



Acquisition accounting- What's next for you?

A global survey of purchase price
allocation practices

February 2009

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Foreword

Mergers and acquisitions have declined over the past year due to a lack of credit in the market and the recent financial turmoil. Nonetheless, M&A activity will remain a growth, or survival, strategy for many companies, particularly once economic stability and market confidence are restored.

Understanding the implications of business combinations accounting standards is important since they can affect balance sheet valuations and future earnings. In an era of intense auditor and regulatory scrutiny on fair value measures, this matter warrants careful attention.

Ernst & Young's Valuation & Business Modelling Services global network has undertaken a global survey of over 700 transactions that were disclosed in 2007 annual reports. 21 countries and 13 major industries are represented in our analysis, making this survey the most comprehensive to date.

Have business combination standards (FAS 141 and IFRS 3) improved the communication of the strategic and financial impacts of acquisitions?

This survey reveals discrepancies in global financial communication practices between companies in the same industry. The consequence of this is that comparisons become difficult (negating one of the supposed benefits of international standards).

Also, many companies were reluctant to fair value tangible assets bought, and to provide detailed information on intangible assets they acquired and how they were valued. As a consequence, there is less amortization affecting annual net income than there might otherwise be. In a downturn this makes net income more susceptible to volatility if high goodwill amounts are impaired. This situation can have a significant impact on investor confidence and on the company's financial health.

We believe that the findings presented in this brochure provide valuable insights on the types of assets companies typically acquire, their typical financial reporting practices, and the resulting implications on earnings.

Our Valuation & Business Modelling Services professionals are available to provide further insights on this, or on any other valuation topic, should you have any questions.

Sincerely,

Jim Eales

Global Leader
Valuation & Business Modelling
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Executive summary

Key implications

► Accounting implications of acquisitions should be taken into account by M&A teams as additional depreciation and amortization impact earnings:

- one company in four communicated a fair value adjustment on tangible assets acquired
- customer-related assets (amortizable) were the most often recognized intangible assets

► Goodwill represented 47% of the total enterprise value and recognized intangible assets represented 23%. As a result one-third of the combined intangible value was allocated to specific intangible assets whereas two-thirds was allocated to goodwill.

As a consequence, purchase price allocations have significant implications related to potential future impairments.

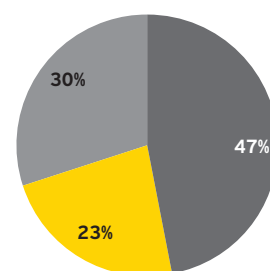
► Companies tend not to disclose information they consider sensitive.

What are the key trends?

We have gathered an extensive sample of transactions to answer this question: 709 transactions disclosed in annual reports from 2007 (mostly using IFRS and US GAAP) which showed consistency with the results observed in over 500 transactions in the 2006 annual reports.

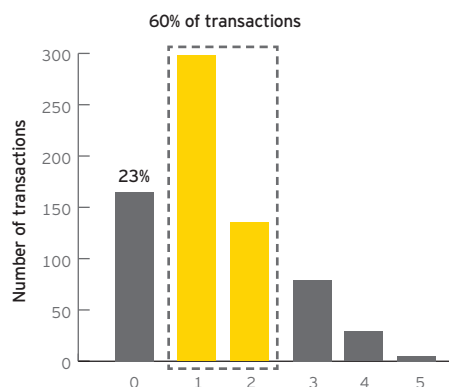
On average, for both preliminary and final purchase price allocations, 23% of the enterprise value of acquired companies (acquisition price plus net financial debt) was allocated to identified intangible assets and almost half was left as goodwill, with the allocation varying considerably from industry to industry.

Allocation of the enterprise value (%)



Goodwill
 Total recognized intangible assets
 Tangible, financial and other

Number of types of intangible assets identified



For the 709 transactions analyzed, the number of different types of intangible assets recognized was up to five per transaction. For 60% of transactions, only one or two separate types of intangible assets were disclosed, with different types of intangible assets sometimes being grouped together.

In 23% of the transactions analyzed, no identifiable intangible asset was recognized.

The main intangible assets disclosed separately were the following:

1. **Customer-related assets** (disclosed in 44% of the transactions where at least one intangible asset was recognized)
2. **Brands/trademarks** (disclosed in 31% of the transactions where at least one intangible asset was recognized)
3. **Technology** (disclosed in 20% of the transactions where at least one intangible asset was recognized)

Many other different types of intangible assets were recognized in addition to these generic types presented above.

For many transactions, only the total fair value of all the intangible assets recognized was disclosed. Therefore, it was not always possible to determine which types of intangible assets were involved and how many were recognized. For these transactions, it was considered in our survey that only one type of intangible asset was recognized.

How much do PPAs impact future earnings?

We have analyzed the intangible assets' remaining useful lives as disclosed by companies and the extent of fixed asset revaluations.

Intangible assets

Identified intangible assets are amortized over their remaining useful lives. The remaining useful lives of each category of intangible asset recognized in a particular transaction were disclosed for less than 20% of the transactions. **Most often, only ranges of useful lives applicable to both historical and recently acquired assets were provided.** In analyzing the disclosure of the remaining useful lives of intangible assets, we noticed:

- ▶ **This information was given mainly for customer-related assets (in more than one transaction out of four). They always had finite lives up to 30 years**
- ▶ The useful lives disclosed for brands and trademarks varied from minimal to indefinite
- ▶ The useful life for most other intangible assets, including technology, non-compete agreements and off-market contracts, was always definite, up to 51 years

Tangible assets

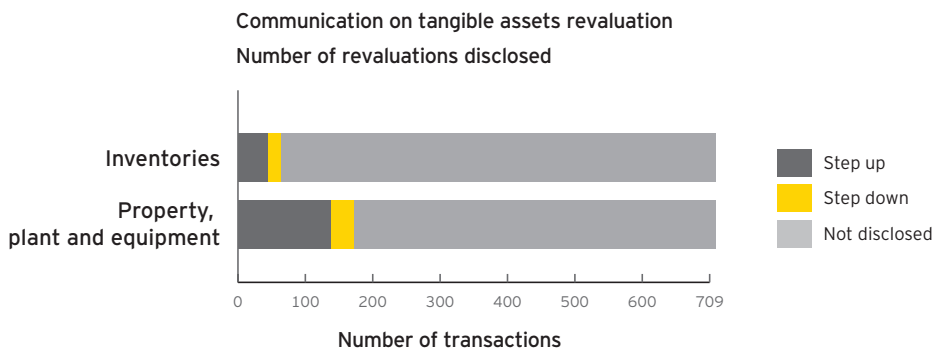
Business combinations accounting standards (including FAS 141 and IFRS 3) require all assets and liabilities of the acquired company to be fair valued, including tangible assets. In our survey, **one company out of four communicated explicitly about the fair value of fixed assets estimated during the PPA process.** In 80% of those cases, this valuation resulted in a step up on fixed assets.

In comparison, revaluations of inventories were disclosed in only 9% of the transactions analyzed. In one instance out of three, the valuation resulted in a step down of the inventories assets.

Differences in the fair value of fixed assets and inventory and in their carrying amounts were observed primarily in the consumer products, technology, real estate and oil and gas industries.

Disclosures on the remaining useful lives of intangible assets are limited

This is consistent with the results of the survey we conducted in 2007.





How much detail is really disclosed?

Our analysis revealed that the level of detail disclosed in annual reports varied widely amongst companies.

Independent expert

Even though our experience is that many companies rely on an independent valuation expert to perform their PPAs, they do not mention it in their annual reports. This information was disclosed only for 23 transactions among the 709 analyzed (or in about 3% of the cases). The experts most often quoted were large audit firms and companies specializing in the valuation of real estate and capital equipment.

However, when they did, we observed some consistency in approaches. The valuation methodologies most often used were:

- For brands: **the relief from royalty method**, an income approach
- For customer-related intangible assets: **the multi-period excess earnings method**, an income approach

The other methods used (much less frequently) were the **market approach**, **the discounted cash flow approach** and the **cost approach**.

Discount rates and royalty rates used were disclosed only in 10 annual reports. In conclusion, there is very little communication on detailed valuation methodologies and parameters used when valuing intangible and tangible assets.

Valuation methodologies

Our survey shows that companies did not usually disclose the methodology employed to value the recognized intangible and tangible assets.

The valuation methodologies applied were rarely disclosed

The components of goodwill

Our survey shows that residual goodwill correlates to the importance of intangible assets in a given transaction: smaller goodwill generally results from the recognition of a key intangible asset.

Accounting standards (including FAS 141 and IFRS 3) require the factors that gave rise to goodwill to be explained. The existence of goodwill was generally explained by synergies and future prospects. It also included the value of those intangible assets that accounting standards do not allow recognition of, such as a trained workforce.

The table below shows various examples of goodwill descriptions used in acquisition disclosures.

In annual reports, companies often only disclosed a brief comment on synergies and other components of the purchase price.



Source: extract from annual reports

What are the practical consequences of changes in accounting standards?

The change in accounting for business combinations, as a result of the revised standards issued by the IASB, calls for new areas to be measured at fair value and may possibly require new valuation models to be developed.

They will also have a significant impact on the amount of goodwill recognized; possibly resulting in goodwill comprising a higher percentage of the purchase price. Such changes result from the underlying philosophy of the revised standards that the underlying exchange transaction is to be measured at fair value.

While these changes become effective for combinations that occur after financial years beginning on or after 1st July, 2009, their effects should be considered early, particularly as **they may impact the way in which some deals are negotiated**. Our publication *Business Combinations and Consolidated Financial Statements: How the changes will impact your business* discusses the key changes to accounting for business combinations. **We discuss below three areas that will have a significant effect on goodwill and require new valuations to be performed.**

- ▶ **Contingent consideration** - Currently, if an element of the purchase price is payable in the future and if certain conditions are met (e.g., performance targets), a liability is recognized when it is probable that an amount will be paid. This often means that at the date of gaining control, there is no liability recognized. At a later date, when payment becomes probable, or at the time of payment, goodwill is adjusted.

In the future, contingent consideration arrangements will give rise to a liability at the date of gaining control - as the liability must be recognized at that date at its fair value - and are therefore factored into the goodwill calculation immediately. Changes that arise subsequent to that date will not impact goodwill - hence getting the right value at the date of the transaction is critical.

Often the terms in any contingent consideration arrangement are unique and complex, hence determining, fair value is likely to be a time consuming exercise, and many traditional valuation techniques may not be appropriate.

In many cases, the contingency itself may meet the definition as a derivative, to be remeasured to fair value at regular intervals until the contingency is settled, with changes in value recognized in the income statement. This will therefore have a significant impact on subsequent performance.

- ▶ **Step acquisitions** - In some cases, a controlling ownership interest is gained over a period of time. The current cost model means that the cost of each individual purchase is added together, and goodwill is calculated for each of these "steps".

The revised standard removes the cost accumulation model. Rather the fair value of any existing interest will be classified as "consideration given" and goodwill calculated as if there was one transaction - gaining control. The premise is that any interest held in an entity at the time control is gained, is "given up" in exchange for a new controlling interest. The interest given up is then part of the consideration given for that controlling interest. **The fair value attributable to the existing investment may be derived from the value determined for the rest of the transaction, but care will be needed to ensure that it does not reflect a control premium.**

- ▶ **Measuring non-controlling interests** - Revisions to the standard introduce a choice as to how non-controlling interests (NCI) are measured (formerly minority interest). These can be measured at their fair value at the date of gaining control or at their share of the fair value of net assets. By adopting the fair value option, goodwill will be recognized relating to the business rather than just the parent's share of the business, hence having a significant impact on the balance sheet. This is therefore likely to result in goodwill being a higher percentage of the value of the business acquired. **The fair value attributable to NCI may be derived from the value determined for the rest of the transaction, but care will be needed to ensure that it does not reflect a control premium.** This means that other valuation models may be needed.

Lynda Tomkins

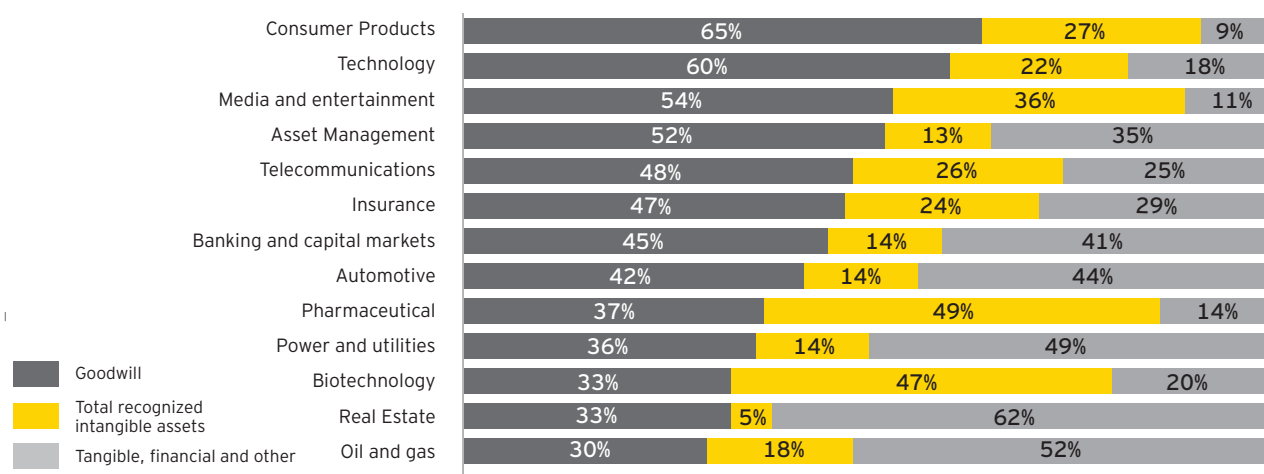
Ernst & Young Global IFRS Services

Future changes in accounting will have a significant impact on how deals are negotiated and structured, and will likely require more involvement of independent experts to determine appropriate values.

What are the trends in your industry?

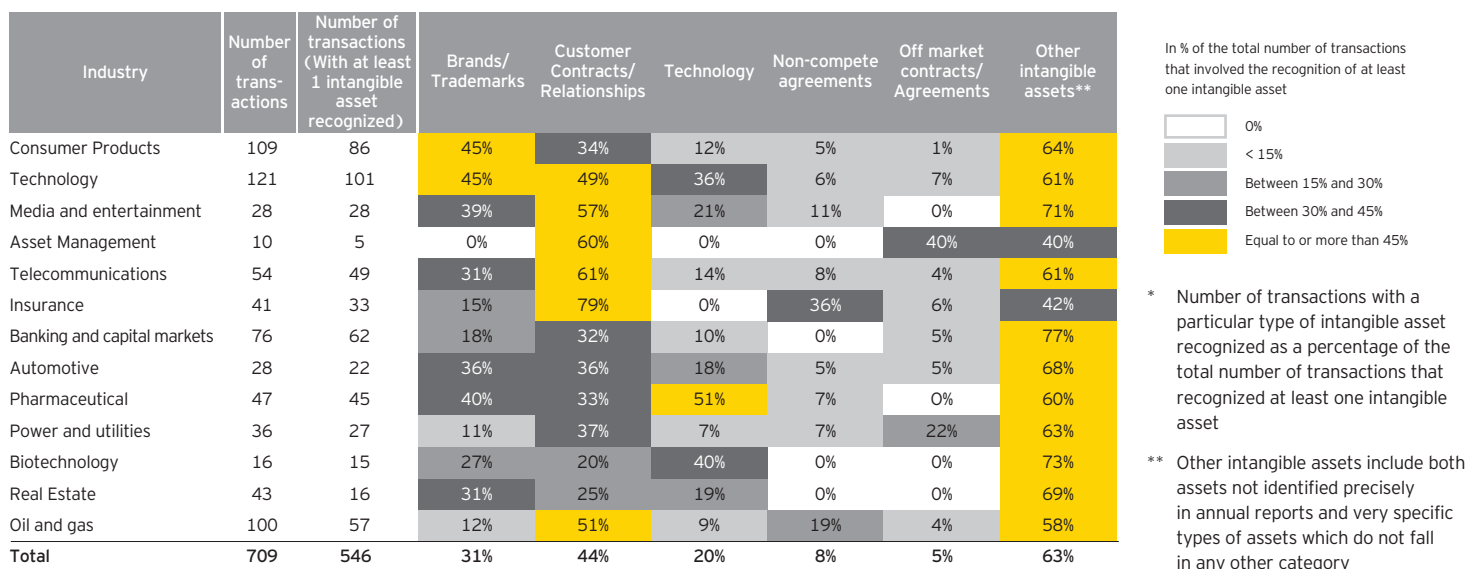
As shown in the graph below, the allocation of the enterprise value between tangible assets, intangible assets and goodwill varied greatly depending on the industry of the company acquired.

Allocation of the enterprise value (%)
(Figures may not add up to 100% due to rounding)



Industries that recognized the highest levels of intangible assets in our survey were the pharmaceuticals and biotechnology industries, since the majority of the value in their activities rely on patents or technology-related intangible assets. Companies in capital-intensive industries and in the financial sector showed a higher weight of tangible assets compared with intangible assets.

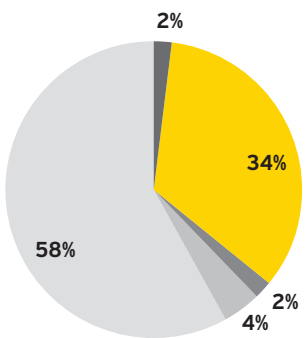
Frequency of intangible assets recognized by industry*



Focus on specific industries

Banking and capital markets

Fair value of recognized intangible assets



- Brands/trademarks
- Customer contracts/relationships
- Technology
- Off Market contracts/agreements
- Other intangible assets

Financial Services

Within the banking and capital markets industry, there is a broad spectrum of subindustries including retail banks, institutional banks, equity traders, trading exchanges and consumer credit, with each subindustry demonstrating a different split of intangibles.

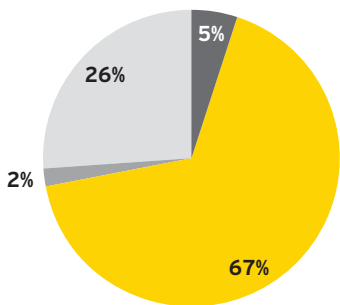
Core deposit intangibles (CDIs) are unique to the retail banking sector. Acquired core deposit accounts typically provide a low-cost source of funds to the buyer. To replace these established, low-cost deposit accounts in a timely manner, the buyer's alternative is to utilize higher-cost funds at current market rates. CDIs represent the majority of the value of identified intangible assets in the retail banking transactions identified. As presented in the opposite graph, our survey revealed that acquirers have not always identified CDIs separately and classified them as either a customer-related intangible asset (34% of identified intangible value) or as other intangible asset (58% of identified intangible value).

While financial services brands are often relatively well known in the marketplace, they represented only 2% of the total value of intangible assets identified, despite being identified in 18% of the 62 transactions in which at least one intangible asset was recognized. In terms of retail banking, low brand value reflects the commoditized nature of the products and price sensitivity of consumers.

In the insurance industry, customer contracts and relationships are the key assets. They represented 67% of the total intangible assets fair value in our survey.

Insurance

Fair value of recognized intangible assets

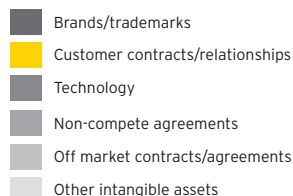
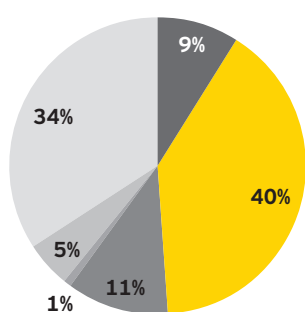


- Brands/trademarks
- Customer contracts/relationships
- Non-compete agreements
- Other intangible assets

Customer-related assets are key in the financial services industry

Focus on specific industries

Fair value of recognized intangible assets



Telecommunications

In the telecommunications industry, customer contracts/relationships and brands/trademarks were the most commonly identified intangible assets (in 30 and 15, respectively, out of 54 cases). Other intangible assets included licenses, interconnect agreements and partner agreements with suppliers. Goodwill proportions varied significantly between the transactions from 0% to 146%* of enterprise value (with an average of 48%).

Plant and equipment, such as fixed and mobile networks, were often adjusted to their fair values (in 37 out of 54 cases).

* In rare circumstances, liabilities exceed assets, resulting in goodwill representing more than 100%.

General survey observations

Customer-related assets are the most often recognized intangible assets

Customer-related intangible assets are the most frequently recognized intangible assets, even before brands and trademarks. They were recognized in 44% of the transactions. The two industries where they were most often valued are insurance and telecommunications.

Companies had the following types of customer-related intangible assets:

- ▶ Customer contracts
- ▶ Customer relationships
- ▶ Customer base
- ▶ Subscriber, advertiser, lead generation, sponsor and distribution relationships
- ▶ Backlog

Names specific to certain industries were also used:

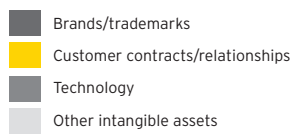
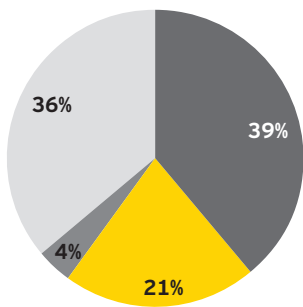
- ▶ "Portfolio of insurance contracts" or "future margins" for banking and insurance contracts
- ▶ CDIs for banking
- ▶ "Management contracts" in real estate
- ▶ "Loyalty card customer relationships", in consumer products

Customer-related assets were amortized over a remaining useful life of up to 30 years, with an average of around 10 years.



Consumer products

Fair value of recognized intangible assets



As would be expected, the consumer products industry had the highest proportion of value allocated to brands of all industry groups (39% of identified intangible assets fair value as shown in chart on the left).

In this sector, transactions tend to have lower-than-average net tangible assets, which leads to higher-than-average goodwill (65% of the enterprise value in our survey). Within the consumer products industry, companies involved in the telecommunications, media and leisure markets had very large allocations to goodwill, and many customer contracts, with virtually no allocation to brands and technology.

For consumer products as a whole, a very small amount of the price paid was allocated to technology (4% of identified intangible value). Technology intangibles arose primarily from the industrial products and healthcare subgroups.

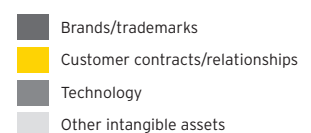
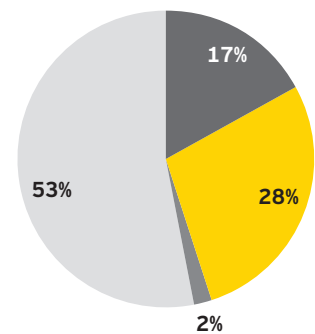
Media and entertainment

Media and entertainment transactions typically have lower net tangible assets than in the other industry groups, which leads to higher-than-average allocations to goodwill (54% of enterprise value in our survey).

The most significant intangible assets within the sector were customer relationships and brands. Both were recognized in nearly half of all transactions.

Within the media and entertainment sector, publishing companies typically had higher-than-average allocations to brands and customer relationships. In certain subgroups, there were specific high allocations to "other intangible assets" which included catalogs for the music industry or domain names for online gaming companies.

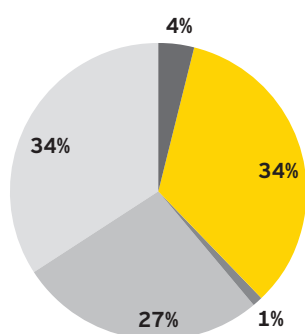
Fair value of recognized intangible assets



Focus on specific industries

Power and utilities

Fair value of recognized intangible assets



- Brands/trademarks
- Customer contracts/relationships
- Technology
- Off market contracts/agreements
- Other intangible assets

Integrated utilities are globally transforming into a value chain of discrete businesses:

Production → Trade → Transmission → Distribution → Metering → Sales

Utilities are often infrastructure businesses, which require large multi-year asset investments. This leads to a high percentage of net tangible assets (49% of enterprise value on average in our survey), especially within the businesses of power generation, transmission and distribution.

In many transactions, the determination of purchase price is influenced by strategic considerations like “participation in the liberalization of markets”, “access to new markets”, “access to raw materials” and “demonstration of environmental responsibility” which frequently cannot be captured in an identified intangible asset and leads to the recognition of goodwill in a PPA.

Business in the power and utilities industry is frequently dependent on long-term procurement and sales contracts to hedge against price volatility. As a consequence, favorable or onerous contracts were often valued in the PPAs (in 22% of the utilities transactions).

Whereas in the sales business, customer relationships are of high importance (34% of identified intangible value on average), transmission and distribution businesses often involve a “natural monopoly” element. In a true monopoly, the utility company obtains its customers by virtue of its franchise, and not by building customer relationships; this results in a higher goodwill value.

Alternative energy generation (e.g., renewable) or metering are associated with technology intangibles (patents, in-progress research and development, among others) that provide competitive advantages.

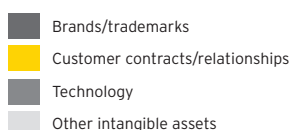
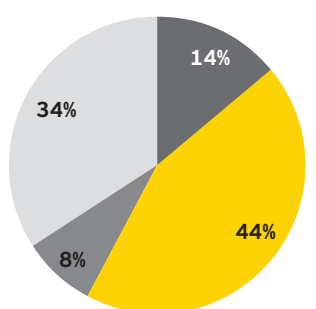
In the business-to-consumer sales business, trade names and trademarks provide value for utility companies.

Alternative energy generation is often restricted by environmental regulations. Thus, contingent liabilities can play a significant role in a PPA.



Automotive

Fair value of recognized intangible assets



The collected data contained PPA information for 28 transactions in the automotive industry. The business activities of the acquired companies range from the production and sale of industrial products to automotive manufacturers and transportation and logistic services.

On average, 44% of the value was captured within net tangible assets, and the remaining portion was split between intangible assets and goodwill.

The information regarding the split of intangible asset value was limited. For this reason, “other intangible assets” in the chart on the left include customer-related, marketing-related and technology-based intangible assets.

Customer relationships disclosed separately accounted for 44% of the total identified intangible value on average. Allocation of purchase price to technology was relatively small within this sector, with a total identified intangible value of only 8% on average. However, actual allocations to customers and technology were probably higher as some value was captured within “other intangible assets”.

The results of the study show that the allocation of the purchase price in business combinations varies widely within the automotive industry. This depends on the business activities and focus of the target, the strengths and weaknesses of the target company compared to its competitors and the opportunities and challenges in the market the target is serving. Therefore, one cannot expect a constant percentage of the target’s entity value to be allocated to goodwill, intangible assets or net tangible assets.

For instance, the branding/trademarks are a driving intangible asset for car manufacturers and are expected to receive a material amount of value. Also, innovations and investments in new technologies are critical. Customer demand for the latest technology in safety equipment, entertainment systems, and communications devices. Therefore, one would expect a significant value in research and development projects and other technology-based intangible assets. High step-ups on technology-based intangible assets can occur even though automotive manufacturers capitalize research and development expenses heavily. While the capitalization of research and development expenses are based on actual costs in the purchase price allocation such projects are typically valued by an income approach valuing future potential rather than the actual incurred costs.

General survey observations Specific “other intangible assets”

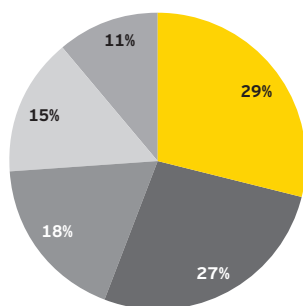
In this analysis, “other intangible assets” include intangible assets not disclosed separately, but also specific intangible assets recognized by companies during their PPAs. Such assets include:

- ▶ For the oil and gas industry: exploitation and exploration licenses and mineral rights
- ▶ For pharmaceutical and biotechnology companies: product rights and in-process research and development
- ▶ For industrial activities: supply contracts and distribution networks
- ▶ For consumer products: exclusivity rights or recipes
- ▶ For telecommunications and media and entertainment activities: intellectual property rights, musical rights and catalogs, artists’ contracts, publication rights, investment in films and TV shows, domain name and internet presence, mastheads and publication rights
- ▶ For technological activities: capitalized expenditure for development work and merchant and partner contracts

Other industries

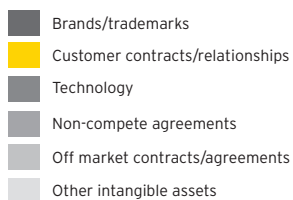
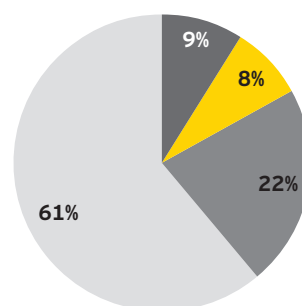
Pharmaceutical

Fair value of recognized intangible assets



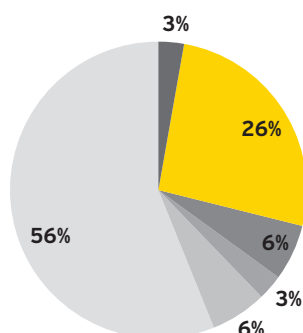
Biotechnology

Fair value of recognized intangible assets



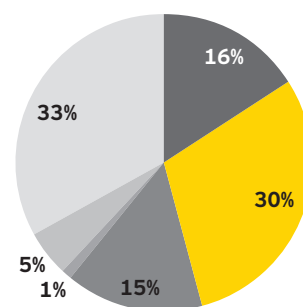
Oil and gas

Fair value of recognized intangible assets



Technology

Fair value of recognized intangible assets



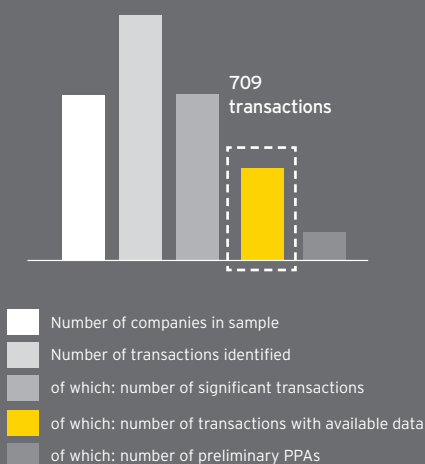
Methodology

This survey is based on information disclosed in 2007 annual reports and other public sources, such as OneSource or Mergermarket. The Ernst & Young Transaction Advisory Services teams that worked on this study did not have access to any confidential information.

Results are presented as percentages of enterprise value (calculated as the sum of net financial debt and the acquisition price). When the net financial debt was not available, it was assumed to be zero, potentially leading to an overestimation of the total share of goodwill and identifiable intangible assets in the enterprise value.

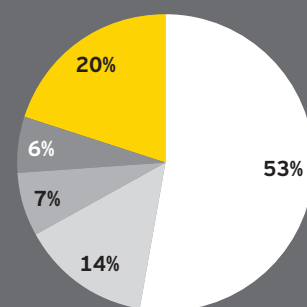
Scope

Scope of the study

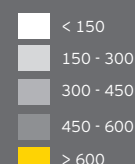


- ▶ This survey presents the analysis of PPAs disclosed in annual reports of a number of major companies based in 21 countries: South America (3 transactions), Australia (36), Belgium (4), Brazil (4), Canada (26), Colombia (5), Czech Republic (6), Denmark (31), France (106), Germany (21), Greece (20), Hungary (5), Italy (17), Malta (1), Romania (2), Serbia (1), Singapore (19), Spain (4), Sweden (74), the United Kingdom (77) and the United States (247).
- ▶ Companies in 18 countries disclosed their financial information in IFRS GAAP, 2 countries disclosed it in US GAAP (United States and Colombia) and Canada used Canadian GAAP.
- ▶ Our sample excludes:
 - Very small transactions
 - Acquisitions for which no PPA information is available
- ▶ In most cases, acquirers disclosed PPAs related to the acquisition of one identified target. In 15% of cases, this disclosure was grouped for multiple transactions (from 2 to 67).
- ▶ More than half of our sample consists of transactions with an enterprise value smaller than €150m.

Split of the 709 transactions by size



Enterprise value (€m)



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