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,
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.

Travis W. Harms
harmst@mercercapital.com

B. Patrick Lynch
lynchp@mercercapital.com
### MERCER CAPITAL'S E-BOOK LIBRARY

<table>
<thead>
<tr>
<th>TITLE</th>
<th>DESCRIPTION</th>
<th>INVESTMENT</th>
<th>RELEASE DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuing Shareholder Cash Flows:</td>
<td>Quantifying Marketability Discounts has been updated and is now offered as an e-book. Titled Valuing Shareholder Cash Flows: Quantifying Marketability Discounts - 2005 E-Book, this edition provides a brand new chapter which discusses each of the five assumptions of the QMDM in depth. As a bonus, when you purchase the e-book, you will also receive the QMDM Companion, the latest edition of the Quantitative Marketability Discount Model, in spreadsheet format.</td>
<td>$95.00</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Valuing Financial Institutions</td>
<td>We are responding to requests to put this 1992 book back into print and we are doing so as an E-Book.</td>
<td>$65.00</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Are S Corporations Worth More Than C Corporations?</td>
<td>An e-booklet that adds to the S Corp vs. C Corp debate</td>
<td>$19.95</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Embedded Capital Gains</td>
<td>A closer look at the Embedded Capital Gains issue.</td>
<td>$19.95</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Rate &amp; Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions</td>
<td>In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution. In states where an owner/spouse's active management of a business does not preclude the consideration of passive appreciation, we offer a fresh approach based on rate and flow analysis</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>QMDM Fact Sheet</td>
<td>The latest information about the QMDM in a pdf format.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
</tbody>
</table>

Visit our website at www.mercercapital.com for more information or to download an e-book.

---

### NEW WHITEPAPER SERIES: “UNDERSTAND THE VALUE OF…”

<table>
<thead>
<tr>
<th>TITLE</th>
<th>DESCRIPTION</th>
<th>INVESTMENT</th>
<th>RELEASE DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understand the Value of Your Independent Trust Company</td>
<td>Due to their variance in size, there is no one-size-fits-all definition of an independent trust company, and recognition of the particular attributes of independent trust companies is significant to understanding their value.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Truck Dealership</td>
<td>Contrary to popular belief, not all truck dealers are worth book value. This article provides useful information as to how truck dealers are valued and what impact that might have on their owners.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Brick Business</td>
<td>This article provides an informative overview regarding the valuation of businesses operating in the brick industry, including a discussion of value as it relates generally to both manufacturers and wholesalers, as understanding how brick businesses are valued may help you understand how to grow the value of your business.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Insurance Brokerage</td>
<td>For the past several years, insurance brokerages have been in a period of consolidation, and the current soft market is expected to persist for at least the near term. As such, it is an opportune time for business owners to have an idea of what their brokerage business is worth.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Physician Practice</td>
<td>The event that triggers ownership transfer can be categorized as either voluntary or involuntary. It is important for physicians to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Auto Dealership</td>
<td>Because your dealership will change hands, it is important for you to understand the key concepts of business value and how value is determined for your dealership.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
<tr>
<td>Understand the Value of Your Wholesale Distributorship of Malt Beverage Products</td>
<td>The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.</td>
<td>Complimentary</td>
<td>Currently Available</td>
</tr>
</tbody>
</table>

Visit our website at www.mercercapital.com for more information or to download a whitepaper.
The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

- Buy-Sell Agreements
- The Integrated Theory of Business Valuation
- Is Your Business Ready for Sale?™
- Purchase Price Allocation
- Valuation of Employee Stock Options
- Litigation Support and Expert Testimony
- Valuation of Privately Held Businesses, Partnerships, or LLCs
- Financial Institution Valuation
- ESOP Valuation

To book a Mercer Capital professional as a speaker at your next conference or CLE/CPE meeting, please contact Barbara Walters Price at priceb@mercercapital.com.
MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

Corporate Valuation. Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Valuation for ESOPs
- Purchase Price Allocations
- Valuation of Employee Options
- Goodwill Impairment Testing
- Valuation of Intangible Assets
- Fairness Opinions

Investment Banking. Mercer Capital’s investment banking division and specializes in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

INTERNET COMMERCE: OBTAIN PROPOSALS TO VALUE YOUR COMPANY, BANK, FLP OR LLC VIA OUR WEBSITE

The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

UNSUBSCRIBE

We will continue to send the newsletter as published at no cost unless you notify us that you wish to be removed from the distribution list. To REMOVE yourself from this list, send an e-mail to: newsletters@mercercapital.com and type the words “Unsubscribe – Value Matters” in the subject line (without the quotation marks).

A GENTLE PLUG FOR OUR FIRM

MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

DISCLAIMER. This publication does not constitute legal, valuation, tax, or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries to discuss specific valuation or corporate finance matters are welcomed. Permission is specifically granted to send copies of this Value Matters™ to others who might have an interest in its contents. Permission is also granted to quote portions of this newsletter with proper attribution.

Copyright © 2007 by Mercer Capital Management, Inc., all rights reserved. Text, graphics, and HTML code are protected by US and International Copyright Laws, and may not be copied, reprinted, published, translated, hosted, or otherwise distributed by any means without explicit permission.
To summarize _Buy-Sell Agreements_ in one word, that word would be “methodical.” Mercer focuses like a laser beam on virtually all of the possible permutations of the pricing and valuation provisions of buy-sell agreements, together with the advantages and disadvantages of each... _Buy-Sell Agreements_ offers a comprehensive buy-sell audit checklist that alone makes it worthy of purchase, serious use and study...If you are looking for a book that has a comprehensive discussion of the pricing and valuation aspects of buy-sell agreements (which I’ve really not ever seen before), this is it... _Buy-Sell Agreements_ is a no-brainer addition to the library of every one who works with or who drafts buy-sell agreements.

L. PAUL HOOD, ESQ.
Courtesy: Leimberg Information Services, Inc. (LISI) at www.leimbergservices.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.
Chair of the American Business Appraisers National Network
Published on IBA Discussions Blog at www.go-iba.org/blog

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
“...is terrific - sophisticated, refreshingly thoughtful and the first really new ideas (to me, anyway) in this area I’ve heard or seen in a long time.”

Putnam C. Smith, J.D., LL.M, Partner, Lipscomb, Johnson, Sleister, Dailey & Smith, LLP, Cumming, Georgia

Written for business owners, attorneys, CPAs, business appraisers, and other professional advisors to business, this book provides a roadmap for you (or your clients) to develop or improve your buy-sell agreement. The first book written from a valuation perspective which is important to note because business appraisers are usually consulted when there is a problem. Learn from our 25 years of experience working with well-constructed and terribly constructed buy-sell agreements (in almost every case no one realized there were problems until a trigger event occurred)!

HIGHLIGHT SECTIONS/CHAPTERS INCLUDE:

- Categories & Types of Buy-Sell Agreements
- Process & Single Appraiser Buy-Sell Agreements
- Process Timetables - Why it takes more time than you think
- The Six Defining Elements of Buy-Sell Agreements - Agreements must have all six but most do not!
- War Stories from our experience
- The Buy-Sell Audit Checklist - This alone is worth the price of the book
- In addition, the ASA BV Standards and USPAP Standards 3, 9 & 10 are reprinted in full for your convenience

To order, fax back to 901.685.2199, call us at 901.685.2120, or visit www.mercercapital.com

<table>
<thead>
<tr>
<th>QTY</th>
<th>Regular Price</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Book</td>
<td>$79</td>
<td></td>
</tr>
<tr>
<td>2 or More</td>
<td>$12.00</td>
<td></td>
</tr>
<tr>
<td>FedEx Ground</td>
<td>$7.00</td>
<td></td>
</tr>
<tr>
<td>2-Day</td>
<td>$11.00</td>
<td></td>
</tr>
<tr>
<td>Overnight</td>
<td>$35.00</td>
<td></td>
</tr>
</tbody>
</table>

Sales Tax - TN Residents (9.25%)

Shipping Charge

TOTAL