

Purchase Price Allocation: Fair Value Accounting Principles

Acquisitions of both assets and entire companies require special accounting and financial analysis. Purchase Price Allocation studies determine the *fair values* of tangible and intangible assets, as well as liabilities and goodwill.

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Acquisitions are rarely simple. Finding the opportunity, negotiating the terms, and closing the deal are just the beginning.

Many of our clients are venture capital backed technology companies that have been growing successfully and have commenced making acquisitions. On the one hand, they feel great about getting their deals done. On the other hand, they must confront the pain and complexity of *fair value* accounting.

The Basics of Purchase Price Allocation

The information needed to make a purchase decision is very different from the information required for *fair value* accounting.

A company that makes an acquisition must adjust its financial statements to reflect the inclusion of the acquired assets and liabilities at their *fair values*. *Fair value* is closely related to the traditional concept of *fair market value*. For many items (such as cash assets, accounts receivable, and accounts payable) the determination of *fair value* is usually straight forward because the values recorded on the seller's financial statements often reflect the items' values. In the case of hard assets such as property, plant, and equipment, the market value of the assets may be different than the values carried on the seller's books. As a result, the acquirer may have appraisals performed to determine *fair value* conclusions.

However, accounting principles require that the *fair value* of intangible assets and goodwill must also be determined. Intangible assets can include technology that was developed by the seller (or was in the process of being developed), existing customer relationships, marketing intangibles (such as trade names and trademarks), non-compete agreements, and other contractual arrangements that may be expected to generate economic benefits for the buyer, as well as other items. The extent to which the price paid for a company exceeds the *fair value* of the identifiable acquired assets (net of the *fair value* of assumed liabilities) is called *goodwill*.

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The Challenge of Fair Value Accounting Principles

The challenge for a client is that the *fair value* framework entails concepts and definitions which may seem very distant from the specific business strategies and objectives that led to the acquisition in the first place. The challenge exists because the information needed to make the purchase decision is very different from the information required for *fair value* accounting measurement. The *fair value* of acquired assets (and liabilities) does not measure the value an asset to the acquirer based on what the acquirer intends to do with the asset. Instead, *fair value* is the value to a hypothetical "market participant" that will use the asset to its highest and best use.

Take a hypothetical example where one of our clients has just acquired a smaller relatively unsuccessful company that had developed an attractive technology. The conversation concerns the value of the acquired company's brand name:

"We didn't buy this company to get its brand name; we bought the company to get the technology. We thought this company was unable to build an adequate marketing and sales capability. That's why their investors decided to exit. So obviously the brand name is worth nothing."

The difference between value of the brand name as perceived by management and value under accounting rules may be extreme. In this case, a "market participant" might would be assumed to utilize the acquired brand name as its "highest and best use". If so, its value would need to be quantified.

Another difference can occur when the client intends to utilize a specific asset, and expects synergies from the acquisition to produce significant economic returns. In this case, the "market participant" assumption can result in a lower accounting value than the value that is perceived by management. The *fair value* rules spell out "...buyer specific attributes and intent should be disregarded if different than another market participant" (ASC 820, <http://asc.fasb.org>). Synergistic effects would not be included in determining the value of the asset. For instance, if the sales projections included synergies that are unique to the client and not available to other market participants, then the sales projections would need to be reduced to remove the synergies.

Summary

Acquisitions require accounting and financial analysis to analyze the transaction from a perspective that is different from management's perceptions. The first difference requires that the analyst disregard the specific costs and benefits to the buyer - including synergistic benefits that may not be available to other potential acquirers. Instead, the analyst must examine the acquisition from the perspective of other potential acquirers ("market participants"), and assume each identifiable asset is put to its best and highest use.