Purchase Price Allocation (PPA): Definition and Examples



Purchase Price Allocation, or PPA, is used in acquisition accounting. It's the process of assigning a fair value to all the assets and liabilities associated with an acquired company, also known as the target. It takes place after a deal has closed.

If, for instance, if Company A were to purchase Company 1, then PPA would assign a fair value to all of Company 1's assets and liabilities since in this example, it is the target or acquired company.

PPA is a critical part of accounting when an acquisition or merger is complete. The same would also apply if Company A and Company 1 merged to form company A1, whether the new entity would be a private company or not.

During this process, it's likely there will be some unallocated value. That's typically the result of goodwill and the assembled workforce.

PPA is a process the International Financial Reporting Standards (IFRS) requires whenever there is any business combination deal. It applies to both mergers and acquisitions.

Previous accounting standards only required PPA when there were acquisitions –

not in mergers. In the United States, it's typically done in accordance with the Financial Accounting Standards Board (FASB)'s regulations.

> *PPA is an important part of accounting for businesses.*

What are the Components of PPA?

PPA mainly consists of three parts: net identifiable assets, write-up, and goodwill.

Net Identifiable Assets

Net identifiable assets refer to the total asset value of anything belonging to the acquired company after liabilities have been subtracted. Identifiable assets are those that have a certain value at any particular point in time, and those that have clearly, reasonably quantified benefits.

These assets represent the book value of assets on the acquired company's balance sheet. Identifiable assets may be both tangible and intangible assets.

Write Up

A write-up is an adjustment increase to an asset's book value if the asset's carrying value is less than its current fair market value. That write-up amount is determined by an independent business valuation specialist.

They complete a fair market value assessment on all of the target assets, and that assessment determines when write-ups are necessary, and what the write-up amount should be.

Goodwill

Basically, goodwill is the excess amount paid over the target company's net value. It may also sometimes be referred to as residual purchase consideration. It's the difference between an acquired company's purchase price and the fair market value of its assets and liabilities.

From the acquirer's point of view, goodwill is essential in accurate accounting reporting, because both IFRS and US GAAP mandate that a company re-evaluate

all recorded goodwill at least once every year to see if it can be recovered and record any necessary adjustments.

If the goodwill isn't recoverable, in whole or in part, it must be recorded as an impairment. Goodwill isn't subject to depreciation, but may sometimes fall into amortization.

Any acquisition-related costs, such as consulting fees, advisory costs, legal fees, etc. aren't part of PPA. Accounting standards mandate that an acquirer has to expense the costs whenever they've been charged, while the services are provided.

An Example of Purchase Price Allocation

In the early stages, it's important to determine the elements and a fair value of the purchase consideration. Then, an IRR analysis needs to be performed to estimate the rate of return.

After the appraiser's due diligence and discussions with the buyer, it's necessary to find the intangible assets that must be valued. In step three, the appropriate valuation is applied.

Generally, it's income approach-based and provides an estimate of the preliminary values of each intangible asset.

The last step is to determine whether the relative asset values and the resulting goodwill is reasonable based on the purchase price paid, the nature of the target's business, financial forecast, and market expectation.

Company A recently purchased Company 1 for $5 billion. After the acquisition is complete, Company A has to perform PPA to be compliant with accounting standards.

The book value of Company 1's assets is $7 billion. The book value of liabilities is $3 billion. Since $7 billion – $3 billion is $4 billion, then that $4 billion is the net identifiable assets.

After the independent business valuation specialist completes their assessment, it's found that the fair market value of Company 1's assets and liabilities is $6

billion. This means that Company A has to recognize a $2 billion write-up ($6 billion – $4 billion net identifiable assets) to adjust the value of the company's assets to its fair market value.

Finally, Company A has to record goodwill because the actual price paid for the company ($5 billion) exceeds the sum of the net identifiable assets and the write-up (4 billion + 2 billion = $6 billion). Therefore, Company A has to recognize $1 billion ($6 billion – $5 billion as goodwill.

FAQs About PPA

Are there any other instances where PPA is required?

Beyond mergers and acquisitions, PPA must also be performed whenever there is a change in control of the company.

This could happen outside a traditional merger or acquisition environment when a shareholder purchases more equity and then has enough to take controlling interest within a company.

What broad categories can be used to separate out the value of a business?

Broad categories for addressing asset acquisition include:

- **Working capital items:** This includes cash, accounts receivable, and an inventory of current liabilities, such as accounts payable, deferred revenue, and accruals
- **Personal property and real property:** This includes machinery and equipment, buildings, leaseholds, etc.
- **Identifiable intangible assets:** This includes things like developed technology, any technology currently under development, non-compete agreements, trade names and trade secrets, intellectual property, customer relationships, etc.
- Any other intangible assets that don't meet criteria to be separable from goodwill

How is a value determined for intangible assets?

Most of the time, various iterations of a discounted cash flow analysis are used to determine the value of intangible assets. The analysis generally starts with preparing an internal rate of return or IRR analysis based on the purchase price and a financial forecast.

Income is allocated to the identifiable intangible assets based on the amount of the total target business forecast income that's been assigned to each asset.

What if there's a contingent consideration?

If a portion of the consideration is contingent upon achieving particular milestones, known as earnouts, it will be included in the fair value of the purchase consideration.

The financial forecast is used to value both the contingent consideration and the identifiable tangible assets, there will be similarities between the two, so no special adjustments should be necessary.

What are the tax implications?

Regulations under the IRS tax code may or may not heavily impact the valuation of intangible assets when it comes to financial reporting required under U.S. GAAP.

The greatest impact is usually when there are any historical net operating losses and hypothetical tax amortization benefits.

How might a poorly performed PPA impact a business?

If the acquirer prepares financial statements in accordance with IFRS or GAAP and makes the acquisition because they are bound by the reporting requirements, they have to perform a PPA.

The only exception is when the acquisition is so small it's immaterial.

The acquirer's auditor is required to rigorously review the valuations per

Accounting Standards Codification (ASC) 805. If not done well, the appraiser and acquirer may have to answer a lot of questions from the auditor, which takes time and costs money.

Generally speaking, the higher quality valuations and the more experience an appraiser has, the lower the cost for the acquirer.

As such, businesses looking to acquire other companies should seek highly experienced appraisers who are well versed in ASC 805. Failure to do so means the business will spend more time and money in the long term.

PPA is a highly complex process that requires financial experts and business experts with deep understanding of business plans and various accounting principles.

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