

INTRODUCTION TO PURCHASE PRICE ALLOCATION (PPA)

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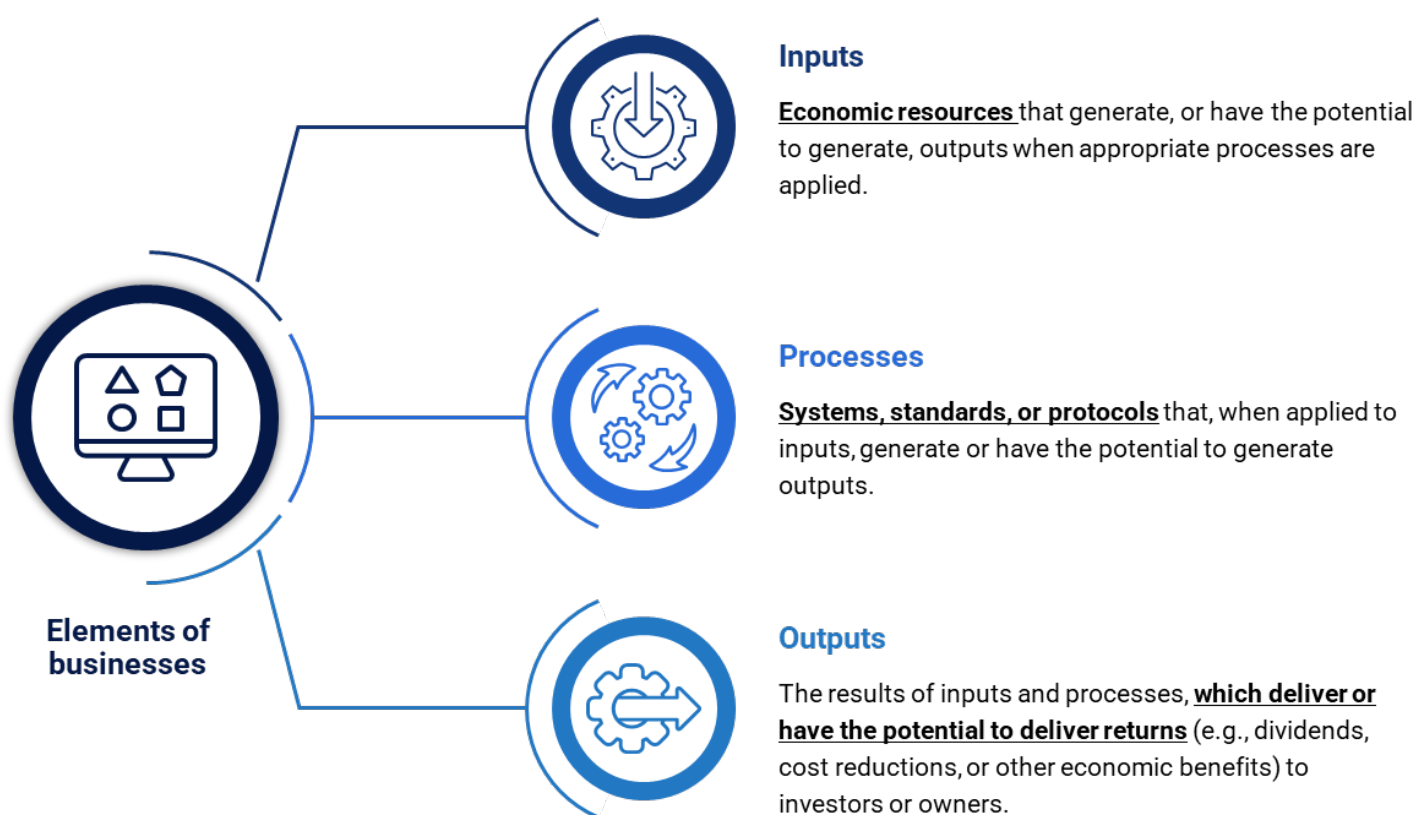


Overview of Purchase Price Allocation (PPA)

Purchase Price Allocation (PPA) refers to the process of assigning the purchase price paid in a **business acquisition** to the **identifiable tangible & intangible assets acquired and liabilities assumed** and **resultant goodwill/bargain purchase**, based on their fair values at the **acquisition date** (which is usually the Completion Date as per the Purchase/Business Transfer Agreements).

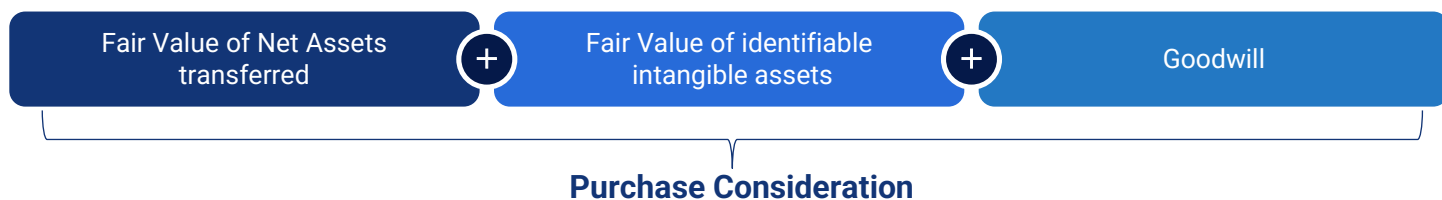
What constitutes a Business Acquisition?

For a transaction to be considered as a **business acquisition**, the set of assets acquired and assumed, altogether, needs to constitute a business. To be considered a business, the set of activities and assets is required to have inputs and processes, which together should have the ability to create outputs.



What is Goodwill, and how is it calculated?

Goodwill = Purchase Price - Net Fair Value of Assets/Liabilities



Case scenario

Imagine that a cola company has decided to acquire BeverageCo, a successful smaller beverage company known for its innovative energy drinks. The cola company pays \$500 million to acquire BeverageCo.

1. In such a case, the payment of \$500 million the cola company pays for BeverageCo becomes the Purchase Price.
2. There were tangible assets (PP&E) of BeverageCo which were taken over and were fair valued at \$100 million. Additionally, inventory was fair valued at \$20 million.
3. Certain liabilities were assumed at their fair value. These included accounts payables and other short-term liabilities at \$30 million and Long-term debt at \$40 million.
4. As part of the PPA process the following intangibles were identified and recognized:
 - a. **Trademarks and Brand Names:** BeverageCo has a strong brand in the energy drink market valued at \$50 million.
 - b. **Customer Relationships:** BeverageCo has established long-term relationships with retailers and distributors valued at \$60 million.
 - c. **Patents and Technology:** BeverageCo owns patents for unique formulas and production processes valued at \$40 million.
 - d. **Non-compete Agreements:** BeverageCo's founders agree not to compete with the cola company for a specified period, valued at \$10 million.
5. Accordingly, fair value of identifiable net assets is value of tangible assets = Fair Value of Tangible Assets (+) Fair Value of Identified Intangible Assets (-) Fair Value of Liabilities assumed
 i.e. $\$(100+20+50+60+40+10) - \$(30+40) = \$210$ million
6. Here, Goodwill=Purchase Price–Fair Value of Net Identifiable Assets
 i.e. $\$500 \text{ million} - \$210 \text{ million} = \$290 \text{ million}$

We will briefly discuss the intangible assets mentioned above in the following sections.

Understanding the Intangible Assets

An intangible asset is a non-physical, non-monetary asset that holds value due to its intellectual or legal properties, contributing to the revenue and competitive advantage of a company. Unlike tangible assets such as machinery or buildings, intangible assets lack physical substance but are essential to the business's operations and value proposition. However, not all intangible assets are recognized in your books of accounts; only those intangible assets will be recognized that are identifiable and where it can be ascertained that:

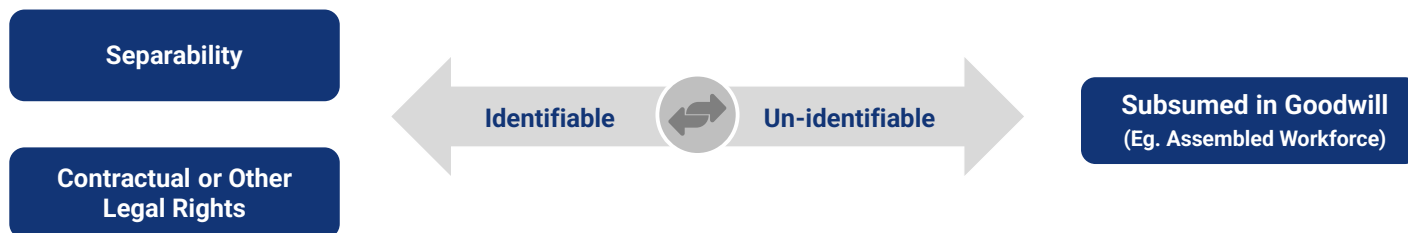
- The probable future revenue/earning will flow to the entity and such benefit being clearly attributable to the intangible asset; and
- The cost of such an intangible asset can be measured reliably.

These requirements apply irrespective of whether an intangible asset is acquired externally or generated internally by the Target.

Further, an intangible asset will be considered as **identifiable** when it:

- It can be separated and sold, transferred, licensed, rented, or exchanged on its own or with a related contract, or,
- It comes from legal or contractual rights, even if those rights cannot be transferred or separated from the company or other rights and obligations.

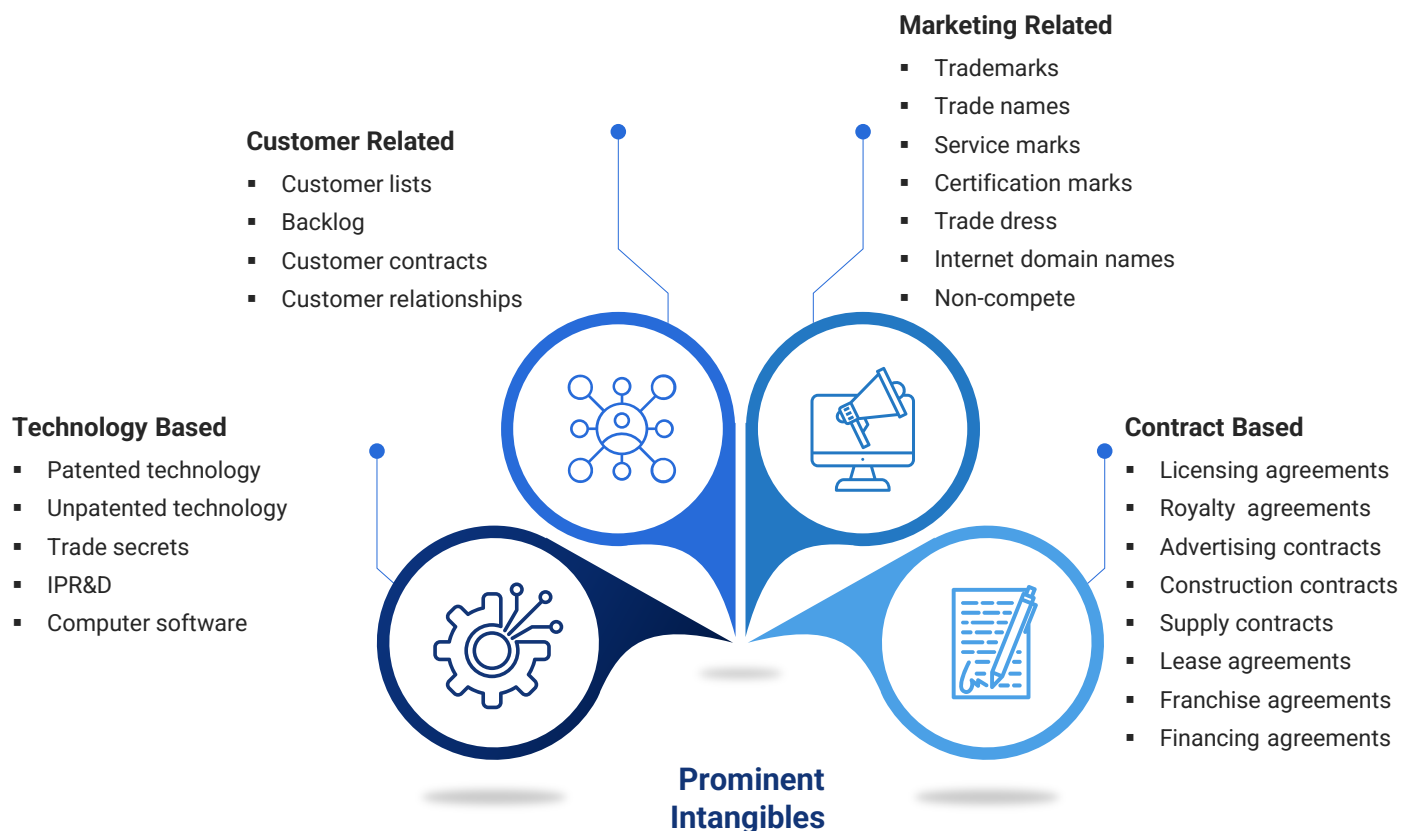
Accordingly, to consider an intangible asset to be



If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, expenditure on this item to be recognized as an expense when incurred.

Prominent Categories of Identifiable Intangible Assets

The identifiable intangible assets can be categorized into different buckets depending on the nature of such assets:



Technology/Innovation-based Intangible Assets

These are assets that arise from technological innovations and the rights to use or produce technology. Select examples:

- **Patents** are exclusive rights to inventions, allowing the holder to exclude others from making, using, or selling the invention. For example, pharmaceutical patents are highly valuable due to their exclusivity and market potential.
- **Trade Secrets** are confidential business information that provide a competitive edge, such as proprietary manufacturing processes or recipes.
- **Software and Databases** are proprietary computer program used in operations or sold as products. For example, a company's internally developed software for managing customer relationships.



Customer-related Intangible Assets

These are assets that arise from relationships with customers and provide economic benefits through repeat business or contractual agreements. Select examples:

- **Customer Lists**, which are databases containing detailed information about customers.
- **Order or Production Backlogs**, which are signed contracts or purchase orders from customers that are not yet fulfilled but indicate future revenue.
- **Customer Relationships** are a company's established relationships with its customers. These relationships can provide economic benefits to the acquiring company through repeat business and customer loyalty.
- **Customer Contracts** are a subset of Customer Relationships and are long-term binding agreements with customers, such as service contracts or subscription agreements.



Marketing-related Intangible Assets

These assets are used primarily for marketing or promoting products and services. Select examples:

- **Trademarks, Trade Names and Service Marks** that are recognizable by consumers and provide a competitive advantage. For instance, the brand name "Coca-Cola" carries significant value due to its global recognition and customer loyalty.
- **Trade Dress** are the unique visual elements of a product or its packaging that are legally protected. For instance, the distinctive shape and design of a Toblerone chocolate bar package.
- **Internet Domain Names** which are valuable web addresses that drive significant traffic. For example, "www.amazon.com" has intrinsic value due to its established customer base and online presence.



Other Contract-based Intangible Assets

Assets that arise from contractual agreements, providing economic benefits through the rights granted by these contracts. Select examples:

- **Licensing Agreements** are rights to use patents, technology, or brand names. For instance, a licensing agreement to produce and sell merchandise featuring a popular character.
- **Franchise Agreements** are rights granted to operate a business using a franchisor's brand and business model. For example, the rights to operate a McDonald's franchise.
- **Lease Agreements** are rights to use property or equipment under lease contracts. These are valued based on the terms of the lease and the market rates for similar leases.
- **Construction Permits** are rights granted to build on a specific site, valuable in the context of real estate development projects.

If any agreements are entered into on terms that are significantly more favorable (unfavorable) than those available in the general market for the acquiring entity, then a separate intangible asset (liability) must be identified and recognized.

Most Commonly Valued Intangible Assets

The following table mentions some of the most commonly valued intangible assets and certain factors that may need to be considered when valuing them.

Heading	Particulars
Intangible Asset	Existing Customer Relationships
Commonly used Methodologies	1. Multi-period Excess Earnings Method (MPEEM) 2. With-and-Without Method (or Incremental Income Method)
Key Considerations	1. If customer relationships are considered the most important intangible asset for a transaction, use the Multi-Period Excess Earnings Method (MPEEM). However, if multiple intangible assets are primary to the transaction, limit the application of MPEEM to the single most important intangible asset to avoid circular references in the Contributory Asset Charge Calculation. In such cases, the With-and-Without Method can be a suitable alternative valuation methodology to value Customer Relationships. 2. Revenue from existing customer relationships should be calculated net of attrition, which should account for both revenue contraction (i.e., reduction of revenue from continuing customers) and revenue churn (loss of revenue due to customer loss). 3. The net revenue should reflect any expected changes in price or general volume from these existing customers, not covered in the attrition rate calculation. Additionally, the value of any up-sells or cross-sells by the target, which formed the basis of the overall transaction price, should be included. However, only those up-sells and cross-sells available to any general market participant buyer should be considered.
Intangible Asset	Trademarks, Trade Names, Brand Names
Commonly used Methodologies	1. Relief From Royalty Method
Key Considerations	1. Royalty Rates on Trademarks and Tradename can be reliably collated from databases such as KtMine, RoyaltyStats, etc. However, care needs to be exercised in delineating the relevant industry and royalty agreements. In case the Target operates in a niche sector, the relevant industry would need to be considered at a broader level. 2. During the screening the of benchmarked royalty rate, be mindful of the basis of the royalty rate calculation. A royalty rate based on gross revenue is different than on net revenue. Further when such royalty rates are based on revenue-based metrics, determine if the revenue recognition policy is consistent with that of the Target. 3. In the absence of any relevant royalty rate benchmarks, the 'Rule of Thumb' may be applied. Here, 25% of the profits are considered as a proxy of royalty payments. Here, 'profits' are usually associated with the Earnings before Interest and Taxes (EBIT).

Heading	Particulars
Intangible Asset	Software
Commonly used Methodologies	1. Multi-period Excess Earnings Method (MPEEM) 2. Relief From Royalty Method 3. Replacement Cost Method
Key Considerations	1. If the Software of the target is considered the primary intangible asset driving the transaction rationale, MPEEM is the most appropriate valuation methodology. 2. The value of the software should be determined on an as-is basis. However, if revenue cannot be realized until certain updates are made to the software, the cost of these updates and the deferment of the forecasted revenue should be appropriately captured. 3. Revenue loss due to obsolescence must be appropriately considered. The valuer may place reliance on management inputs to understand the overall life of the Software and to arrive at the appropriate obsolescence rates. Statistical tools like Derivation of Citation Frequency Distribution may be used to supplement the workings of such obsolescence factor. 4. When the Software is a secondary consideration in the overall transaction rationale, other valuation methodologies such as the Relief from Royalty Method and the Replacement Cost Method can be used. 5. All key considerations mentioned for intangible assets mentioned in the above sections, relating to royalty rate-based screening, proxies, and return-on and return-off components apply to Software as well. 6. Where the Software is in the early stages of development and the revenue from this Software cannot be reliably estimated, the Replacement Cost method may be applied. Under this method, all historical costs involved in bringing the Software to its present condition must be considered. These costs should reflect market levels, including any in-kind investments, such as foregone salaries of key software engineers and the proportionate fair value of ESOPs extended to such employees. However, care should be taken to exclude any portions of these expenses that may be treated as sunk costs.
Intangible Asset	Non-compete Agreements
Commonly used Methodologies	With-and-Without Method (or Incremental Income Method)
Key Considerations	1. Evaluate the tenure of the non-compete covenants from the Share Purchase/Business Transfer Agreement. If the covenants apply to multiple sellers with varying tenures, an average of these tenures may be used. 2. In cases where the tenure of these intangible assets is short with such covenants limited to only a few individuals, the value arising from this intangible asset may be immaterial to the overall transaction. Accordingly, the Valuer may choose to ignore its standalone valuation and subsume the value of such Non-compete Arrangements with the value of Goodwill. 3. Assess the personal relationships of these sellers with the Target's top clients. Determine the extent to which revenues from existing customers could be affected by competition from

Heading	Particulars
	these key personnel. Accordingly, evaluate the potential revenue loss from both existing and new customers. - Analyze the increase in costs due to the loss of expertise resulting from competition with the key personnel. However, exclude salary and other benefit costs related to these key personnel. - Estimate the probability of competition. Notably, if any of these key personnel are retained as employees' post-acquisition, the probability of competition from such personnel significantly decreases.
Intangible Asset	Assembled Workforce
Commonly used Methodologies	Replacement Cost Method
Key Considerations	- The valuation of an assembled workforce typically includes consideration of recruitment expenses, cost of training, and loss due to inefficiencies until the employees reach 100% productivity. - The overall value of the assembled workforce generally ranges between 15-20% of the total employee benefit expenses. - In certain instances, the target may outsource a portion of its workforce on a Full-Time Equivalent (FTE) basis to third-party agencies or professionals. The valuer may include these contract employees in the calculation of the assembled workforce, considering the time and effort the target would ideally spend to assemble such a competent workforce at full efficiency. - Assembled workforce is not considered an identifiable intangible asset since it primarily does not meet the separability criteria. However, its value is considered for calculating the Cost of Contributory Assets (CAC), which is used in the Multi-Period Excess Earnings Method (MPEEM) and in calculating the Weighted Average Return on Assets (WARA). Ultimately, the value of the assembled workforce is subsumed into the value of goodwill or bargain purchase.

Applicable Accounting Standards

A PPA exercise is typically carried out to meet financial reporting requirements. Therefore, the valuer must carefully consider identifying the relevant financial reporting framework and appropriately factor in the adjustments and treatments outlined under the relevant Accounting Standard.

In cases where the organization is based outside of the United States, the valuer will need to refer to the local Accounting Standards or International Financial Reporting Standards (IFRS). For instance, Saudi-based companies follow IFRS. If IFRS is applicable to the organization, the accounting for the PPA is typically conducted in accordance with **IFRS 3 'Business Combinations'**, read together with **IAS 38 'Intangible Assets'**.

Key Recommendations

1. To streamline the valuation process, the Valuer may **document their initial comprehension** of the transaction, identifiable intangible assets, and an overview of the methodology intended for valuing each intangible. This includes a concise summary of crucial valuation inputs and key considerations. This document can then be shared with relevant parties, particularly the purchaser and its auditors. Such proactive communication ensures alignment among all stakeholders, mitigating potential challenges during the submission of the final report.
2. In a PPA report, the **focus should be on intangible valuation**. The company's valuation will be carried out only to the extent of calculating the IRR which is generally used as the base discount rate for valuing any intangible asset.
3. The client might consider the life of an intangible asset to be indefinite. However, for practical purposes, the auditors may suggest limiting the life to a definite period. In such cases, it is recommended to extend the forecasting of cash flows attributable to the specific intangible asset, until the year that it **cumulatively captures at least 95% of the value** as if it had been projected indefinitely.
4. If the PPA exercise results in a **bargain purchase**, the relevant accounting standards may require the valuer to provide a **brief explanation of the reasons** behind the transaction resulting in such a bargain purchase.

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