A perfect set of conditions is aligning to potentially further raise merger and acquisition activity levels in 2017. Public company valuations are at an all-time high, as evidenced by the Dow Jones industrial average surpassing the 20,000 barrier. Strategic and private equity investors have ample cash ready to invest. Interest rates remain at near-historic lows. Favorable changes to tax policies are anticipated, which could further unlock cash available to fund deals. Buyers are under increased pressure to drive growth. But even in light of these positive factors, acquirers face an increasingly competitive, regulated and highly scrutinized business environment.

As a result, independent, third-party valuation partners continue to take on an even larger role in acquisitions, beginning with the pre-acquisition stage where a preliminary valuation can help determine if the deal will be accretive or dilutive to earnings/earnings per share (EPS) based on values, as well as lives of acquired intangible assets and the resulting amortization. These valuation partners remain involved throughout the process as companies organize their operations from management, tax and legal perspectives through the post-deal stage, such as impairment testing. Valuations need to meet the requirements of all stakeholders — corporate development, financial reporting and tax. The overarching goal is to work with a valuation partner who gets to the right values that will not only stand up to current and future scrutiny, but also effectively represent the acquisition rationale and motivation for why the acquirer paid what they did for the company — and that goes far beyond modeling.

VRC discussed M&A-focused valuation challenges with CFOs, controllers, tax directors and corporate development professionals of publicly traded companies. This whitepaper shares the knowledge gained from these discussions, identifies the valuation issues and offers solutions to balance the needs of deal stakeholders.

IDENTIFYING AND UNDERSTANDING DEAL STAKEHOLDERS

STAKEHOLDER. ORIGINALLY DEFINED AS “THOSE GROUPS WITHOUT WHOSE SUPPORT THE ORGANIZATION WOULD CEASE TO EXIST.”

The ultimate determination of success is based on the value created by the M&A transaction. However, within the acquiring company there are many stakeholders who play a critical role in determining the success of the acquisition; often stakeholders in corporate development, the controller’s group and tax have diverging interests. Following is an overview of the role each stakeholder plays.

CORPORATE DEVELOPMENT OFFICER

The corporate development officer (CDO) often implements the company’s M&A strategy and is expected to develop strategic initiatives that will drive growth and transform the organization. The CDO must align the M&A strategy with corporate strategy, and is tasked and incentivized to lead the deal process in a way that is accretive to company EPS and shareholder value. They must articulate a vision for a transaction, whether it is the potential for developing new products or gaining access to expanded markets or customers. The CDO takes initial ownership of the deal, including the strategic rationale and deal model.

Optically, the first few years of a deal are highly critical as the internal assessment of it will occur immediately post-transaction as the company starts to integrate the acquired target, restructure and realize synergies. During this time, the cushion for goodwill impairment testing (the difference between the fair value and carrying value) is extremely small. Post-close, the CDO and his or her boss want to know if the deal was successful. The answer, however, may not be known for several years, if at all. This presents a challenge for the CDO as he or she is measured by the ability to find and close deals that are in line with a company’s strategy and value accretive.

THE CDO’S VALUATION SOLUTION

CDOs understand the importance of considering how a transaction will impact overall company growth, and spend significant time on financial analysis and planning for the integration of an acquisition target. They are under high pressure, and must consider how multiple issues could impact and influence the deal’s success, including: overall growth outlook (industry growth, inflation), the impact of the stock market, election results, financial reporting and tax issues, cost of capital and valuation. The CDO’s analysis shouldn’t stop there; the issuance of the Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 805 (ASC 805) for business combinations and Topics 350 and 360 (ASC 350 and ASC 360) for impairment testing, evolving tax rules and the continuing interpretation of these rules have made it critical for a CDO to consider how a transaction will impact its financial and tax reporting. In structuring the deal, CDOs may benefit from considering the accounting or tax treatment of earnouts (compensation or consideration), deferred revenue haircuts, IPR&D and minority interests, as well as the values and resulting depreciation and amortization from acquired tangible and intangible assets. Additionally, understanding the valuation treatment early in the deal process can help avoid unpleasant surprises on the back end.

For this reason, VRC’s valuation experts often become key partners to the CDO in the early stages of a deal. Most companies do one or two deals per year, making it difficult for them to remain current with best practices. VRC works on more than 400 deals a year with public and private equity-backed companies. This enables VRC experts to share thoughts on best practices, current pressure points in financial reporting and tax, whether pre- or post-deal.
CORPORATE CONTROLLER’S GROUP

The role of the corporate controller’s group continues to grow and evolve into a critical position within the deal team. They have become more involved with advising and collaborating on future decisions related to running, funding and growing the business.

The controller’s group now often handles additional strategic accounting work that is core to the business and had been previously handled by the CFO. The evolution of the controller’s role has involved them more closely than ever with deal teams.

The controller must account for acquisitions quickly to then focus on integrating the acquired company. As the baton passes from the corporate development team to the financial reporting team, the focus often shifts from an optimistic, incremental and often strategic view of the deal to a more conservative view. This reflects the need to account for the transaction, both today and in the future, with ongoing scrutiny from auditors and other external parties. Subsequent to the deal-related accounting, the team must also concentrate on testing the acquisition for goodwill impairment. Testing for goodwill impairment is often not required in year one, but doing so is a best practice. No one expects a goodwill impairment immediately after acquisition, absent a major financial crisis or other unique situation; as such, it offers the company an opportunity to recalibrate inputs for the change in perspective, and set baseline expectations for future years.

THE CORPORATE CONTROLLER’S VALUATION SOLUTION

Traditionally, the controller’s group spent time accounting for various company transactions and understanding internal and external risks. They also manage through pressure from continuously evolving reporting standards (FASB, IASB), their internal audit team and multiple regulatory bodies (SEC, PCAOB).

Partnering with a valuation firm before a deal is closed will help the controller’s group get ahead of any unanticipated surprises and shorten the post-close window, which will allow more focus on strategic issues. One such strategic issue is preparing for the impact of the new accounting rules on revenue recognition taking effect in 2018 for all public companies. For most, the transition has already started. The new standard marks a significant change, and is expected to allow companies to recognize revenue earlier, potentially reducing the number of situations in which deferred revenue will be adjusted in an M&A transaction. The valuation of deferred revenues, and the implied haircut, can have an unexpected impact on a company’s post-transaction financial statement.

In many ways, the controller’s group is concerned with the same issues as the CDOs: the accounting or tax treatment of earnouts (compensation or consideration), deferred revenue haircuts, IPR&D and minority interests, as well as the values and resulting depreciation and amortization from acquired tangible and intangible assets. The implications, however, are slightly different. The controller’s group must account for the transaction in a timely manner and meet deadlines for earnings calls 10-K, 10-Q, 8-K and other SEC filings so the transaction stands up to multiple levels of scrutiny – internally from upper management and externally from auditors (i.e. no audit deficiencies), the SEC, the PCAOB and other interested parties. For this reason, VRC’s valuation experts often become key partners to the controller’s group to help them stay on top of current rules, regulations and best practices.
CORPORATE TAX ACCOUNTING PROFESSIONALS

In today’s changing tax landscape, corporate tax professionals are tasked with establishing tax-efficient corporate structures that meet business goals while protecting and maintaining flexibility in cash and other corporate assets. In contrast to the corporate tax professionals, there is a worldwide, federal and state and local focus by the government and various taxing jurisdictions on creating rules and legislation in an attempt to find new and innovative ways to raise tax revenues. Tax groups are significantly expanding their role in how a deal is structured, such as which legal entity will acquire the target or its components. In particular, global companies need to pay extra attention to transfer pricing rules, increased disclosure requirements and regulations. For example, newly issued rules under Internal Revenue Code Section 385 (IRC §385) may impact how deals are structured and how to finance global transactions and foreign subsidiaries and/or foreign acquisition targets. This leads to many important questions. Where is the money to do a deal going to come from? How will the deal be structured and financed? Are there any unique attributes to consider, such as an IP Holdco, contract manufacturer or toll manufacturer model?

THE CORPORATE TAX ACCOUNTING PROFESSIONAL’S VALUATION SOLUTION

Traditionally, the tax group spent time accounting for and structuring various company transactions as well as understanding the various internal and external risks — all from a tax perspective. They also navigated the evolving global tax rules that impact the company’s various transactions.

Partnering with a valuation firm prior to deal close will help the tax group better understand the value implications of various transactions, whether internal or external, and get ahead of any unanticipated surprises, while at the same time minimizing risk and ultimately tax exposure. This may relate to the movement of entities or assets within the company’s organizational chart, the preparation for the impact of the new global tax rules around base erosion and profit shifting (BEPS), compliance with new rules made to stop inversions (IRC §385) and many other types or regular day-to-day transactions in which companies are involved. Given this scrutiny, looking at entity values from an operating perspective and bridging to tax and/or book perspectives provides a supportable and transparent valuation analysis. VRC’s valuation experts should be viewed as a key partner to the tax group as they contemplate various transactions and also help them stay on top of current rules, regulations and best practices.
SURVIVING SCRUTINY: THE AUDIT AND REGULATORY ENVIRONMENT

In this high-scrutiny environment, whether related to deals, impairment testing or tax, there is a significantly increased focus placed on inputs in a valuation. Auditors are questioning management forecasts and parsing the model line-by-line. This scrutiny extends to valuations in the form of discount rates, long-term growth rates, attrition rates and royalty rates. Auditor expectations and inquiry have greatly increased with scrutiny on the audit firms from the PCAOB. Auditors want to understand the rationale for value conclusions, as well as see the inputs with support and thought given to the future impact operationally and to future accounting needs, including testing for impairment. In the end, all parties want to avoid financial restatements and will push to ensure values are reasonably stated with strong support for the inputs used to derive them.

Like the auditors, the SEC and IRS look closely at a company’s accounting for transactions, and may also include controls and processes.

The IRS seeks detailed documentation about all transactions having a potential tax impact in addition to financial statement auditor scrutiny. When an organization is acquiring a company with international operations, it should look carefully at the transfer pricing policy. The OECD BEPS rules adopted in 2015 now ramp up reporting and information-sharing across countries in master files with country-by-country reporting. The transfer pricing rules highlight where firms are making money and paying taxes. In the past, companies transferred or shifted revenues, but did not necessarily pay taxes where it was earned.

BALANCING THE FLOW OF INFORMATION

What are the keys to a successful M&A deal? Structure and communication. It is imperative that each stakeholder group understands the impact of the business combination on the company’s earnings at all stages of the deal. Companies that are mindful in meeting the differing perspectives and needs of the diverse deal stakeholders may find they can better transition valuations from the pre- to post-deal stage. Leveraging valuation as part of the deal conversation, the struggle for priority between corporate finance and tax can become a balanced approach.

THE BOTTOM LINE? The best practice for navigating the needs of the corporate developer, controller and tax director and managing related audit and regulatory scrutiny is to get the deal values correct quickly, using the right methods and processes that will stand the test of time. A valuation partner who understands the functional role and responsibilities of each of these stakeholders who can also work effectively with the diverging perspectives of valuation can bridge a solution that ultimately meets the objectives of an acquisition.

For a more in-depth conversation about business combination valuations, the continuing evolution of complex reporting requirements for financial and tax professionals, contact a VRC professional today.
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