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Reviewing a Purchase Price Allocation Report

Reviewing a purchase price allocation report can be a daunting task if you don't do it for a living - especially if you aren't familiar with the rules and standards governing the allocation process and the valuation methods used to determine the fair value of intangible assets. While it can be tempting as a financial manager to leave this job to your auditor and valuation specialist, it is important to stay on top of the allocation process. Too often, managers find themselves struggling to answer eleventh hour questions from auditors or being surprised by the effect on earnings from intangible asset amortization. This guide is intended to make the report review process easier while helping to avoid these unnecessary hassles.

Please note that a review of the valuation methods and fair value accounting standards is beyond the scope of this guide. Grappling with these issues is the responsibility of the valuation specialist, and a purchase price allocation report should explain the valuation issues relevant to your particular acquisition. Instead, this guide focuses on providing an overview of the structure and content of a properly prepared purchase price allocation report.

GENERAL RULES

While every acquisition will present different circumstances that will impact the purchase price allocation process, there are a few general rules common to all properly prepared reports. From a qualitative standpoint, a purchase price allocation report should satisfy three conditions:

1. *The report should be well-documented.* As a general rule, the reviewer of the purchase price allocation should be able to follow the allocation process step-by-step. Supporting documentation used by the valuation specialist in the determination of value should be clearly listed and the report narrative should be sufficiently detailed so that the methods used in the allocation can be understood.

2. *The report should demonstrate that the valuation specialist is knowledgeable of all relevant facts and circumstances pertaining to the acquisition.* If a valuation specialist is not aware of pertinent facts related to the company or transaction, he or she will be unable to provide a reasonable purchase price allocation. If the report does not demonstrate this knowledge, the reviewer of the report will be unable to rely on the allocation.

3. *The report should make sense.* A purchase price allocation report will not make sense if it describes an unsound valuation process or if it describes a reasonable valuation process in an abbreviated,

INSIDE

ambiguous, or dense manner. Rather, the report should be written in clear language and reflect the economic reality of the acquisition (within the bounds of fair value accounting rules).

ASSIGNMENT DEFINITION

A purchase price allocation report should include a clear definition of the valuation assignment. For a purchase price allocation, the assignment definition should include:

» *Objective* – The definition of the valuation objective should specify the client, the acquired business, and the intangible assets to be valued.

» *Purpose* – The purpose explains why the valuation specialist was retained. Typically, a purchase price allocation is completed to comply with GAAP financial reporting rules.

» *Effective Date* – The effective date of the purchase price allocation is typically the closing date of the acquisition.

» *Standard of Value* – The standard of value specifies the definition of value used in the purchase price allocation. If the valuation is being conducted for financial reporting purposes, the standard of value will generally be fair value as defined in SFAS 157.

» *Statement of Scope and Limitations* – Most valuation standards of practice require such statements that clearly delineate the information relied upon and specify what the valuation does and does not purport to do.

BACKGROUND INFORMATION

The purchase price allocation report should demonstrate that the valuation specialist has a thorough understanding of the acquired business, the intangible assets to be valued, the company's historical financial performance, and the transaction giving rise to the purchase price allocation.

Company Overview

Discussion related to the acquired company should demonstrate that the valuation specialist is knowledgeable of the company and has conducted sufficient due diligence for the valuation. The overview should also discuss any characteristics of the company that play a material role in the valuation process. The description should almost always include discussion related to the history and structure of the company, the competitive environment, and key operational considerations.

Intangible Assets

The intangible assets discussion should both provide an overview of all relevant technical guidance related to the particular asset and detail the characteristics of the asset that are significant to the valuation. The overview of guidance demonstrates the specialist is aware of all the relevant standards and acceptable valuation methods for a given asset.

After reading this section, the reviewer of the purchase price allocation report should have a clear understanding of how the existence of the various intangible assets contribute to the value of the enterprise (how they impact cash flow, risk, and growth).

Historical Financial Performance

The historical financial performance of the acquired company provides important context to the story of what the purchasing company plans to do with its new acquisition. While prospective cash flows are most relevant to the actual valuation of intangible assets, the acquired company's historical performance is a useful tool to substantiate the reasonableness of stated expectations for future financial performance.

This does not mean that a company that has never historically made money cannot reasonably be expected to operate profitably in the future. It does mean that management must have a compelling growth or turn-around story (which the specialist would thoroughly explain in the company overview discussion in the report).

Transaction Overview

Transaction structures can be complicated and specific deal terms often have a significant impact on value. Purchase agreements may specify various terms for initial purchase consideration, include or exclude specific assets and liabilities, specify various structures of earn-out consideration, contain embedded contractual obligations, or contain other unique terms. The valuation specialist must demonstrate a thorough understanding of the deal terms and discuss the specific terms that carry significant value implications.

Fair Value Determination

The report should provide adequate description of the valuation approaches and methods relevant to the purchase price allocation. In general, the report should outline the three approaches to valuation (the cost approach, the market approach, and the income approach), regardless of the approaches selected for use in the valuation. This demonstrates that the valuation specialist is aware of and considered each of the approaches in the ultimate selection of valuation methods appropriate for the given circumstances.

Depending on the situation, any of a number of valuation methods could be appropriate for a given intangible asset. While selection of the appropriate method is the responsibility of the valuation specialist, the reasoning should be documented in the report in such a way that a report reviewer can assess the valuation specialist's judgment.

At the closing of the discussion related to the valuation process, the report should provide some explanation of the overall reasonableness of the allocation. This discussion should include both a qualitative assessment and quantitative analysis for support. While this support will differ depending on circumstances, the report should adequately present how the valuation "hangs together."

SOMETHING TO REMEMBER

A purchase price allocation is not intended to be a black box that is fed numbers and spits out an allocation. The fair value accounting rules and valuation guidance require that it be a reliable and auditable process so that users of financial statements can have a clear understanding of the actual economics of a particular acquisition. As a result, the allocation process should be sufficiently transparent that you are able to understand it without excessive effort, and the narrative of the report is a necessary component of this transparency.

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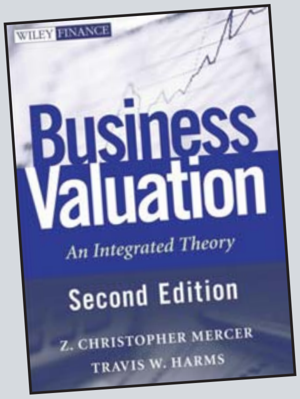

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Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

RELEASED IN JANUARY 2007, *"BUY-SELL AGREEMENTS: TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?"* **HAS QUICKLY BECOME A VALUABLE TOOL FOR ATTORNEYS, BUSINESS ADVISORS AND BUSINESS OWNERS WHO RECOGNIZE THE IMPORTANCE OF BUY-SELL AGREEMENTS. DON'T TAKE OUR WORD FOR IT. BELOW ARE JUST SOME OF THE PUBLISHED REVIEWS OF** *"BUY-SELL AGREEMENTS: TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?."*

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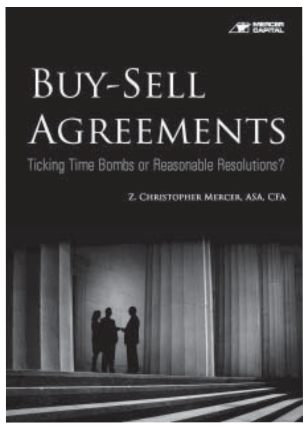
L. PAUL HOOD, ESQ.
Steve Leimberg's Business Entities Newsletter,
Issue 119, February 13, 2007.
Courtesy: Leimberg Information Services, Inc. (LISI)
at www.leimbergservices.com



In the teacher's manual to our *Business Associations* case book, my friend, colleague and coauthor Bill Klein posits that "any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice." Z. Christopher Mercer's new book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions* offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

STEPHEN BAINBRIDGE
William D. Warren Professor of Law, UCLA
Published on ProfessorBainbridge.com

In this eminently well-written, concise, and non-technical book, Chris lays out the fundamental parameters and processes that must be considered to minimize problems...Appraisers who read this book and apply its lessons will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.

RAND M. CURTISS, FIBA, MCBA, ASA, ASA
President, Loveman-Curtiss, Inc.
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Mr. Mercer has done a great job of addressing the reasons business owners might want to have a buy-sell agreement and the business factors these business owners should consider in the agreement... Overall, Mr. Mercer provides valuation practitioners, business consultants, and business owners with a very useful handbook for preparing, reviewing and interpreting buy-sell agreements.

DAVID A. ELLNER, CPA/ABV
The Financial Valuation Group
Published in the AICPA ABV e-Alert
Volume 9, Issue 2, February/March 2007

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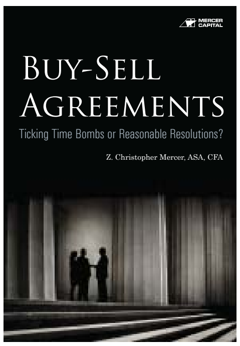
Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?



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