-fastest write-off (3-7 years) – technology items, equipment, furniture
3. Real estate improvements – slower write-off: 15-39 years (parking lot, residential or commercial bldg.)
4. Goodwill and other intangibles – 15-year
5. Land and subsidiary stock are non-depreciable.

Cost/Benefit Of Allocations: Buyer (2)

1. Faster write-offs delay income recognition (timing difference).
2. Depending on difference in tax rates and available losses, deferring income to future may not be preferable.
3. For taxpayers that will benefit from capital gains tax treatment, avoiding short-life personal property will prevent ordinary income recapture later.

Cost/Benefit Of Allocations: Buyer (3)

1. Real estate generally does not require Form 8594 disclosure.

2. "Cost segregation": Engineering firms study property in detail to maximize allocation to short-life personal property and minimize allocation to 27-to-39-year building shell.

3. Potential short-life property within real estate: Floor coverings, wall partitions, signs, window treatments, appliances/kitchen, back-up generators, specialized HVAC, plumbing, electrical (for kitchens, labs, etc., not for whole buildings)

Insolvency

1. Insolvency is judged immediately prior to COD event.

2. Insolvency relief applies to the extent a taxpayer is insolvent. If debts are $100,000; FMV of assets is $60,000, and $50,000 of COD occurs; only $40,000 of COD qualifies for insolvency exception.

3. Per Merkel case, loan guarantees are considered debts if it is more likely than not taxpayer will be called on to pay.

4. However, cancellation of loan guarantee is generally not COD (COD income incurred by the borrower).

Cost/Benefit Of Allocations: Seller

1. Capital gains vs. ordinary income (Note: C corporations do not receive favorable tax rates from capital gains)

2. Availability of installment sale treatment for seller-financed acquisitions (on capital assets only)

3. Availability of Sect. 1031 tax-free exchange treatment (for real estate and certain fixed assets, not goodwill)

4. Goodwill is a capital asset; sale produces capital gain (except to extent amortization taken on purchased goodwill)

Example: Stock Vs. Asset Sale

1. Buyer is acquiring Plony Co., a family-owned C corporation, for $10 million.

2. Plony Co. is a service business; its only asset is goodwill.

3. Stock sale
   a. Seller pays $1.5 million in federal tax (owner's 1040)
   b. Buyer gets $10 million stock basis, no goodwill basis

4. Asset sale
   a. Seller pays $3.5 million in corporate tax, $1 million in tax on owner's 1040, nets $5.5 million
   b. Buyer gets $10 million goodwill basis, deducts $666,667/year from income for 15 years

Steve Hastings, ValueScope Inc.

ACCOUNTING ISSUES WITH PRE-CLOSE PPAs

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Accounting Standards

FASB guidance: Accounting standards codifications (ASC)

- ASC 805 (business combinations)
- ASC 350 (goodwill and intangible assets)
- ASC 360 (accounting for the impairment or disposal of long-lived assets)
- ASC 740 (income taxes)

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Accounting Standards (Cont.)

ASC 805 (business combinations)

- Formerly Statements of Accounting Standards (SFAS) 141(R)
- Requires purchase method of accounting for acquisitions
  - Specifically prohibits use of pooling of interests
- Provides recognition criteria for identifiable intangible assets separate from goodwill
  - An asset arising from a contractual or legal right, such as a patent, trademark or copyright; or
  - An asset other than contractual that can be sold, transferred, licensed, rented or exchanged individually or in combination

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Accounting Standards (Cont.)

ASC 805 (business combinations), Cont.

- Intangibles categorized by type
  - Marketing, customer, artistic, contractual, technology
  - Examples: Trade name, trademark, customer list, patent, software, intellectual property, non-competition agreements

- Intangibles valued by appropriate approaches and methods
  - Approaches: Income, market and cost
  - Methods: Relief from royalty, excess earnings, cost to recreate, etc.

- Determination of the intangible's remaining useful life
  - Definite: Specific estimate with support such as contract term or utilization of attrition rate (customer list/relationships)
  - Indefinite: Subject to ASC 350 impairment testing in subsequent reporting periods

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Accounting Standards (Cont.)

ASC 350 (goodwill and intangible assets)

- Amortization of goodwill is not permitted.
  - Prior to SFAS 142 (effective Jan. 1, 2002), goodwill was amortized over its useful life up to 40 years.
- Goodwill is still recognized on the balance sheet and tested with other indefinite-lived intangibles on an annual basis, via a two-step process.
- **Step #1**: Test for potential impairment by comparing fair value of reporting unit to its carrying value
- **Step #2** (if necessary): Allocate the fair value of the firm to its tangible and intangible assets, and compare the residual with the carrying value of goodwill

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Accounting Standards (Cont.)

ASC 360 (accounting for impairment of long-lived assets)

- FASB guidance on treatment of finite-lived assets
- Two-step process, although different than ASC 350
- Initial test utilizes undiscounted cash flows for recoverability
  - Less impairment risk
- Impairment loss is only recognized if the carrying value of the finite-lived asset is not recoverable, based on sum of undiscounted cash flows.
- Amount of the impairment loss is the excess of carrying value over its fair value.

Accounting Standards (Cont.)

Income tax considerations

- Contingent consideration arrangements are generally not recognized for tax purposes until they become fixed and determinable.
- If acquisition-related costs will result in a future deduction should the combination not occur, the acquirer would report a deferred tax asset when related cost is charged to expense.
- If a deferred tax asset is reported for acquisition-related costs once the combination is consummated, acquirer must assess whether the deferred tax asset continues to exist or should be written off.

Accounting Standards (Cont.)

Income tax considerations (Cont.)

- Difference in book and tax goodwill results in a temporary difference, and deferred taxes should be recognized.
- A deferred tax liability related to the temporary difference in goodwill that is not deductible is prohibited.
- A deferred tax liability is not recorded for the excess of book goodwill over tax goodwill, while a deferred tax asset is recorded for the excess of tax goodwill over book goodwill.

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Accounting Standards (Cont.)

Book and tax valuation differences

- Valuation estimates are important for acquisitions, restructurings and tax planning.
- Some inconsistencies between financial reporting and tax reporting continue to exist, despite improvements in recent standards.
- Key differences include:
  - Allocation standards
  - Standards and definitions of value
  - Difference in purchase price

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Accounting Standards (Cont.)

Book and tax valuation differences (Cont.)

Financial Reporting	Tax Reporting
Allocation Standards	
ASC 805 - formerly FAS 141, 141(R)	IRC Section 338, 197, 754, 1060
ASC 350 and 820	Revenue Ruling 59-60 and Tax Court Cases
Standards and Definitions of Value	
"Fair Value" - market participants	"Fair Market Value" - willing buyer, willing seller
Intangible categories valued in aggregate at reporting unit level	Certain intangibles valued on individual basis at legal entity level
Fair value estimate always includes tax amortization benefit	Tax amortization benefit is included if amortization in deductible
Valuation may not consider legal ownership or transfer pricing	Consideration of difference between economic and legal ownership and transfer pricing policies
Differences in Purchase Price	
Transaction costs are excluded	Certain transaction costs are included
Fair value measurement of contingent consideration and liabilities	Contingent consideration and liabilities not included
Deferred taxes are included	Deferred taxes are excluded
Accrued Liabilities are included	Accrued Liabilities are primarily excluded

Sensitivity Analysis: Allocation And Amortization

Pulling it all together: The valuation dashboard

- Allows for sensitivity analysis of key intangible assumptions and the associated effect on fair value and annual amortization
- Purchase price allocation models are typically dynamic, especially when utilizing an excess earnings model with contributory asset charges.

Purchase Price Allocation			
Valuation Method	Indicated Value	Estimated Life	Annual Intangible Amortization
Discounted Cash Flow Analysis	$ 209,131		
Working Capital	$ 43,095		
Fixed Assets	622		
Other Assets	12,581		
Trade Name / Trademarks	40,656	Indefinite	Tested annually
Customer List	41,288	12	3,441
Sponsor Relationships	4,562	13	351
Training/Compliance	4,624	15	308
Non Compete Agreement 1	3,962	2	1,981
Non Compete Agreement 2	1,297	4	371
Proprietary Software	12,000	8	1,500
Goodwill (including workforce)	44,444	Indefinite	Tested annually
Fair Value of Net Assets	**$ 209,131**		**$ 7,951**

Purchase Price Allocation Sensitivity		
Resulting Input	Input	Controls
Unsystematic Risk Premium	5.24%	
Intangible Discount Rate	22.55%	
Trade Name Royalty Rate	3.00%	
Customer List - Attrition Rate	4.00%	
Sponsor Relationships - Attrition Rate	2.50%	
Training/Compliance Months to Recreate	3.0	
Non Compete 1 - Ability (1st year)	25.00%	
Non Compete 1 - Ability (2nd year)	50.00%	
Non Compete 1 - Ability (Cumulative)	50.00%	Cumulative cannot exceed 100%
Non Compete 1 - Willingness (1st year)	5.00%	
Non Compete 1 - Willingness (2nd year)	5.00%	
Non Compete 1 - Willingness (Cumulative)	5.26%	Cumulative cannot exceed 100%
Non Compete 2 - Ability (1st year)	15.00%	
Non Compete 2 - Ability (2nd year)	25.00%	
Non Compete 2 - Ability (Cumulative)	20.00%	Cumulative cannot exceed 100%
Non Compete 2 - Willingness (1st year)	5.00%	
Non Compete 2 - Willingness (2nd year)	5.00%	
Non Compete 2 - Willingness (Cumulative)	5.26%	Cumulative cannot exceed 100%
Software Life (prior to obsolescence)	10	

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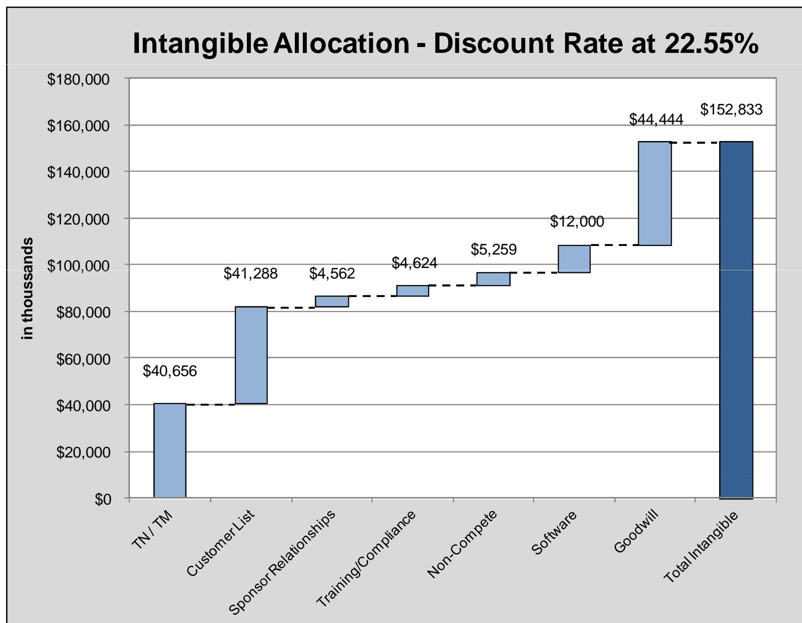
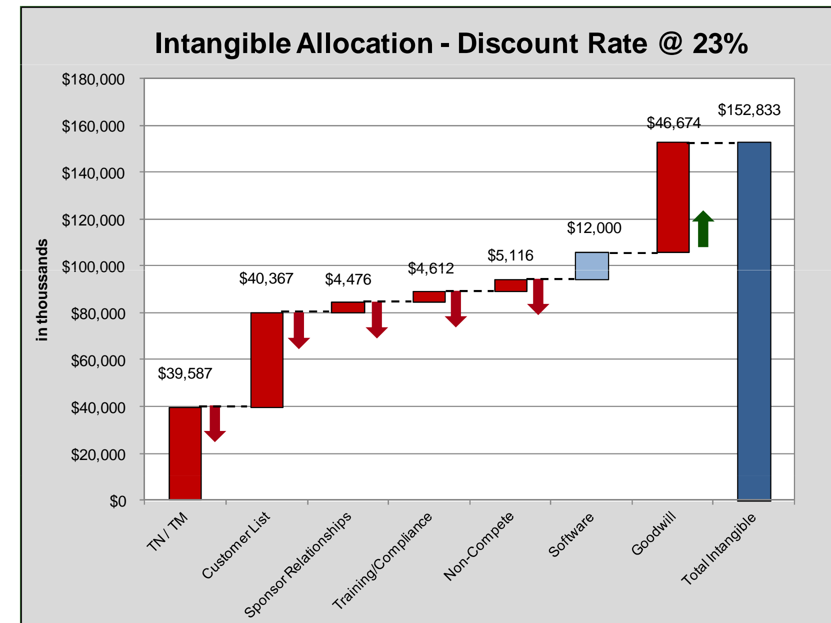
Sensitivity Analysis: Allocation And Amortization (Cont.)

Intangible valuation - Sensitivity of intangible discount rate





- Increasing the intangible discount rate results in lower intangible values that are based on the income approach.
- Software was based on the cost approach, so it remains the same.

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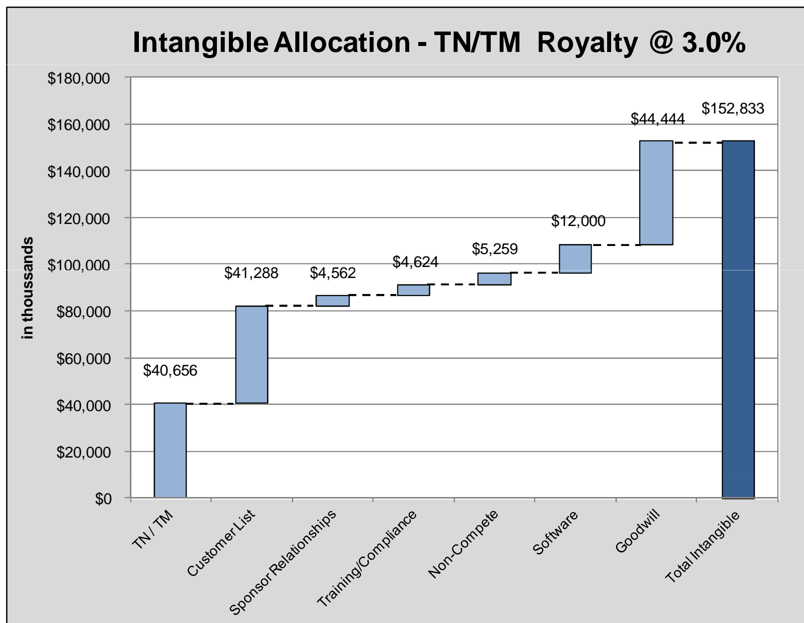
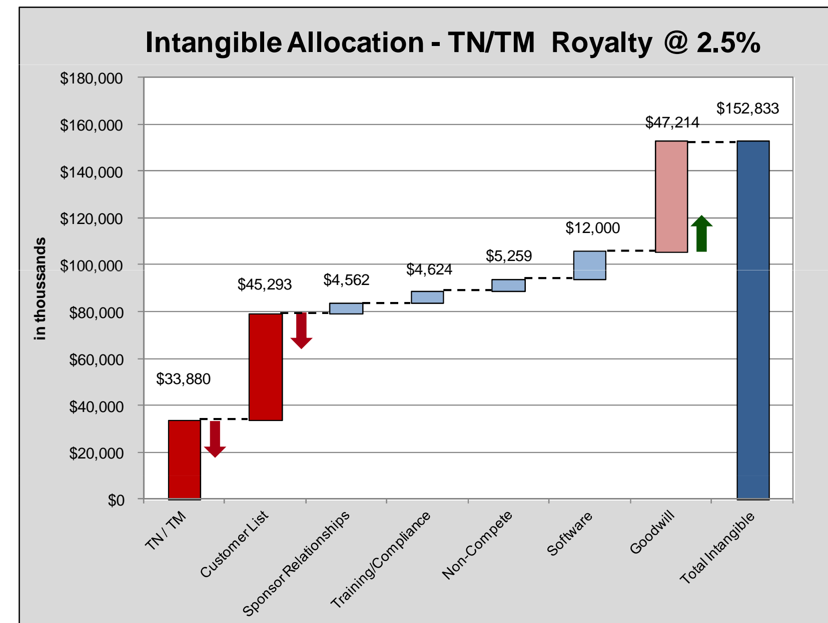
Sensitivity Analysis: Allocation And Amortization (Cont.)

Trade name/trademark – Sensitivity of royalty rate

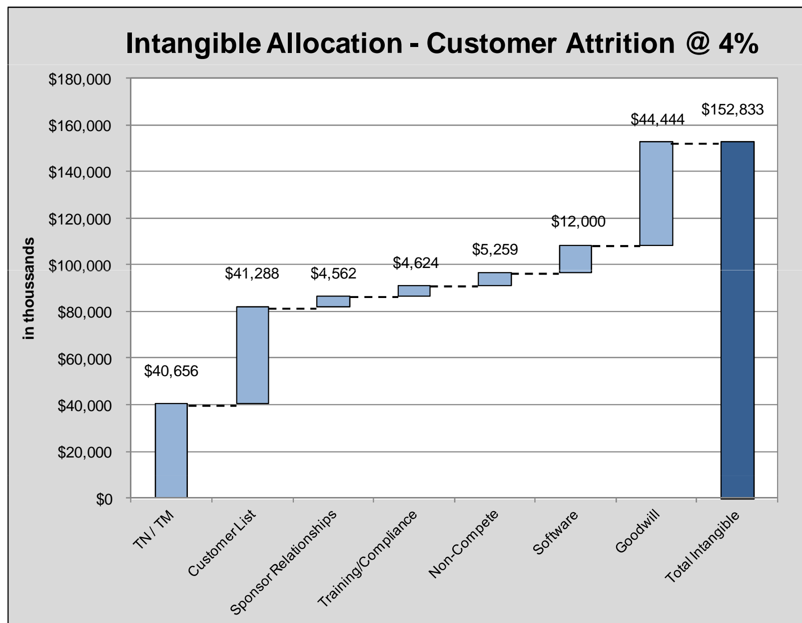


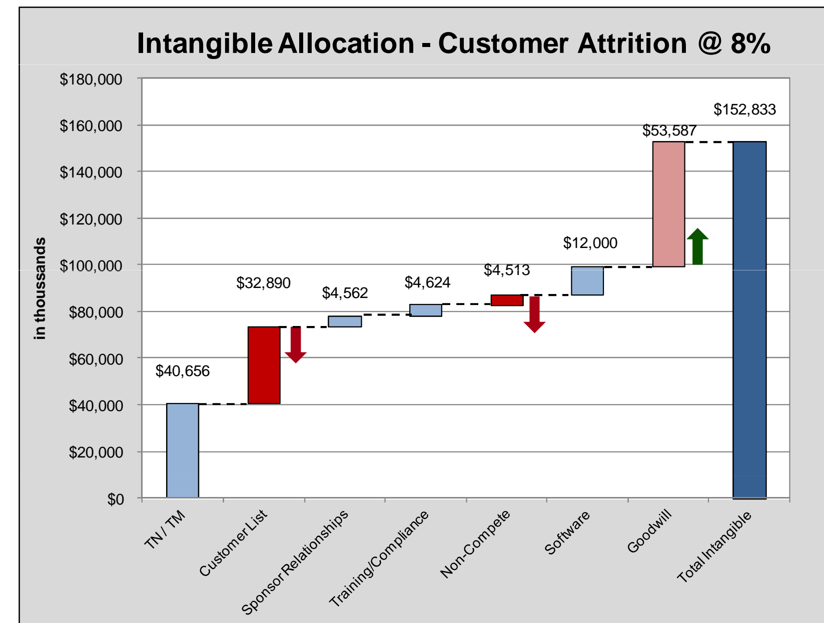


- Decreasing the royalty rate lowers the value for trade name and trademarks, but increases the value of the customer list and goodwill.
- Customer list increases, because the value of a contributory asset and the associated charge have decreased.

Sensitivity Analysis: Allocation And Amortization (Cont.)

Customer list – Sensitivity of the annual attrition rate





- Higher attrition results in lower customer list value and affects non-compete value, based on applied methodology.
- Decrease in customer list and non-compete allocated to goodwill
- Higher attrition also reduced remaining useful life from 12 years to 10 years.

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Sensitivity Analysis: Allocation And Amortization (Cont.)

Determination of definite or indefinite life

Example: Trade *name/trademarks*

Estimated Useful Life	10 years	Indefinite
PV of estimated net cash flows over 10 years	$27,742	$27,742
PV residual value	None	8,224
Tax Amortization Benefit	3,618	4,690
Tax Amortization Benefit Premium	13.0%	13.0%
Fair Value of Intangible	31,360	40,656
Annual amortization (book)	3,136	None, tested annually for impairment

Sensitivity Analysis: Allocation And Amortization (Cont.)

Ranges of value – Reasonableness and sanity checks

- Not always one answer. Allowing auditors to get comfortable with how model moves and impact of changes makes reviews go much smoother.
- As shown, there is always an offset to other asset categories given a change.

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Brian Jones, Kotzin Valuation Partners

CURRENT HOT TOPICS IN THE PPA ARENA

Why Should We Care?

- **Earnings per share impact of the transaction - will the deal be accretive or dilutive?**
  - Acquisition-related costs are expensed vs. 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 with 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 by 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 re-measured. The settlement of the contingency will be accounted for within equity.
- **Counter-intuitive accounting treatment and potential risks**
  - If the initial fair value measurement of the earn-out is less than the actual payment, then 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, then a gain is recorded in the income statement, even though the business is performing worse than originally expected.

Leases: Operating, Capital Or Failed/Sale Lease-Back

- 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 lease-back
  - 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 with debt covenants.

KOTZIN VALUATION PARTNERS

In-Process Research And 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 with 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 and maintenance agreements
  - Implementation agreements
  - Work under contract with associated retainers
    - Large transactions in which 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 and EPS projections.

Defensive Assets

- A defensive asset is one the buyer does not intend to actively use but rather 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, then the asset is **not** a defensive asset.