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Purchase Price Allocations Why Now?

Statement of Financial Accounting Standards No. 141, Business Combinations ("FAS 141"), drew a sharp distinction between goodwill and other intangible assets acquired in a transaction. As a result, the allocation of the purchase price to the various assets acquired has taken on new urgency for both public and private acquirers. The purpose of this brief article is to address four critical questions that are likely to be asked by the members of finance departments at the acquiring company.

1. Does my company need to perform a purchase price allocation for acquisitions?

Yes. Allocations have actually been required since APB Opinions 16 and 17. However, prior to the issuance of FAS 141 (and 142), there was really no difference in the manner in which goodwill or other specifically identifiable intangible assets were treated subsequent to the acquisition. For this reason, readers of financial statements generally observed a single line item, "Goodwill & Intangibles" on the balance sheet, to which a uniform amortization schedule was applied. Given the disparate amortization treatment for goodwill and other intangibles under the new standards, the FASB has indicated that specific allocations of the purchase price are necessary.

As noted by the FASB's Emerging Issues Task Force in Topic No. D-100, "The Board believes that many entities concluded that their financial statements were prepared in accordance with generally accepted accounting principles, in all material respects, even though intangible assets acquired in a business combination were not recognized and accounted for separately from goodwill." Such treatment will certainly not be deemed appropriate in the future.

"... the allocation of the purchase price to various assets acquired has taken on a new urgency for both public and private acquirers"

2. What is the process for creating a sound, defensible purchase price allocation?

The process for determining the appropriate purchase price allocation invariably differs for each transaction. However, the following outline can serve as a general guide:

- *Determination of the Purchase Price* - This often-overlooked step is not so simple when a portion of the consideration consists of assets other than cash.
- *Identification of Intangible Assets Acquired* - FAS 141 provides extensive guidance to aid in determining whether a specific intangible asset needs to be recog-

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Negotiating Strategies to Create the Best Deal

There are many different styles of negotiating when getting a deal done. Some of the most useful and realistic ways to approach various scenarios are fairly simple but they can be easy to overlook while in the line of fire. As such, below is a list of ten things to help create value for a deal.

1. Be confident

The way to become confident in any transaction is to always be prepared. In being confident we should be able to anticipate issues that could arise in the course of negotiations. We spend many hours reviewing the material that is important to the deal as well as any related information.

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nized in the financial statements. In general, an intangible asset must be recognized if it arises from contractual or legal rights, or if it is separable from the acquired entity.

- *Valuation of Tangible Assets Acquired* - Before determining the value to assign to the intangible assets acquired (including goodwill), the appropriate valuation of the acquired tangible assets must be considered. In other words, do the tangible assets require a discount or premium to their stated book values? For acquisitions with a large component of fixed assets, the services of a real estate or machinery and equipment appraiser may be helpful.
- *Valuation of the Recognized Intangible Assets* - While specific techniques may vary somewhat, the valuation of intangible

assets relies upon the same basic approaches (cost, market, and income) as the valuation of business interests. Valuations should include thorough support for each major assumption.

- *Reconciliation to Purchase Price* - When all required intangible asset valuations have been performed, the conclusions should be compared and reconciled to the price paid for the acquired entity. On a relative basis, are the amounts assigned to the various assets consistent with the purpose of, and rationale for, the acquisition? What does the amount of goodwill imply regarding the motivations of the buyer and seller, the prevailing market and industry conditions, and the nature of the business acquired?

3. What is the deadline for completing the purchase price allocation?

FAS 141 is not explicit with regard to how promptly the purchase price allocation must be completed after an acquisition. The Standard defines the allocation period as "the period that is required to identify and measure the fair value of the assets acquired and the liabilities assumed in a business combination. The allocation period ends when the acquiring entity is no longer waiting for information that is arranged to obtain and that is known to be available or obtainable." The Standard further states that "Although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination."

4. Can we perform the purchase price allocation internally?

There is no specific proscription in the Standard against performing the purchase price allocation internally. However, FAS 141 does state (at paragraph 36) that, "Among other sources of relevant information, independent apprais-

als and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed." In other words, retention of a valuation expert is not required, but your auditor will likely be eager to hear the explanation of why an independent expert was not retained to assist in the allocation.

The best independent expert to assist in the allocation process will possess a breadth of experience in business valuation, intangible asset valuation, and transaction advisory work. The expert should be thoroughly acquainted with the provisions of SFAS 141 and 142 and have experience performing both purchase price allocations and goodwill impairment testing. We will partner with your finance staff in completing an appropriate, defensible purchase price allocation. ♦

Negotiating Strategies

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2. Ask for more than you actually expect to receive

By asking for more than you actually expect to receive, you are establishing a perceived value to the other side that may be beyond actual value. This concept also provides room to compromise later if we need to do so and still helps to achieve a transaction that meets our client's expectations. This strategy also helps break any deadlocks and keeps the discussions open to move the transaction along.

By asking for more than you expect, it gives the other side the feeling that they have won a point or two when expectations are lowered. The purpose of any negotiation is to be fair and achieve a win-win situation for all parties involved. An acquirer's focus on a specific performance measure often creates an unnecessary and sometimes unrealistic

price ceiling. Public acquirers will likely focus on dilution, thereby making price-to-earnings multiples the most important pricing measure. Conversely, a privately held entity may focus on a "build or buy" strategy, which may hinge on a certain return on investment. By catering to an acquirer's perspective while pointing out other important pricing multiples, return measures and synergistic possibilities it is often possible to justify a higher price than initially offered by the acquirer.

3. Be patient but keep a realistic timetable

Always keep timeframes in mind in doing a deal. Deals usually take time to complete yet by controlling the timetable we should keep logs and try to push the other side as quickly as possible. It is a good idea to continually give the other side a timeframe that requires certain conditions be met at specified times.

4. Be personal and let others try to get to know you as a person

It is helpful in negotiations to let the other side get to know you and also for you to get to know them. This helps to bring things in focus and makes creates better lines of communication.

5. Try not to burn bridges

Negotiations can be very tense and emotions will enter the picture at various times during the process. Do not let emotions play a role and always try to leave the door open if and when negotiations stall because there is usually another opportunity to reopen the door later.

6. Recognize different personalities

It is not uncommon to deal with others that might test your patience, but learn to hold on for the good of the deal. Be aware that it is important to be careful in your reactions to the way others try to negotiate.

7. Be honest but firm

Know the facts and do not say something or reveal information

that may come back to haunt you. If you do not know something, say so. Advise the other side that you will get back to them after you have confirmed the information.

8. Pick your battles

There are times in any negotiation to draw the line and other times to be flexible. Sometimes others want to draw the line in the sand at an early stage of the negotiation. Keep the end goal in mind and be careful when picking your battles.

9. Do not take shortcuts

In the deal process others may want to take shortcuts in trying to move to the next step. We do not believe in shortcuts.

10. Do not be afraid to lighten things up with humor

In all deals there are tense moments that may cause stress to all concerned. Sometimes the use of appropriate humor helps to lighten the mood and move the process along.

If you keep these ten simple but important hints in mind as you go through the negotiation process, you are on your way to a successful negotiation where all parties will win and the deal will get done. ♦

A Primer on Employee Options

As the FASB continues its quest to improve the transparency and economic meaningfulness of financial reporting, the push is on to rationalize accounting for employee stock options. The FASB is continuing to pull the valuation and accounting communities closer together, but the transition is neither simple nor straightforward. Indeed, although adopting FAS 123 signals a company's commitment to disclosure, it also requires commitment to skillful interpretation of and compliance with the pronouncement.

Current accounting rules do not require companies to record any expense when they grant their employees stock options. However, when an employee exercises the option, the company can expense the difference between the exercise price and the market value of the stock, providing a tax break for the corporation. This expense does not have to be recognized in the financial statements, although the difference in taxes paid if the expense had not been taken for tax purposes is explained in the notes to the financial statements.

APB Opinion No. 25, issued in October 1972, states that compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. The measurement date is defined as the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option purchase price, if any. Therefore, a corporation issuing at the money options does not recognize any compensation cost for the options.

The Financial Accounting Standards Board, "Accounting for Stock-based Compensation", Exposure Draft in June 1993 proposed that a modified version of an option pricing model (fair value method) be used to value employee stock options and that this value be recognized as an expense on the grant date. Negative public reaction to the proposal resulted in FASB postponing implementation. When the Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" (FAS 123) was issued in October 1995 it encouraged companies to adopt reporting the fair value of the consideration but allowed firms to continue to account for option expense under APB Opinion No. 25, provided their

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financials included pro-forma statements indicating the effect the option grants would have had on their earnings had they adopted FAS 123.

FAS 123 suggests using an option pricing model, which takes into account (1) the option's exercise price, (2) the expected life of the option, (3) the current price of the underlying stock, (4) the expected volatility of the underlying stock returns, (5) the expected dividends on the underlying stock; and, (6) the risk free rate over the life of the option.

However, following these guidelines blindly would tend to overstate the value of a compensatory option as it does not consider (1) vesting or restrictions on transfer of the option, (2) lack of an active market for compensatory options, or (3) other restrictive conditions. According to FAS No 123, nonpublic entities are permitted to exclude the volatility factor in estimating the value of their stock options, which results in measurement at minimum value.

Generally accepted modifications of an option pricing model to adjust for such factors as the non-transferability of employee stock options are described in FAS 123. The standard op-

tion pricing models were designed to estimate the value of transferable stock options. Transferable stock options must be more valuable than non-transferable options because they can be sold, while nontransferable options may only be exercised. To adjust for the non-transferability of employee stock options it may be necessary to estimate the expected life of the option at a shorter length of time than its maximum term (expiration date) when developing inputs for an option pricing model. This adjustment would lower the value of the option, as the holder would have less time to benefit from favorable stock price movements.

There are frequently terms, restrictions and conditions attached to employee stock options that will affect their value relative to publicly traded options. To capture the effects of these factors on the value of the option, adjustments to the standard option pricing models must be made.

There are several revenue procedures that offer guidance for valuing stock options. Revenue Procedure 98-34 provides safe harbor valuation guidelines for non-publicly traded compensatory stock options on stock that, at the valuation date, is publicly traded

on an established securities market. Revenue Procedure 2002-13 also provides guidance to valuing compensatory options on publicly traded or non-publicly traded stock and is purported to be based on the Black-Scholes Option Pricing Model. Both procedures state that options may be valued using methodology consistent with generally accepted accounting principles, such as FAS 123.

Currently, investors are demanding more transparency in financial statements and several large companies have adopted the fair value method of accounting for stock-based compensation. An exposure draft for an amendment to FAS 123 was issued on October 4, 2002. This proposed statement would require new disclosures that would provide greater clarity of the effect of stock-based compensation on reported results. It also permits two additional transition methods for firms that adopt FAS 123 in accounting for stock based compensation.

A copy of the exposure draft can be found at www.fasb.org. If you have any questions, feel free to contact us. ♦

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